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Title 26—Internal Revenue

(This book contains part 1, §§ 1.501 to 1.640)

Part

CHAPTER I—Internal Revenue Service, Department of the Treasury (Continued) 1

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

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

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

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

SUBCHAPTER A—INCOME TAX (CONTINUED)

PART 1—INCOME TAXES (CONTINUED)

NORMAL TAXES AND SURTAXES (CONTINUED)

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EXEMPT ORGANIZATIONS

General Rule

§ 1.501(a)–1 Exemption from taxation.

(a) *In general; proof of exemption.* (1) Section 501(a) provides an exemption from income taxes for organizations which are described in section 501 (c) or (d) and section 401(a), unless such organization is a *feeder organization* (see section 502), or unless it engages in a transaction described in section 503. However, the exemption does not extend to *unrelated business taxable income* of such an organization (see part III (Section 511 and following), subchapter F, chapter 1 of the Code).

(2) [Reserved] For further guidance, see § 1.501(a)–1T(a)(2).

(3) An organization claiming exemption under section 501(a) and described in any paragraph of section 501(c) (other than section 501(c)(1) shall file the form of application prescribed by the Commissioner and shall include thereon such information as required

by such form and the instructions issued with respect thereto. For rules relating to the obtaining of a determination of exempt status by an employees' trust described in section 401(a), see the regulations under section 401.

(b) *Additional proof by particular classes of organizations.* (1) [Reserved] For further guidance, see § 1.501(a)–1T(b)(1).

(2) In addition to the information specifically called for by this section, the Commissioner may require any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 501(a), and when deemed advisable in the interest of an efficient administration of the internal revenue laws, he may in the cases of particular types of organizations prescribe the form in which the proof of exemption shall be furnished.

(3) [Reserved] For further guidance, see § 1.501(a)–1T(b)(3).

(c) *Private shareholder or individual defined.* The words *private shareholder or individual* in section 501 refer to persons having a personal and private interest in the activities of the organization.

(d) *Requirement of annual returns.* For the annual return requirements of organizations exempt under section 501(a), see section 6033 and § 1.6033–1.

(e) *Certain Puerto Rican pension, etc., trusts.* Effective for taxable years beginning after December 31, 1973, section 1022(i)(1) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 942) provides that trusts under certain Puerto Rican pension, etc., plans (as defined under P.R. Laws Ann. tit. 13, section 3165, and the articles thereunder), all of the participants of which are residents of the Commonwealth of Puerto Rico, are to be treated only for purposes of section 501(a) as trusts described in section 401(a). The practical effect of section 1022(i)(1) is to exempt these trusts from U.S. income tax on income from their U.S. investments. For purposes of section 1022(i)(1), the term *residents of the Commonwealth of Puerto Rico* means bona fide residents of Puerto Rico, and persons who perform labor or services primarily within the Commonwealth of Puerto Rico, regardless of residence for other purposes, and the term *participants* is restricted to current employees who are not excluded under the eligibility provisions of the plan.

(f) [Reserved] For further guidance, see § 1.501(a)–1T(f).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7428, 41 FR 34619, Aug. 16, 1976; T.D. 7859, 47 FR 54298, Dec. 2, 1982; T.D. 9674, 79 FR 37631, July 2, 2014]

§ 1.501(a)–1T Exemption from taxation (temporary).

(a)(1) [Reserved] For further guidance see § 1.501(a)–1(a)(1).

(2) An organization, other than an employees' trust described in section 401(a), is not exempt from tax merely because it is not organized and operated for profit. In order to establish its exemption, it is necessary that every such organization claiming exemption file an application form as set forth below with the appropriate office as designated by the Commissioner in guidance published in the Internal Revenue Bulletin, forms or instructions to the applicable forms. Subject only to the Commissioner's inherent power to revoke rulings, including with retroactive effect as permitted under section 7805(b), because of a change in the law or regulations or for other good cause, an organization that has been determined by the Commissioner (or previously by a district director) to be exempt under section 501(a) or the corresponding provision of prior law may rely upon such determination so long as there are no substantial changes in the organization's character, purposes, or methods of operation. An organization that has been determined to be exempt under the provisions of the Internal Revenue Code of 1939 or prior law is not required to secure a new determination of exemption merely because of the enactment of the Internal Revenue Code of 1954 unless affected by substantive changes in law made by such Code.

(3) [Reserved] For further guidance, see § 1.501(a)–1(a)(3).

(b) *Additional proof by particular classes of organizations.* (1) Unless otherwise prescribed by applicable regulations or other guidance published in the Internal Revenue Bulletin, organizations mentioned below shall submit with and

as a part of their applications the following information:

(i) Mutual insurance companies shall submit copies of the policies or certificates of membership issued by them.

(ii) In the case of title holding companies described in section 501(c)(2), if the organization for which title is held has not been specifically notified in writing by the Internal Revenue Service that it is held to be exempt under section 501(a), the title holding company shall submit the information indicated herein as necessary for a determination of the status of the organization for which title is held.

(iii) An organization described in section 501(c)(3) shall submit with, and as a part of, an application filed after July 26, 1959, a detailed statement of its proposed activities.

(2) [Reserved] For further guidance, see § 1.501(a)–1(b)(2).

(3) An organization claiming to be specifically exempted by section 6033(a) from filing annual returns shall submit with and as a part of its application (or in such other manner as is prescribed in guidance published in the Internal Revenue Bulletin) a statement of all the facts on which it bases its claim.

(c) through (e) [Reserved] For further guidance, see § 1.501(a)–1(c) through (e).

(f) *Effective/applicability date.* (1) Paragraphs (a)(2), (b)(1), and (b)(3) of this section apply on and after July 1, 2014.

(2) *Expiration date.* Paragraphs (a)(2), (b)(1), and (b)(3) of this section expire on or before June 30, 2017.

[T.D. 9674, 79 FR 37631, July 2, 2014; 79 FR 41886, July 18, 2014]

§ 1.501(c)(2)–1 Corporations organized to hold title to property for exempt organizations.

(a) A corporation described in section 501(c)(2) and otherwise exempt from tax under section 501(a) is taxable upon its unrelated business taxable income. For taxable years beginning before January 1, 1970, see § 1.511–2(c)(4). Since a corporation described in section 501(c)(2) cannot be exempt under section 501(a) if it engages in any business other than that of holding title to property and collecting income therefrom, it cannot have unrelated business taxable income as defined in section 512 other than income which is treated as unrelated business taxable income solely because of the applicability of section 512(a)(3)(C); or debt financed income which is treated as unrelated business taxable income solely because of section 514; or certain interest, annuities, royalties, or rents which are treated as unrelated business taxable income solely because of section 512(b)(3)(B)(ii) or (13). Similarly, exempt status under section 501(c)(2) shall not be affected where certain rents from personal property leased with real property are treated as unrelated business taxable income under section 512(b)(3)(A)(ii) solely because such rents attributable to such personal property are more than incidental when compared to the total rents received or accrued under the lease, or under section 512(b)(3)(B)(i) solely because such rents attributable to such personal property exceed 50 percent of the total rents received or accrued under the lease.

(b) A corporation described in section 501(c)(2) cannot accumulate income and retain its exemption, but it must turn over the entire amount of such income, less expenses, to an organization which is itself exempt from tax under section 501(a).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7658, 45 FR 33972, May 21, 1980]

§ 1.501(c)(3)–1 Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

(a) *Organizational and operational tests.* (1) In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

(2) The term *exempt purpose or purposes*, as used in this section, means any purpose or purposes specified in section 501(c)(3), as defined and elaborated in paragraph (d) of this section.

(b) *Organizational test*—(1) *In general.* (i) An organization is organized exclusively for one or more exempt purposes

only if its articles of organization (referred to in this section as its *articles*) as defined in subparagraph (2) of this paragraph:

(A) Limit the purposes of such organization to one or more exempt purposes; and

(B) Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

(ii) In meeting the organizational test, the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes stated in section 501(c)(3). Therefore, an organization which, by the terms of its articles, is formed *for literary and scientific purposes within the meaning of section 501(c)(3) of the Code* shall, if it otherwise meets the requirements in this paragraph, be considered to have met the organizational test. Similarly, articles stating that the organization is created solely *to receive contributions and pay them over to organizations which are described in section 501(c)(3) and exempt from taxation under section 501(a)*) are sufficient for purposes of the organizational test. Moreover, it is sufficient if the articles set for the purpose of the organization to be the operation of a school for adult education and describe in detail the manner of the operation of such school. In addition, if the articles state that the organization is formed for *charitable purposes,* such articles ordinarily shall be sufficient for purposes of the organizational test (see subparagraph (5) of this paragraph for rules relating to construction of terms).

(iii) An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it to carry on, otherwise than as an insubstantial part of its activities, activities which are not in furtherance of one or more exempt purposes, even though such organization is, by the terms of such articles, created for a purpose that is no broader than the purposes specified in section 501(c)(3). Thus, an organization that is empowered by its articles *to engage in a manufacturing business,* or *to engage in the operation of a social club* does not meet the organizational test regardless of the fact that its articles may state that such organization is created *for charitable purposes within the meaning of section 501(c)(3) of the Code.*

(iv) In no case shall an organization be considered to be organized exclusively for one or more exempt purposes, if, by the terms of its articles, the purposes for which such organization is created are broader than the purposes specified in section 501(c)(3). The fact that the actual operations of such an organization have been exclusively in furtherance of one or more exempt purposes shall not be sufficient to permit the organization to meet the organizational test. Similarly, such an organization will not meet the organizational test as a result of statements or other evidence that the members thereof intend to operate only in furtherance of one or more exempt purposes.

(v) [Reserved] For further guidance see § 1.501(c)(3)–1T(b)(1)(v).

(2) *Articles of organization.* For purposes of this section, the term *articles of organization* or *articles* includes the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created.

(3) *Authorization of legislative or political activities.* An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it:

(i) To devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise; or

(ii) Directly or indirectly to participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office; or

(iii) To have objectives and to engage in activities which characterize it as an *action* organization as defined in paragraph (c)(3) of this section.

The terms used in subdivisions (i), (ii), and (iii) of this subparagraph shall have the meanings provided in paragraph (c)(3) of this section. An organization's articles will not violate the provisions of paragraph (b)(3)(i) of this section even though the organization's

articles expressly empower it to make the election provided for in section 501(h) with respect to influencing legislation and, only if it so elects, to make lobbying or grass roots expenditures that do not normally exceed the ceiling amounts prescribed by section 501(h)(2)(B) and (D).

(4) *Distribution of assets on dissolution.* An organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization's assets will be considered dedicated to an exempt purpose, for example, if, upon dissolution, such assets would, by reason of a provision in the organization's articles or by operation of law, be distributed for one or more exempt purposes, or to the Federal Government, or to a State or local government, for a public purpose, or would be distributed by a court to another organization to be used in such manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized. However, an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.

(5) *Construction of terms.* The law of the State in which an organization is created shall be controlling in construing the terms of its articles. However, any organization which contends that such terms have under State law a different meaning from their generally accepted meaning must establish such special meaning by clear and convincing reference to relevant court decisions, opinions of the State attorney-general, or other evidence of applicable State law.

(6) [Reserved] For further guidance see § 1.501(c)(3)–1T(b)(6).

(c) *Operational test*—(1) *Primary activities.* An organization will be regarded as *operated exclusively* for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

(2) *Distribution of earnings.* An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. For the definition of the words *private shareholder or individual,* see paragraph (c) of § 1.501(a)–1.

(3) *Action organizations.* (i) An organization is not operated exclusively for one or more exempt purposes if it is an *action* organization as defined in subdivisions (ii), (iii), or (iv) of this subparagraph.

(ii) An organization is an *action* organization if a substantial part of its activities is attempting to influence legislation by propaganda or otherwise. For this purpose, an organization will be regarded as attempting to influence legislation if the organization:

(*a*) Contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or

(*b*) Advocates the adoption or rejection of legislation.

The term *legislation,* as used in this subdivision, includes action by the Congress, by any State legislature, by any local council or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure. An organization will not fail to meet the operational test merely because it advocates, as an insubstantial part of its activities, the adoption or rejection of legislation. An organization for which the expenditure test election of section 501(h) is in effect for a taxable year will not be considered an *action* organization by reason of this paragraph (c)(3)(ii) for that year if it is not denied exemption from taxation under section 501(a) by reason of section 501(h).

(iii) An organization is an *action* organization if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office.

The term *candidate for public office* means an individual who offers himself, or is proposed by others, as a contestant for an elective public office, whether such office be national, State, or local. Activities which constitute

participation or intervention in a political campaign on behalf of or in opposition to a candidate include, but are not limited to, the publication or distribution of written or printed statements or the making of oral statements on behalf of or in opposition to such a candidate.

(iv) An organization is an *action* organization if it has the following two characteristics: (*a*) Its main or primary objective or objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation; and (*b*) it advocates, or campaigns for, the attainment of such main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public. In determining whether an organization has such characteristics, all the surrounding facts and circumstances, including the articles and all activities of the organization, are to be considered.

(v) An *action* organization, described in subdivisions (ii) or (iv) of this subparagraph, though it cannot qualify under section 501(c)(3), may nevertheless qualify as a social welfare organization under section 501(c)(4) if it meets the requirements set out in paragraph (a) of §1.501(c)(4)–1.

(d) *Exempt purposes*—(1) *In general.* (i) An organization may be exempt as an organization described in section 501(c)(3) if it is organized and operated exclusively for one or more of the following purposes:

(*a*) Religious,

(*b*) Charitable,

(*c*) Scientific,

(*d*) Testing for public safety,

(*e*) Literary,

(*f*) Educational, or

(*g*) Prevention of cruelty to children or animals.

(ii) An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

(iii) *Examples.* The following examples illustrate the requirement of paragraph (d)(1)(ii) of this section that an organization serve a public rather than a private interest:

Example 1. (i) O is an educational organization the purpose of which is to study history and immigration. O's educational activities include sponsoring lectures and publishing a journal. The focus of O's historical studies is the genealogy of one family, tracing the descent of its present members. O actively solicits for membership only individuals who are members of that one family. O's research is directed toward publishing a history of that family that will document the pedigrees of family members. A major objective of O's research is to identify and locate living descendants of that family to enable those descendants to become acquainted with each other.

(ii) O's educational activities primarily serve the private interests of members of a single family rather than a public interest. Therefore, O is operated for the benefit of private interests in violation of the restriction on private benefit in paragraph (d)(1)(ii) of this section. Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

Example 2. (i) O is an art museum. O's principal activity is exhibiting art created by a group of unknown but promising local artists. O's activity, including organized tours of its art collection, promotes the arts. O is governed by a board of trustees unrelated to the artists whose work O exhibits. All of the art exhibited is offered for sale at prices set by the artist. Each artist whose work is exhibited has a consignment arrangement with O. Under this arrangement, when art is sold, the museum retains 10 percent of the selling price to cover the costs of operating the museum and gives the artist 90 percent.

(ii) The artists in this situation directly benefit from the exhibition and sale of their art. As a result, the principal activity of O serves the private interests of these artists. Because O gives 90 percent of the proceeds from its sole activity to the individual artists, the direct benefits to the artists are substantial and O's provision of these benefits to the artists is more than incidental to its other purposes and activities. This arrangement causes O to be operated for the benefit of private interests in violation of the restriction on private benefit in paragraph (d)(1)(ii) of this section. Based on these facts and circumstances, O is not operated

exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

Example 3. (i) O is an educational organization the purpose of which is to train individuals in a program developed by P, O's president. The program is of interest to academics and professionals, representatives of whom serve on an advisory panel to O. All of the rights to the program are owned by Company K, a for-profit corporation owned by P. Prior to the existence of O, the teaching of the program was conducted by Company K. O licenses, from Company K, the right to conduct seminars and lectures on the program and to use the name of the program as part of O's name, in exchange for specified royalty payments. Under the license agreement, Company K provides O with the services of trainers and with course materials on the program. O may develop and copyright new course materials on the program but all such materials must be assigned to Company K without consideration if and when the license agreement is terminated. Company K sets the tuition for the seminars and lectures on the program conducted by O. O has agreed not to become involved in any activity resembling the program or its implementation for 2 years after the termination of O's license agreement.

(ii) O's sole activity is conducting seminars and lectures on the program. This arrangement causes O to be operated for the benefit of P and Company K in violation of the restriction on private benefit in paragraph (d)(1)(ii) of this section, regardless of whether the royalty payments from O to Company K for the right to teach the program are reasonable. Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

(iv) Since each of the purposes specified in subdivision (i) of this subparagraph is an exempt purpose in itself, an organization may be exempt if it is organized and operated exclusively for any one or more of such purposes. If, in fact, an organization is organized and operated exclusively for an exempt purpose or purposes, exemption will be granted to such an organization regardless of the purpose or purposes specified in its application for exemption. For example, if an organization claims exemption on the ground that it is *educational*, exemption will not be denied if, in fact, it is *charitable*.

(2) *Charitable defined.* The term *charitable* is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of *charity* as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency. The fact that an organization which is organized and operated for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily prevent such organization from being exempt as an organization organized and operated exclusively for charitable purposes. The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under section 501(c)(3) so long as it is not an *action* organization of any one of the types described in paragraph (c)(3) of this section.

(3) *Educational defined*—(i) *In general.* The term *educational*, as used in section 501(c)(3), relates to:

(*a*) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(*b*) The instruction of the public on subjects useful to the individual and beneficial to the community.

An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.

(ii) *Examples of educational organizations*. The following are examples of organizations which, if they otherwise meet the requirements of this section, are educational:

Example 1. An organization, such as a primary or secondary school, a college, or a professional or trade school, which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.

Example 2. An organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs. Such programs may be on radio or television.

Example 3. An organization which presents a course of instruction by means of correspondence or through the utilization of television or radio.

Example 4. Museums, zoos, planetariums, symphony orchestras, and other similar organizations.

(4) *Testing for public safety defined*. The term *testing for public safety*, as used in section 501(c)(3), includes the testing of consumer products, such as electrical products, to determine whether they are safe for use by the general public.

(5) *Scientific defined*. (i) Since an organization may meet the requirements of section 501(c)(3) only if it serves a public rather than a private interest, a *scientific* organization must be organized and operated in the public interest (see subparagraph (1)(ii) of this paragraph). Therefore, the term *scientific*, as used in section 501(c)(3), includes the carrying on of scientific research in the public interest. Research when taken alone is a word with various meanings; it is not synonymous with *scientific*; and the nature of particular research depends upon the purpose which it serves. For research to be *scientific*, within the meaning of section 501(c)(3), it must be carried on in furtherance of a *scientific* purpose. The determination as to whether research is *scientific* does not depend on whether such research is classified as *fundamental* or *basic* as contrasted with *applied* or *practical*. On the other hand, for purposes of the exclusion from unrelated business taxable income provided by section 512(b)(9), it is necessary to determine whether the organization is operated primarily for purposes of carrying on *fundamental*, as contrasted with *applied*, research.

(ii) Scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, as, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc.

(iii) Scientific research will be regarded as carried on in the public interest:

(*a*) If the results of such research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis;

(*b*) If such research is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof; or

(*c*) If such research is directed toward benefiting the public. The following are examples of scientific research which will be considered as directed toward benefiting the public, and, therefore, which will be regarded as carried on in the public interest: (*1*) Scientific research carried on for the purpose of aiding in the scientific education of college or university students; (*2*) scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public; (*3*) scientific research carried on for the purpose of discovering a cure for a disease; or (*4*) scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area. Scientific research described in this subdivision will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research.

(iv) An organization will not be regarded as organized and operated for

the purpose of carrying on scientific research in the public interest and, consequently, will not qualify under section 501(c)(3) as a *scientific* organization, if:

(*a*) Such organization will perform research only for persons which are (directly or indirectly) its creators and which are not described in section 501(c)(3), or

(*b*) Such organization retains (directly or indirectly) the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and does not make such patents, copyrights, processes, or formulae available to the public. For purposes of this subdivision, a patent, copyright, process, or formula shall be considered as made available to the public if such patent, copyright, process, or formula is made available to the public on a nondiscriminatory basis. In addition, although one person is granted the exclusive right to the use of a patent, copyright, process, or formula, such patent, copyright, process, or formula shall be considered as made available to the public if the granting of such exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be utilized to benefit the public. In such a case, however, the research from which the patent, copyright, process, or formula resulted will be regarded as carried on in the public interest (within the meaning of subdivision (iii) of this subparagraph) only if it is carried on for a person described in subdivision (iii)(*b*) of this subparagraph or if it is scientific research described in subdivision (iii)(*c*) of this subparagraph.

(v) The fact that any organization (including a college, university, or hospital) carries on research which is not in furtherance of an exempt purpose described in section 501(c)(3) will not preclude such organization from meeting the requirements of section 501(c)(3) so long as the organization meets the organizational test and is not operated for the primary purpose of carrying on such research (see paragraph (e) of this section, relating to organizations carrying on a trade or business). See paragraph (a)(5) of §1.513–2, with respect to research which constitutes an unrelated trade or business, and section 512(b) (7), (8), and (9), with respect to income derived from research which is excludable from the tax on unrelated business income.

(vi) The regulations in this subparagraph are applicable with respect to taxable years beginning after December 31, 1960.

(e) *Organizations carrying on trade or business*—(1) *In general*. An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3) even though it has certain religious purposes, its property is held in common, and its profits do not inure to the benefit of individual members of the organization. See, however, section 501(d) and §1.501(d)–1, relating to religious and apostolic organizations.

(2) *Taxation of unrelated business income*. For provisions relating to the taxation of unrelated business income of certain organizations described in section 501(c)(3), see sections 511 to 515, inclusive, and the regulations thereunder.

(f) *Interaction with section 4958*—(1) *Application process*. An organization that applies for recognition of exemption under section 501(a) as an organization described in section 501(c)(3) must establish its eligibility under this section. The Commissioner may deny an application for exemption for failure to establish any of section 501(c)(3)'s requirements for exemption. Section 4958 does not apply to transactions with an organization that has failed to establish that it satisfies all

of the requirements for exemption under section 501(c)(3). See § 53.4958–2.

(2) *Substantive requirements for exemption still apply to applicable tax-exempt organizations described in section 501(c)(3)*—(i) *In general*. Regardless of whether a particular transaction is subject to excise taxes under section 4958, the substantive requirements for tax exemption under section 501(c)(3) still apply to an applicable tax-exempt organization (as defined in section 4958(e) and § 53.4958–2) described in section 501(c)(3) whose disqualified persons or organization managers are subject to excise taxes under section 4958. Accordingly, an organization will no longer meet the requirements for tax-exempt status under section 501(c)(3) if the organization fails to satisfy the requirements of paragraph (b), (c) or (d) of this section. See § 53.4958–8(a).

(ii) *Determination of whether revocation of tax-exempt status is appropriate when section 4958 excise taxes also apply*. In determining whether to continue to recognize the tax-exempt status of an applicable tax-exempt organization (as defined in section 4958(e) and § 53.4958–2) described in section 501(c)(3) that engages in one or more excess benefit transactions (as defined in section 4958(c) and § 53.4958–4) that violate the prohibition on inurement under section 501(c)(3), the Commissioner will consider all relevant facts and circumstances, including, but not limited to, the following—

(A) The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;

(B) The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;

(C) Whether the organization has been involved in multiple excess benefit transactions with one or more persons;

(D) Whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions; and

(E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6) and § 53.4958–7), or the organization has made good faith efforts to seek correction from the disqualified person(s) who benefited from the excess benefit transaction.

(iii) All factors will be considered in combination with each other. Depending on the particular situation, the Commissioner may assign greater or lesser weight to some factors than to others. The factors listed in paragraphs (f)(2)(ii)(D) and (E) of this section will weigh more heavily in favor of continuing to recognize exemption where the organization discovers the excess benefit transaction or transactions and takes action before the Commissioner discovers the excess benefit transaction or transactions. Further, with respect to the factor listed in paragraph (f)(2)(ii)(E) of this section, correction after the excess benefit transaction or transactions are discovered by the Commissioner, by itself, is never a sufficient basis for continuing to recognize exemption.

(iv) *Examples*. The following examples illustrate the principles of paragraph (f)(2)(ii) of this section. For purposes of each example, assume that O is an applicable tax-exempt organization (as defined in section 4958(e) and § 53.4958–2) described in section 501(c)(3). The examples read as follows:

Example 1. (i) O was created as a museum for the purpose of exhibiting art to the general public. In Years 1 and 2, O engages in fundraising and in selecting, leasing, and preparing an appropriate facility for a museum. In Year 3, a new board of trustees is elected. All of the new trustees are local art dealers. Beginning in Year 3 and continuing to the present, O uses a substantial portion of its revenues to purchase art solely from its trustees at prices that exceed fair market value. O exhibits and offers for sale all of the art it purchases. O's Form 1023, ''Application for Recognition of Exemption,'' did not disclose the possibility that O would purchase art from its trustees.

(ii) O's purchases of art from its trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, O's purchases of art from its trustees at more than fair market value violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. Beginning in Year 3, O does not engage primarily in regular and ongoing activities that further exempt purposes because a substantial portion of O's activities consists of purchasing art from its trustees and dealing in such art in a manner similar to a commercial art gallery. The size and scope of the excess benefit transactions collectively are significant in relation to the size and scope of any of O's ongoing activities that further exempt purposes. O has been involved in multiple excess benefit transactions, namely, purchases of art from its trustees at more than fair market value. O has not implemented safeguards that are reasonably calculated to prevent such improper purchases in the future. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from the disqualified persons who benefited from the excess benefit transactions (the trustees). The trustees continue to control O's Board. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 3.

Example 2. (i) The facts are the same as in *Example 1*, except that in Year 4, O's entire board of trustees resigns, and O no longer offers all exhibited art for sale. The former board is replaced with members of the community who are not in the business of buying or selling art and who have skills and experience running charitable and educational programs and institutions. O promptly discontinues the practice of purchasing art from current or former trustees, adopts a written conflicts of interest policy, adopts written art valuation guidelines, hires legal counsel to recover the excess amounts O had paid its former trustees, and implements a new program of activities to further the public's appreciation of the arts.

(ii) O's purchases of art from its former trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, O's purchases of art from its trustees at more than fair market value violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. In Year 3, O does not engage primarily in regular and ongoing activities that further exempt purposes. However, in Year 4, O elects a new board of trustees comprised of individuals who have skills and experience running charitable and educational programs and implements a new program of activities to further the public's appreciation of the arts. As a result of these actions, beginning in Year 4, O engages in regular and ongoing activities that further exempt purposes. The size and scope of the excess benefit transactions that occurred in Year 3, taken collectively, are significant in relation to the size and scope of O's regular and ongoing exempt function activities that were conducted in Year 3. Beginning in Year 4, however, as O's exempt function activities grow, the size and scope of the excess benefit transactions that occurred in Year 3 become less and less significant as compared to the size and scope of O's regular and ongoing exempt function activities. O was involved in multiple excess benefit transactions in Year 3. However, by discontinuing its practice of purchasing art from its current and former trustees, by replacing its former board with independent members of the community, and by adopting a conflicts of interest policy and art valuation guidelines, O has implemented safeguards that are reasonably calculated to prevent future violations. In addition, O has made a good faith effort to seek correction from the disqualified persons who benefited from the excess benefit transactions (its former trustees). Based on the application of the factors to these facts, O continues to meet the requirements for tax exemption under section 501(c)(3).

Example 3. (i) O conducts educational programs for the benefit of the general public. Since its formation, O has employed its founder, C, as its Chief Executive Officer. Beginning in Year 5 of O's operations and continuing to the present, C caused O to divert significant portions of O's funds to pay C's personal expenses. The diversions by C significantly reduced the funds available to conduct O's ongoing educational programs. The board of trustees never authorized C to cause O to pay C's personal expenses from O's funds. Certain members of the board were aware that O was paying C's personal expenses. However, the board did not terminate C's employment and did not take any action to seek repayment from C or to prevent C from continuing to divert O's funds to pay C's personal expenses. C claimed that O's payments of C's personal expenses represented loans from O to C. However, no contemporaneous loan documentation exists, and C never made any payments of principal or interest.

(ii) The diversions of O's funds to pay C's personal expenses constitute excess benefit transactions between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, these transactions violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is

as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transactions occurred. However, the size and scope of the excess benefit transactions engaged in by O beginning in Year 5, collectively, are significant in relation to the size and scope of O's activities that further exempt purposes. Moreover, O has been involved in multiple excess benefit transactions. O has not implemented any safeguards that are reasonably calculated to prevent future diversions. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from C, the disqualified person who benefited from the excess benefit transactions. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 5.

Example 4. (i) O conducts activities that further exempt purposes. O uses several buildings in the conduct of its exempt activities. In Year 1, O sold one of the buildings to Company K for an amount that was substantially below fair market value. The sale was a significant event in relation to O's other activities. C, O's Chief Executive Officer, owns all of the voting stock of Company K. When O's board of trustees approved the transaction with Company K, the board did not perform due diligence that could have made it aware that the price paid by Company K to acquire the building was below fair market value. Subsequently, but before the IRS commences an examination of O, O's board of trustees determines that Company K paid less than the fair market value for the building. Thus, O concludes that an excess benefit transaction occurred. After the board makes this determination, it promptly removes C as Chief Executive Officer, terminates C's employment with O, and hires legal counsel to recover the excess benefit from Company K. In addition, O promptly adopts a conflicts of interest policy and new contract review procedures designed to prevent future recurrences of this problem.

(ii) The sale of the building by O to Company K at less than fair market value constitutes an excess benefit transaction between an applicable tax-exempt organization and a disqualified person under section 4958 in Year 1. Therefore, this transaction is subject to the applicable excise taxes provided in that section. In addition, this transaction violates the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transaction occurred. Although the size and scope of the excess benefit transaction were significant in relation to the size and scope of O's activities that further exempt purposes, the transaction with Company K was a one-time occurrence. By adopting a conflicts of interest policy and new contract review procedures and by terminating C, O has implemented safeguards that are reasonably calculated to prevent future violations. Moreover, O took corrective actions before the IRS commenced an examination of O. In addition, O has made a good faith effort to seek correction from Company K, the disqualified person who benefited from the excess benefit transaction. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

Example 5. (i) O is a large organization with substantial assets and revenues. O conducts activities that further its exempt purposes. O employs C as its Chief Financial Officer. During Year 1, O pays $2,500 of C's personal expenses. O does not make these payments pursuant to an accountable plan, as described in § 53.4958–4(a)(4)(ii). In addition, O does not report any of these payments on C's Form W–2, ''Wage and Tax Statement,'' or on a Form 1099–MISC, ''Miscellaneous Income,'' for C for Year 1, and O does not report these payments as compensation on its Form 990, ''Return of Organization Exempt From Income Tax,'' for Year 1. Moreover, none of these payments can be disregarded as nontaxable fringe benefits under § 53.4958–4(c)(2) and none consisted of fixed payments under an initial contract under § 53.4958–4(a)(3). C does not report the $2,500 of payments as income on his individual Federal income tax return for Year 1. O does not repeat this reporting omission in subsequent years and, instead, reports all payments of C's personal expenses not made under an accountable plan as income to C.

(ii) O's payment in Year 1 of $2,500 of C's personal expenses constitutes an excess benefit transaction between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, this transaction is subject to the applicable excise taxes provided in that section. In addition, this transaction violates the proscription against inurement in section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O engages in regular and ongoing activities that further exempt purposes. The payment of $2,500 of C's personal expenses represented only a de minimis portion of O's assets and revenues; thus, the size and scope of the excess benefit transaction were not significant in relation to the size and scope of O's activities that further exempt purposes. The reporting omission that resulted in the excess benefit transaction in Year 1 occurred only once and is not repeated in subsequent years. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

Example 6. (i) O is a large organization with substantial assets and revenues. O furthers its exempt purposes by providing social services to the population of a specific geographic area. O has a sizeable workforce of employees and volunteers to conduct its work. In Year 1, O's board of directors adopted written procedures for setting executive compensation at O. O's executive compensation procedures were modeled on the procedures for establishing a rebuttable presumption of reasonableness under § 53.4958–6. In accordance with these procedures, the board appointed a compensation committee to gather data on compensation levels paid by similarly situated organizations for functionally comparable positions. The members of the compensation committee were disinterested within the meaning of § 53.4958–6(c)(1)(iii). Based on its research, the compensation committee recommended a range of reasonable compensation for several of O's existing top executives (the Top Executives). On the basis of the committee's recommendations, the board approved new compensation packages for the Top Executives and timely documented the basis for its decision in board minutes. The board members were all disinterested within the meaning of § 53.4958–6(c)(1)(iii). The Top Executives were not involved in setting their own compensation. In Year 1, even though payroll expenses represented a significant portion of O's total operating expenses, the total compensation paid to O's Top Executives represented only an insubstantial portion of O's total payroll expenses. During a subsequent examination, the IRS found that the compensation committee relied exclusively on compensation data from organizations that perform similar social services to O. The IRS concluded, however, that the organizations were not similarly situated because they served substantially larger geographic regions with more diverse populations and were larger than O in terms of annual revenues, total operating budget, number of employees, and number of beneficiaries served. Accordingly, the IRS concluded that the compensation committee did not rely on ''appropriate data as to comparability'' within the meaning of § 53.4958–6(c)(2) and, thus, failed to establish the rebuttable presumption of reasonableness under § 53.4958–6. Taking O's size and the nature of the geographic area and population it serves into account, the IRS concluded that the Top Executives' compensation packages for Year 1 were excessive. As a result of the examination, O's board added new members to the compensation committee who have expertise in compensation matters and also amended its written procedures to require the compensation committee to evaluate a number of specific factors, including size, geographic area, and population covered by the organization, in assessing the comparability of compensation data. O's board renegotiated the Top Executives' contracts in accordance with the recommendations of the newly constituted compensation committee on a going forward basis. To avoid potential liability for damages under state contract law, O did not seek to void the Top Executives' employment contracts retroactively to Year 1 and did not seek correction of the excess benefit amounts from the Top Executives. O did not terminate any of the Top Executives.

(ii) O's payments of excessive compensation to the Top Executives in Year 1 constituted excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these payments are subject to the applicable excise taxes provided under that section, including second-tier taxes if there is no correction by the disqualified persons. In addition, these payments violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transactions occurred. The size and scope of the excess benefit transactions, in the aggregate, were not significant in relation to the size and scope of O's activities that further exempt purposes. O engaged in multiple excess benefit transactions. Nevertheless, prior to entering into these excess benefit transactions, O had implemented written procedures for setting the compensation of its top management that were reasonably calculated to prevent the occurrence of excess benefit transactions. O followed these written procedures in setting the compensation of the Top Executives for Year 1. Despite the board's failure to rely on appropriate comparability data, the fact that O implemented and followed these written procedures in setting the compensation of the Top Executives for Year 1 is a factor favoring continued exemption. The fact that O amended its written procedures to ensure the use of appropriate comparability data and renegotiated the Top Executives' compensation packages on a going-forward basis are also factors favoring continued exemption, even though O did not void the Top Executives' existing contracts and did not seek correction from the Top Executives. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

(3) *Applicability*. The rules in paragraph (f) of this section will apply with respect to excess benefit transactions occurring after March 28, 2008.

(g) *Applicability of regulations in this section*. The regulations in this section

are, except as otherwise expressly provided, applicable with respect to taxable years beginning after July 26, 1959. For the rules applicable with respect to taxable years beginning before July 27, 1959, see 26 CFR (1939) 39.101(6)–1 (Regulations 118) as made applicable to the Code by Treasury Decision 6091, approved August 16, 1954 (19 FR 5167; C.B. 1954–2, 47).

(h) [Reserved] For further guidance see § 1.501(c)(3)–1T(h).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6525, 26 FR 189, Jan. 11, 1961; T.D. 6939, 32 FR 17661, Dec. 12, 1967; T.D. 7428, 41 FR 34620, Aug. 16, 1976; T.D. 8308, 55 FR 35587, Aug. 31, 1990; T.D. 9390, 73 FR 16521, Mar. 28, 2008; T.D. 9390, 73 FR 23069, Apr. 29, 2008; T.D. 9674, 79 FR 37631, July 2, 2014]

§ 1.501(c)(3)–1T Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals (temporary).

(a) through (b)(1)(iv) [Reserved] For further guidance see § 1.501(c)(3)–1(a) through (b)(1)(iv).

(v) Unless otherwise prescribed by applicable regulations or other guidance published in the Internal Revenue Bulletin, an organization must, in order to establish its exemption, submit a detailed statement of its proposed activities with and as a part of its application for exemption (see paragraph (b) of § 1.501(a)–1).

(b)(2) through (b)(5) [Reserved] For further guidance see § 1.501(c)(3)–1(b)(2) through (b)(5).

(6) *Applicability of the organizational test.* A determination by the Commissioner that an organization is described in section 501(c)(3) and exempt under section 501(a) will not be granted after July 26, 1959, regardless of when the application is filed, unless such organization meets the organizational test prescribed by this paragraph (b)(6). If, before July 27, 1959, an organization has been determined by the Commissioner or district director to be exempt as an organization described in section 501(c)(3) or in a corresponding provision of prior law and such determination has not been revoked before such date, the fact that such organization does not meet the organizational test prescribed by this paragraph (b)(6) shall not be a basis for revoking such determination. Accordingly, an organization that has been determined to be exempt before July 27, 1959, and which does not seek a new determination of exemption is not required to amend its articles of organization to conform to the rules of this paragraph (b)(6), but any organization that seeks a determination of exemption after July 26, 1959, must have articles of organization that meet the rules of this paragraph (b)(6). For the rules relating to whether an organization determined to be exempt before July 27, 1959, is organized exclusively for one or more exempt purposes, see 26 CFR (1939) 39.101(6)–1 (Regulations 118) as made applicable to the Code by Treasury Decision 6091, approved August 16, 1954 (19 FR 5167; CB 1954–2, 47).

(c) through (g) [Reserved] For further guidance, see § 1.501(c)(3)–1(c) through (g).

(h) *Effective/applicability date.* (1) Paragraphs (b)(1)(v) and (b)(6) of this section apply on and after July 1, 2014.

(2) *Expiration date.* Paragraphs (b)(1)(v) and (b)(6) of this section expire on or before June 30, 2017.

[T.D. 9674, 79 FR 37631, July 2, 2014; 79 FR 39311, July 10, 2014; 79 FR 41886, July 18, 2014]

§ 1.501(c)(4)–1 Civic organizations and local associations of employees.

(a) *Civic organizations*—(1) *In general.* A civic league or organization may be exempt as an organization described in section 501(c)(4) if—

(i) It is not organized or operated for profit; and

(ii) It is operated exclusively for the promotion of social welfare.

(2) *Promotion of social welfare*—(i) *In general.* An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements. A *social welfare* organization will qualify for exemption as a charitable organization if it falls within the definition of *charitable* set forth in paragraph (d)(2) of § 1.501(c)(3)–1 and is not an *action* organization as

set forth in paragraph (c)(3) of § 1.501(c)(3)–1.

(ii) *Political or social activities.* The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. Nor is an organization operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations which are operated for profit. See, however, section 501(c)(6) and § 1.501(c)(6)–1, relating to business leagues and similar organizations. A social welfare organization that is not, at any time after October 4, 1976, exempt from taxation as an organization described in section 501(c)(3) may qualify under section 501(c)(4) even though it is an *action* organization described in § 1.501(c)(3)–1(c)(3)(ii) or (iv), if it otherwise qualifies under this section. For rules relating to an organization that is, after October 4, 1976, exempt from taxation as an organization described in section 501(c)(3), see section 504 and § 1.504–1.

(b) *Local associations of employees.* Local associations of employees described in section 501(c)(4) are expressly entitled to exemption under section 501(a). As conditions to exemption, it is required (1) that the membership of such an association be limited to the employees of a designated person or persons in a particular municipality, and (2) that the net earnings of the association be devoted exclusively to charitable, educational, or recreational purposes. The word *local* is defined in paragraph (b) of § 1.501(c)(12)–1. See paragraph (d) (2) and (3) of § 1.501(c)(3)–1 with reference to the meaning of *charitable* and *educational* as used in this section.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8308, 55 FR 35588, Aug. 31, 1990]

§ 1.501(c)(5)–1 Labor, agricultural, and horticultural organizations.

(a) The organizations contemplated by section 501(c)(5) as entitled to exemption from income taxation are those which:

(1) Have no net earnings inuring to the benefit of any member, and

(2) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

(b)(1) *General rule.* An organization is not an organization described in section 501(c)(5) if the principal activity of the organization is to receive, hold, invest, disburse or otherwise manage funds associated with savings or investment plans or programs, including pension or other retirement savings plans or programs.

(2) *Exception.* Paragraph (b)(1) of this section shall not apply to an organization which—

(i) Is established and maintained by another labor organization described in section 501(c)(5) (determined without regard to this paragraph (b)(2));

(ii) Is not directly or indirectly established or maintained in whole or in part by one or more—

(A) Employers;

(B) Governments or agencies or instrumentalities thereof; or

(C) Government controlled entities;

(iii) Is funded by membership dues from members of the labor organization described in this paragraph (b)(2) and earnings thereon; and

(iv) Has not at any time after September 2, 1974 (the date of enactment of the Employee Retirement Income Security Act of 1974, Pub. L. 93–406, 88 Stat. 829) provided for, permitted or accepted employer contributions.

(3) *Example.* The principles of this paragraph (b) are illustrated by the following example:

Example. Trust A is organized in accordance with a collective bargaining agreement between labor union K and multiple employers. Trust A forms part of a plan that is established and maintained pursuant to the agreement and which covers employees of the signatory employers who are members of K. Representatives of both the employers and K serve as trustees. A receives contributions from the employers who are subject to the agreement. Retirement benefits paid to K's members as specified in the agreement are funded exclusively by the employers' contributions and accumulated earnings. A also provides information to union members about their retirement benefits and assists

them with administrative tasks associated with the benefits. Most of A's activities are devoted to these functions. From time to time, A also participates in the renegotiation of the collective bargaining agreement. A's principal activity is to receive, hold, invest, disburse, or otherwise manage funds associated with a retirement savings plan. In addition, A does not satisfy all the requirements of the exception described in paragraph (b)(2) of this section. (For example, A accepts contributions from employers.) Therefore, A is not a labor organization described in section 501(c)(5).

(c) Organizations described in section 501(c)(5) and otherwise exempt from tax under section 501(a) are taxable upon their unrelated business taxable income. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8726, 62 FR 40449, July 29, 1997]

§ 1.501(c)(6)–1 Business leagues, chambers of commerce, real estate boards, and boards of trade.

A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest, even though all of its income is devoted to the purpose stated. A stock or commodity exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of section 501(c)(6) and is not exempt from tax. Organizations otherwise exempt from tax under this section are taxable upon their unrelated business taxable income. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder.

§ 1.501(c)(7)–1 Social clubs.

(a) The exemption provided by section 501(a) for organizations described in section 501(c)(7) applies only to clubs which are organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, but does not apply to any club if any part of its net earnings inures to the benefit of any private shareholder. In general, this exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

(b) A club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber, or other products, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not exempt under section 501(a). Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes. However, an incidental sale of property will not deprive a club of its exemption.

§ 1.501(c)(8)–1 Fraternal beneficiary societies.

(a) A fraternal beneficiary society is exempt from tax only if operated under the *lodge system* or for the exclusive benefit of the members so operating. *Operating under the lodge system* means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt it is also necessary that the society have an established system for the payment to its members

or their dependents of life, sick, accident, or other benefits.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7061, 35 FR 14770, Sept. 23, 1970]

§ 1.501(c)(9)–1 Voluntary employees' beneficiary associations, in general.

To be described in section 501(c)(9) an organization must meet all of the following requirements:

(a) The organization is an employees' association,

(b) Membership in the association is voluntary,

(c) The organization provides for the payment of life, sick, accident, or other benefits to its members or their dependents or designated beneficiaries, and substantially all of its operations are in furtherance of providing such benefits, and

(d) No part of the net earnings of the organization inures, other than by payment of the benefits referred to in paragraph (c) of this section, to the benefit of any private shareholder or individual.

[T.D. 7750, 45 FR 1721, Jan. 7, 1981]

§ 1.501(c)(9)–2 Membership in a voluntary employees' beneficiary association; employees; voluntary association of employees.

(a) *Membership*—(1) *In general.* The membership of an organization described in section 501(c)(9) must consist of individuals who become entitled to participate by reason of their being employees and whose eligibility for membership is defined by reference to objective standards that constitute an employment-related common bond among such individuals. Typically, those eligible for membership in an organization described in section 501(c)(9) are defined by reference to a common employer (or affiliated employers), to coverage under one or more collective bargaining agreements (with respect to benefits provided by reason of such agreement(s)), to membership in a labor union, or to membership in one or more locals of a national or international labor union. For example, membership in an association might be open to all employees of a particular employer, or to employees in specified job classifications working for certain employers at specified locations and who are entitled to benefits by reason of one or more collective bargaining agreements. In addition, employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to share an employment-related bond for purposes of an organization through which their employers provide benefits. Employees of a labor union also will be considered to share an employment-related common bond with members of the union, and employees of an association will be considered to share an employment-related common bond with members of the association. Whether a group of individuals is defined by reference to a permissible standard or standards is a question to be determined with regard to all the facts and circumstances, taking into account the guidelines set forth in this paragraph. Exemption will not be denied merely because the membership of an association includes some individuals who are not employees (within the meaning of paragraph (b) of this section), provided that such individuals share an employment-related bond with the employee-members. Such individuals may include, for example, the proprietor of a business whose employees are members of the association. For purposes of the preceding two sentences, an association will be considered to be composed of employees if 90 percent of the total membership of the association on one day of each quarter of the association's taxable year consists of employees (within the meaning of paragraph (b) of this section).

(2) *Restrictions*—(i) *In general.* Eligibility for membership may be restricted by geographic proximity, or by objective conditions or limitations reasonably related to employment, such as a limitation to a reasonable classification of workers, a limitation based on a reasonable minimum period of service, a limitation based on maximum compensation, or a requirement that a member be employed on a full-time basis. Similarly, eligibility for benefits may be restricted by objective conditions relating to the type or amount of benefits offered. Any objective criteria used to restrict eligibility for membership or benefits may not,

however, be selected or administered in a manner that limits membership or benefits to officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association. Similarly, eligibility for benefits may not be subject to conditions or limitations that have the effect of entitling officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association to benefits that are disproportionate in relation to benefits to which other members of the association are entitled. See §1.501(c)(9)–4(b). Whether the selection or administration of objective conditions has the effect of providing disproportionate benefits to officers, shareholders, or highly compensated employees generally is to be determined on the basis of all the facts and circumstances.

(ii) *Generally permissible restrictions or conditions.* In general the following restrictions will not be considered to be inconsistent with §1.501(c)(9)–2(a)(2)(i) or §1.501(c)(9)–4(b):

(A) In the case of an employer-funded organization, a provision that excludes or has the effect of excluding from membership in the organization or participation in a particular benefit plan employees who are members of another organization or covered by a different plan, funded or contributed to by the employer, to the extent that such other organization or plan offers similar benefits on comparable terms to the excluded employees.

(B) In the case of an employer funded-organization, a provision that excludes from membership, or limits the type or amount of benefits provided to, individuals who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that the benefit or benefits provided by the organization were the subject of good faith bargaining between such employee representatives and such employer or employers.

(C) Restrictions or conditions on eligibility for membership or benefits that are determined through collective bargaining, by trustees designated pursuant to a collective bargaining agreement, or by the collective bargaining agents of the members of an association or trustees named by such agent or agents.

(D) The allowance of benefits only on condition that a member or recipient contribute to the cost of such benefits, or the allowance of different benefits based solely on differences in contributions, provided that those making equal contributions are entitled to comparable benefits.

(E) A requirement that a member (or a member's dependents) meet a reasonable health standard related to eligibility for a particular benefit.

(F) The provision of life benefits in amounts that are a uniform percentage of the compensation received by the individual whose life is covered.

(G) The provision of benefits in the nature of wage replacement in the event of disability in amounts that are a uniform percentage of the compensation of the covered individuals (either before or after taking into account any disability benefits provided through social security or any similar plan providing for wage replacement in the event of disability).

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

Example 1. Pursuant to a collective bargaining agreement entered into by X Corporation and W, a labor union which represents all of X Corporation's hourly-paid employees, the X Corporation Union Benefit Plan is established to provide life insurance benefits to employees of X represented by W. The Plan is funded by contributions from X, and is jointly administered by X and W. In order to provide its non-unionized employees with comparable life insurance benefits, X also establishes and funds the X Corporation Life Insurance Trust. The Trust will not be ineligible for exemption as an organization described in section 501(c)(9) solely because membership is restricted to those employees of X who are not members of W.

Example 2. The facts are the same as in Example 1 except that the life insurance benefit provided to the non-unionized employees of X differs from the life insurance benefit provided to the unionized employees of X pursuant to the collective bargaining agreement. The trust will not be ineligible for exemption as an organization described in section 501(c)(9) solely because the life insurance benefit provided to X's nonunionized

employees is not same as the life insurance benefit provided to X's unionized employees.

Example 3. S corporation established a plan to provide health benefits to all its employees. In accordance with the provisions of the plan each employee may secure insurance coverage by making an election under which the employee agrees to contribute periodically to the plan an amount which is determined solely by whether the employee elects a high option coverage or a low option coverage and on whether the employee is unmarried or has a family. As an alternative, the employee may elect high or low options, self only or self and family, coverage through a local prepaid group medical plan. The contributions required of those electing the prepaid group medical plan also vary with the type of coverage selected, and differ from those required of employees electing insurance. The difference between the amount contributed by employees electing the various coverages and the actual cost of purchasing the coverage is made up through contributions by S to the plan, and under the plan, S provides approximately the same proportion of the cost for each coverage. To fund the plan, S established an arrangement in the nature of a trust under applicable local law and contributes all employee contributions, and all amounts which by the terms of the plan it is required to contribute, to the trust. The terms of the plan do not provide for disproportionate benefits to the employees of S and will not be considered inconsistent with §1.501(c)(9)–2(a)(2)(i).

Example 4. The facts are the same as in Example 3 except that, for those employees or former employees covered by Medicare, the plan provides a distinct coverage which supplements Medicare benefits. Eligibility for Medicare is an objective condition relating to a type of benefit offered, and the provision of separate coverage for those eligible for Medicare will not be considered inconsistent with §1.501(c)(9)–2(a)(2)(i).

(b) *Meaning of employee.* Whether an individual is an *employee* is determined by reference to the legal and bona fide relationship of employer and employee. The term *employee* includes the following:

(1) An individual who is considered an employee:

(i) For employment tax purposes under subtitle C of the Internal Revenue Code and the regulations thereunder, or

(ii) For purposes of a collective bargaining agreement,

whether or not the individual could qualify as an employee under applicable common law rules. This would include any person who is considered an employee for purposes of the Labor Management Relations Act of 1947, 61 Stat. 136, *as amended,* 29 U.S.C. 141 (1979).

(2) An individual who became entitled to membership in the association by reason of being or having been an employee. Thus, an individual who would otherwise qualify under this paragraph will continue to qualify as an employee even though such individual is on leave of absence, works temporarily for another employer or as an independent contractor, or has been terminated by reason of retirement, disability or layoff. For example, an individual who in the normal course of employment is employed intermittently by more than one employer in an industry characterized by short-term employment by several different employers will not, by reason of temporary unemployment, cease to be an employee within the meaning of this paragraph.

(3) The surviving spouse and dependents of an employee (if, for purposes of the 90-percent test of §1.501(c)(9)–2(a)(1) they are considered to be members of the association).

(c) *Description of voluntary association of employees*—(1) *Association.* To be described in section 501(c)(9) and this section there must be an entity, such as a corporation or trust established under applicable local law, having an existence independent of the member-employees or their employer.

(2) *Voluntary.* Generally, membership in an association is voluntary if an affirmative act is required on the part of an employee to become a member rather than the designation as a member due to employee status. However, an association shall be considered voluntary although membership is required of all employees, provided that the employees do not incur a detriment (for example, in the form of deductions from pay) as the result of membership in the association. An employer is not deemed to have imposed involuntary membership on the employee if membership is required as the result of a collective bargaining agreement or as an incident of membership in a labor organization.

(3) *Of employees.* To be described in this section, an organization must be controlled—

(i) By its membership,

(ii) By independent trustee(s) (such as a bank), or

(iii) By trustees or other fiduciaries at least some of whom are designated by, or on behalf of, the membership. Whether control by or on behalf of the membership exists is a question to be determined with regard to all of the facts and circumstances, but generally such control will be deemed to be present when the membership (either directly or through its representative) elects, appoints or otherwise designates a person or persons to serve as chief operating officer(s), administrator(s), or trustee(s) of the organization. For purposes of this paragraph an organization will be considered to be controlled by independent trustees if it is an *employee welfare benefit plan*, as defined in section 3(1) of the Employee Retirement Income Security Act of 1974 (ERISA), and, as such, is subject to the requirements of parts 1 and 4 of subtitle B, title I of ERISA. Similarly, a plan will be considered to be controlled by its membership if it is controlled by one or more trustees designated pursuant to a collective bargaining agreement (whether or not the bargaining agent of the represented employees bargained for and obtained the right to participate in selecting the trustees).

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

Example 1. X, a labor union, represents all the hourly-paid employees of Y Corporation. A health insurance benefit plan was established by X and Y as the result of a collective bargaining agreement entered into by them. The plan established the terms and conditions of membership in, and the benefits to be provided by, the plan. In accordance with the terms of the agreement, Y Corporation is obligated to establish a trust fund and make contributions thereto at specified rates. The trustees, some of whom are designated by X and some by Y, are authorized to hold and invest the assets of the trust and to make payments on instructions issued by Y Corporation in accordance with the conditions contained in the plan. The interdependent benefit plan agreement and trust indenture together create a voluntary employees' beneficiary association over which the employees posses the requisite control through the trustees designated by their representative, X.

Example 2. Z Corporation unilaterally established an educational benefit plan for its employees. The purpose of the plan is to provide payments for job-related educational or training courses, such as apprenticeship training programs, for Z Corporation employees, according to objective criteria set forth in the plan. Z establishes a separate bank account which it uses to fund payments to the plan. Contributions to the account are to be made at the discretion of and solely by Z Corporation, which also administers the plan and retains control over the assets in the fund. Z Corporation's educational benefit plan and the related account do not constitute an association having an existence independent of Z Corporation and therefore do not constitute a voluntary employees' beneficiary association.

Example 3. A, an individual, is the incorporator and chief operating officer of Lawyers' Beneficiary Association (LBA). LBA is engaged in the business of providing medical benefits to members of the Association and their families. Membership is open only to practicing lawyers located in a particular metropolitan area who are neither self-employed nor partners in a law firm. Membership in LBA is solicited by insurance agents under the control of X Corporation (owned by A) which, by contract with LBA, is the exclusive sales agent. Medical benefits are paid from a trust account containing periodic *contributions* paid by the members, together with proceeds from the investment of those contributions. Contribution and benefit levels are set by LBA. The *members* of LBA do not hold meetings, have no right to elect officers or directors of the Association, and no right to replace trustees. Collectively, the subscribers for medical benefits from LBA cannot be said to control the association and membership is neither more than nor different from the purchase of an insurance policy from a stock insurance company. LBA is not a voluntary employees' beneficiary association.

Example 4. U corporation unilaterally established a plan to provide benefits to its employees. In accordance with the provisions of the plan, each employee may secure insurance or benefit coverage by making an election under which the employee agrees to contribute to the plan an amount which is determined solely by whether the employee elects a high option coverage or a low option coverage and on whether the employee elects self only or self and family coverage. The difference between the amount contributed by employees electing the various coverages and the actual cost of the coverage is made up through contributions by U to the plan.

To fund the plan, U established an arrangement in the nature of a trust under applicable local law and contributed all employee contributions, and all amounts which by the term of the plan it was required to provide to the plan, to the trust. The trust constitutes an *employee welfare benefit plan* within the meaning of, and subject to relevant requirements of, ERISA. It will be considered to meet the requirements of § 1.501(c)(9)–2(c)(3).

[T.D. 7750, 46 FR 1723, Jan. 7, 1981]

§ 1.501(c)(9)–3 Voluntary employees' beneficiary associations; life, sick, accident, or other benefits.

(a) *In general*. The life, sick, accident, or other benefits provided by a voluntary employees' beneficiary association must be payable to its members, their dependents, or their designated beneficiaries. For purposes of section 501(c)(9), *dependent* means the member's spouse; any child of the member or the member's spouse who is a minor or a student (within the meaning of section 151(e)(4)); any other minor child residing with the member; and any other individual who an association, relying on information furnished to it by a member, in good faith believes is a person described in section 152(a). Life, sick, accident, or other benefits may take the form of cash or noncash benefits. A voluntary employees' beneficiary association is not operated for the purpose of providing life, sick, accident, or other benefits unless substantially all of its operations are in furtherance of the provision of such benefits. Further, an organization is not described in this section if it systematically and knowingly provides benefits (of more than a *de minimis* amount) that are not permitted by paragraphs (b), (c), (d), or (e) of this section.

(b) *Life benefits*. The term *life benefits* means a benefit (including a burial benefit or a wreath) payable by reason of the death of a member or dependent. A *life benefit* may be provided directly or through insurance. It generally must consist of current protection, but also may include a right to convert to individual coverage on termination of eligibility for coverage through the association, or a permanent benefit as defined in, and subject to the conditions in, the regulations under section 79. A *life benefit* also includes the benefit provided under any life insurance contract purchased directly from an employee-funded association by a member or provided by such an association to a member. The term *life benefit* does not include a pension, annuity or similar benefit, except that a benefit payable by reason of the death of an insured may be settled in the form of an annuity to the beneficiary in lieu of a lump-sum death benefit (whether or not the contract provides for settlement in a lump sum).

(c) *Sick and accident benefits*. The term *sick and accident benefits* means amounts furnished to or on behalf of a member or a member's dependents in the event of illness or personal injury to a member or dependent. Such benefits may be provided through reimbursement to a member or a member's dependents for amounts expended because of illness or personal injury, or through the payment of premiums to a medical benefit or health insurance program. Similarly, a sick and accident benefit includes an amount paid to a member in lieu of income during a period in which the member is unable to work due to sickness or injury. Sick benefits also include benefits designed to safeguard or improve the health of members and their dependents. Sick and accident benefits may be provided directly by an association to or on behalf of members and their dependents, or may be provided indirectly by an association through the payment of premiums or fees to an insurance company, medical clinic, or other program under which members and their dependents are entitled to medical services or to other sick and accident benefits. Sick and accident benefits may also be furnished in noncash form, such as, for example, benefits in the nature of clinical care services by visiting nurses, and transportation furnished for medical care.

(d) *Other benefits*. The term *other benefits* includes only benefits that are similar to life, sick, or accident benefits. A benefit is similar to a life, sick, or accident benefit if:

(1) It is intended to safeguard or improve the health of a member or a member's dependents, or

(2) It protects against a contingency that interrupts or impairs a member's earning power.

(e) *Examples of other benefits.* Paying vacation benefits, providing vacation facilities, reimbursing vacation expenses, and subsidizing recreational activities such as athletic leagues are considered *other benefits.* The provision of child-care facilities for preschool and school-age dependents are also considered *other benefits.* The provision of job readjustment allowances, income maintenance payments in the event of economic dislocation, temporary living expense loans and grants at times of disaster (such as fire or flood), supplemental unemployment compensation benefits (as defined in section 501(c)(17)(D)(i) of the Code), severance benefits (under a severance pay plan within the meaning of 29 CFR 2510.3–2(b)) and education or training benefits or courses (such as apprentice training programs) for members, are considered *other benefits* because they protect against a contingency that interrupts earning power. Personal legal service benefits which consist of payments or credits to one or more organizations or trusts described in section 501(c)(20) are considered *other benefits.* Except to the extent otherwise provided in these regulations, as amended from time to time, *other benefits* also include any benefit provided in the manner permitted by paragraphs (5) *et seq.* of section 302(c) of the Labor Management Relations Act of 1947, 61 Stat. 136, *as amended*, 29 U.S.C. 186(c) (1979).

(f) *Examples of nonqualifying benefits.* Benefits that are not described in paragraphs (d) or (e) of this section are not *other benefits.* Thus, *other benefits* do not include the payment of commuting expenses, such as bridge tolls or train fares, the provision of accident or homeowner's insurance benefits for damage to property, the provision of malpractice insurance, or the provision of loans to members except in times of distress (as permitted by §1.501(c)(9)–3(e)). *Other benefits* also do not include the provision of savings facilities for members. The term *other benefits* does not include any benefit that is similar to a pension or annuity payable at the time of mandatory or voluntary retirement, or a benefit that is similar to the benefit provided under a stock bonus or profit-sharing plan. For purposes of section 501(c)(9) and these regulations, a benefit will be considered similar to that provided under a pension, annuity, stock bonus or profit-sharing plan if it provides for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event. Thus, for example, supplemental unemployment benefits, which generally become payable by reason of unanticipated layoff, are not, for purposes of these regulations, considered similar to the benefit provided under a pension, annuity, stock bonus or profit-sharing plan.

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

Example 1. V was organized in connection with a vacation plan created pursuant to a collective bargaining agreement between M, a labor union, which represents certain hourly paid employees of T corporation, and T. The agreement calls for the payment by T to V of a specified sum per hour worked by T employees who are covered by the collective bargaining agreement. T includes the amounts in the covered employees' wages and withholds income and FICA taxes. The amounts are paid by T to V to provide vacation benefits provided under the collective bargaining agreement. Generally, each covered employee receives a check in payment of his or her vacation benefit during the year following the year in which contributions were made by T to V. The amount of the vacation benefit is determined by reference to the contributions during the prior year to V by T on behalf of each employee, and is distributed in cash to each such employee. If the earnings on investments by V during the year preceding distribution are sufficient after deducting the expenses of administering the plan, each recipient of a vacation benefit is paid an amount, in addition to the contributions on his or her behalf, equal to his/her ratable share of the net earnings of V during such year. The plan provides a vacation benefit that constitutes an eligible *other benefit* described in section 501(c)(9) and §1.501(c)(9)–3(e).

Example 2. The facts are the same as in Example 1, except that each covered employee of T is entitled, at his or her discretion, to contribute up to an additional $1,000 each year to V, which agrees in respect of such sum to pay interest at a stated rate from the time of contribution until the time at which the contributing employee's vacation benefit is distributed. In addition, each employee may elect to leave all or a portion of his/her distributable benefit on deposit past the time of distribution, in which case interest will continue to accrue. Because the plan

more closely resembles a savings arrangement than a vacation plan, the benefit payable to the covered employees of T is not a *vacation benefit* and is not an eligible *other benefit* described in section 501(c)(9) and § 1.501(c)(9)–3 (d) or (e).

[T.D. 7750, 46 FR 1724, Jan. 7, 1981]

§ 1.501(c)(9)–4 Voluntary employees' beneficiary associations; inurement.

(a) *General rule.* No part of the net earnings of an employees' association may inure to the benefit of any private shareholder or individual other than through the payment of benefits permitted by § 1.501(c)(9)–3. The disposition of property to, or the performance of services for, a person for less than the greater of fair market value or cost (including indirect costs) to the association, other than as a life, sick, accident or other permissible benefit, constitutes prohibited inurement. Generally, the payment of unreasonable compensation to the trustees or employees of the association, or the purchase of insurance or services for amounts in excess of their fair market value from a company in which one or more of the association's trustees, officers or fiduciaries has an interest, will constitute prohibited inurement. Whether prohibited inurement has occurred is a question to be determined with regard to all of the facts and circumstances, taking into account the guidelines set forth in this section. The guidelines and examples contained in this section are not an exhaustive list of the activities that may constitute prohibited inurement, or the persons to whom the association's earnings could impermissibly inure. See § 1.501(a)–1(c).

(b) *Disproportionate benefits.* For purposes of subsection (a), the payment to any member of disproportionate benefits, where such payment is not pursuant to objective and nondiscriminatory standards, will not be considered a benefit within the meaning of § 1.501(c)(9)–3 even though the benefit otherwise is one of the type permitted by that section. For example, the payment to highly compensated personnel of benefits that are disproportionate in relation to benefits received by other members of the association will constitute prohibited inurement. Also, the payment to similarly situated employees of benefits that differ in kind or amount will constitute prohibited inurement unless the difference can be justified on the basis of objective and reasonable standards adopted by the association or on the basis of standards adopted pursuant to the terms of a collective bargaining agreement. In general, benefits paid pursuant to standards or subject to conditions that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees will not be considered disproportionate. See § 1.501(c)(9)–2(a) (2) and (3).

(c) *Rebates.* The rebate of excess insurance premiums, based on the mortality or morbidity experience of the insurer to which the premiums were paid, to the person or persons whose contributions were applied to such premiums, does not constitute prohibited inurement. A voluntary employees' beneficiary association may also make administrative adjustments strictly incidental to the provision of benefits to its members.

(d) *Termination of plan or dissolution of association.* It will not constitute prohibited inurement if, on termination of a plan established by an employer and funded through an association described in section 501(c)(9), any assets remaining in the association, after satisfaction of all liabilities to existing beneficiaries of the plan, are applied to provide, either directly or through the purchase of insurance, life, sick, accident or other benefits within the meaning of § 1.501(c)(9)–3 pursuant to criteria that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees of the employer. See § 1.501(c)(9)–2(a)(2). Similarly, a distribution to members upon the dissolution of the association will not constitute prohibited inurement if the amount distributed to members are determined pursuant to the terms of a collective bargaining agreement or on the basis of objective and reasonable standards which do not result in either unequal payments to similarly situated members or in disproportionate payments to officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association. Except as otherwise provided in the

first sentence of this paragraph, if the association's corporate charter, articles of association, trust instrument, or other written instrument by which the association was created, as amended from time to time, provides that on dissolution its assets will be distributed to its members' contributing employers, or if in the absence of such provision the law of the state in which the association was created provides for such distribution to the contributing employers, the association is not described in section 501(c)(9).

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

Example. Employees A, B and C, members of the X voluntary employees' beneficiary association, are unemployed. They receive unemployment benefits from X. Those to A include an amount in addition to those provided to B and C, to provide for A's retraining. B has been found pursuant to objective and reasonable standards not to qualify for the retraining program. C, although eligible for retraining benefits has declined. X's additional payment to A for retraining does not constitute prohibited inurement.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§ 1.501(c)(9)–5 Voluntary employees' beneficiary associations; recordkeeping requirements.

(a) *Records*. In addition to such other records which may be required (for example, by section 512(a)(3) and the regulations thereunder), every organization described in section 501(c)(9) must maintain records indicating the amount contributed by each member and contributing employer, and the amount and type of benefits paid by the organization to or on behalf of each member.

(b) *Cross reference*. For provisions relating to annual information returns with respect to payments, see section 6041 and the regulations thereunder.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§ 1.501(c)(9)–6 Voluntary employees' beneficiary associations; benefits includible in gross income.

(a) *In general*. Cash and noncash benefits realized by a person on account of the activities of an organization described in section 501(c)(9) shall be included in gross income to the extent provided in the Internal Revenue Code of 1954, including, but not limited to, sections 61, 72, 101, 104 and 105 of the Code and regulations thereunder.

(b) *Availability of statutory exclusions from gross income*. The availability of any statutory exclusion from gross income with respect to contributions to, or the payment of benefits from, an organization described in section 501(c)(9) is determined by the statutory provision conferring the exclusion, and the regulations and rulings thereunder, not by whether an individual is eligible for membership in the organization or by the permissibility of the benefit paid. Thus, for example, if a benefit is paid by an employer-funded organization described in section 501(c)(9) to a member who is not an *employee*, a statutory exclusion from gross income that is available only for *employees* would be unavailable in the case of a benefit paid to such individual. Similarly, the fact that, for example, under some circumstances educational benefits constitute *other benefits* does not of itself mean that such benefits are eligible for the exclusion of either section 117 or section 127 of the Code.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§ 1.501(c)(9)–7 Voluntary employees' beneficiary associations; section 3(4) of ERISA.

The term *voluntary employees' beneficiary association* in section 501(c)(9) of the Internal Revenue Code is not necessarily coextensive with the term *employees' beneficiary association* as used in section 3(4) of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1002(4), and the requirements which an organization must meet to be an *employees' beneficiary association* within the meaning of section 3(4) of ERISA are not necessarily identical to the requirements that an organization must meet in order to be a *voluntary employees' beneficiary association* within the meaning of section 501(c)(9) of the Code.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§ 1.501(c)(9)–8 Voluntary employees' beneficiary associations; effective date.

(a) *General rule*. Except as otherwise provided in this section, the provisions

of §§ 1.501(c)(9)–1 through 1.501(c)(9)–7 shall apply with respect to taxable years beginning after December 31, 1954.

(b) *Pre-1970 taxable years.* For taxable years beginning before January 1, 1970, section 501(c)(9)(B) (relating to the requirement that 85 percent or more of the association's income consist of amounts collected from members and contributed by employers), as in effect for such years, shall apply.

(c) *Existing associations.* Except as otherwise provided in paragraph (d), the provisions of § 1.501(c)(9)–2(a)(1) and (c)(3) shall apply with respect to taxable years beginning after December 31, 1980.

(d) *Collectively-bargained plans.* In the case of a voluntary employees' beneficiary association which receives contributions from one or more employers pursuant to one or more collective bargaining agreements in effect on December 31, 1980, the provisions of §§ 1.501(c)(9)–1 through 1.501(c)(9)–5 shall apply with respect to taxable years beginning after the date on which the agreement terminates (determined without regard to any extension thereof agreed to after December 31, 1980).

(e) *Election.* Notwithstanding paragraphs (c) and (d) of this section, an organization may choose to be subject to all or a portion of one or more of the provisions of these regulations for any taxable year beginning after December 31, 1954.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981; 46 FR 11971, Feb. 12, 1981]

§ 1.501(c)(10)–1 Certain fraternal beneficiary societies.

(a) For taxable years beginning after December 31, 1969, an organization will qualify for exemption under section 501(c)(10) if it:

(1) Is a domestic fraternal beneficiary society order, or association, described in section 501(c)(8) and the regulations thereunder except that it does not provide for the payment of life, sick, accident, or other benefits to its members, and

(2) Devotes its net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes

Any organization described in section 501(c)(7), such as, for example, a national college fraternity, is not described in section 501(c)(10) and this section.

[T.D. 7172, 37 FR 5618, Mar. 17, 1972]

§ 1.501(c)(12)–1 Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.

(a) An organization described in section 501(c)(12) must receive at least 85 percent of its income from amounts collected from members for the sole purpose of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

(b) The phrase *of a purely local character* applies to benevolent life insurance associations, and not to the other organizations specified in section 501(c)(12). It also applies to any organization seeking exemption on the ground that it is an organization similar to a benevolent life insurance association. An organization of a purely local character is one whose business activities are confined to a particular community, place, or district, irrespective, however, of political subdivisions. If the activities of an organization are limited only by the borders of a State it cannot be considered to be purely local in character.

(c) For taxable years of a mutual or cooperative telephone company beginning after December 31, 1974, the 85 percent member-income test described in paragraph (a) of this section is applied without taking into account income received or accrued from another telephone company for the performance of communication services involving the completion of long distance calls to,

from, or between members of the mutual or cooperative telephone company. For example, if, in one year, a cooperative telephone company receives $85x from its members for telephone calls, $15x as interest income, and $20x as credits under long distance interconnection agreements with other telephone companies for the performance of communication services involving the completion of long distance calls to, from, or between the cooperative's members (whether or not the credits may be offset, in whole or in part, by amounts due the other companies under the interconnection agreements), the member-income fraction is calculated without taking into account, either in the numerator or denominator, the $20x credits received from the other telephone companies. In this example, the 85 percent member-income test is satisfied because at least 85 percent

$$\frac{\text{member income}}{\text{total income}} = \frac{85x}{85x + 15x} = \frac{85}{100} = 85\%$$

of the cooperative's total income is derived from member income.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended at 44 FR 59523, Oct. 16, 1979]

§ 1.501(c)(13)–1 Cemetery companies and crematoria.

(a) *Nonprofit mutual cemetery companies.* A nonprofit cemetery company may be entitled to exemption if it is owned by and operated exclusively for the benefit of its lot owners who hold such lots for bona fide burial purposes and not for the purpose of fesale. A mutual cemetery company which also engages in charitable activities, such as burial of paupers, will be regarded as operating in conformity with this standard. Further, the fact that a mutual cemetery company limits its membership to a particular class of individuals, such as members of a family, will not affect its status as mutual so long as all the other requirements of section 501(c)(13) are met.

(b) *Nonprofit cemetery companies and crematoria.* Any nonprofit corporation, chartered solely for the purpose of the burial, or (for taxable years beginning after December 31, 1970) the cremation of bodies, and not permitted by its charter to engage in any business not necessarily incident to that purpose, is exempt from income tax, provided that no part of its net earnings inures to the benefit of any private shareholder or individual.

(c) *Preferred stock*—(1) *In general.* Except as provided in subparagraph (3) of this paragraph, a cemetery company or crematorium is not described in section 501(c)(13) if it issues preferred stock on or after November 28, 1978.

(2) *Transitional rule for preferred stock issued prior to November 28, 1978.* In the case of preferred stock issued prior to November 28, 1978, a cemetery company or crematorium which issued such stock shall not fail to be exempt from income tax solely because it issued preferred stock which entitled the holders to dividends at a fixed rate, not exceeding the legal rage of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, if its articles of incorporation require:

(i) That the preferred stock be retired at par as rapidly as funds therefor become available from operations, and

(ii) That all funds not required for the payment of dividends upon or for the retirement of preferred stock be used by the company for the care and inprovement of the cemetery property. The term *legal rate of interest* shall mean the rate of interest prescribed by law in the State of incorporation which prevails in the absence of an agreement between contracting parties fixing a rate.

(3) *Transitional rule for preferred stock issued on or after November 28, 1978.* In the case of preferred stok issued on or after November 28, 1978, a cemetery company or crematorium shall not fail to be exempt from income tax if its articles of incorporation and the preferred stock meet the requirements of paragraph (c)(2) and if such stock is issued pursuant to a plan which has been reduced to writing and adopted prior to November 28, 1978. The adoption of the plan must be shown by the acts of the duly constituted responsible officers and appear upon the official records of the cemetery company or crematorium.

(d) *Sales to exempt cemetery companies and crematoria.* Except as provided in paragraph (c)(2) or (c)(3) of this section (relating to transitional rules for preferred stock), no person may have any interest in the net earnings of a tax-exempt cemetery company or crematorium. Thus, a cemetery company or crematorium is not exempt from tax if property is transferred to such organization in exchange for an interest in the net earnings of the organization so long as such interest remains outstanding. An interest in a cemetery company or crematorium that constitutes an equity interest within the meaning of section 385 will be considered an interest in the net earnings of the cemetery. However, an interest in a cemetery company or crematorium that does not constitute an equity interest within the meaning of section 385 may nevertheless constitute an interest in the net earning of the organization. Thus, for example, a bond or other evidence of indebtedness issued by a cemetery company or crematorium which provides for a fixed rate of interest but which, in addition, provides for additional interest payments contingent upon the revenues or income of the organization is considered an interest in the net earnings of the organization. Similarly, a convertible debt obligation issued by a cemetery company or crematorium after July 7, 1975, is considered an interest in the net earnings of the organization.

[T.D. 7698, 45 FR 33972, May 21, 1980]

§ 1.501(c)(14)–1 Credit unions and mutual insurance funds.

Credit unions (other than Federal credit unions described in section 501(c)(1)) without capital stock, organized and operated for mutual purposes and without profit, are exempt from tax under section 501(a). Corporations or associations without capital stock organized before September 1, 1951 and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of, shares or deposits in:

(a) Domestic building and loan associations as defined in section 7701(a)(19),

(b) Cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(c) Mutual savings banks not having capital stock represented by shares

are also exempt from tax under section 501(a). In addition, corporations or associations of the type described in the preceding sentence which were organized on or after September 1, 1951, but before September 1, 1957, are exempt from tax under section 501(a) for taxable years beginning after December 31, 1959.

[T.D. 6493, 25 FR 9219, Sept. 27, 1960]

§ 1.501(c)(15)–1 Mutual insurance companies or associations.

(a) *Taxable years beginning after December 31, 1962.* An insurance company or association described in section 501(c)(15) is exempt under section 501(a) if it is a mutual company or association (other than life or marine) or if it is a mutual interinsurer or reciprocal underwriter (other than life or marine) and if the gross amount received during the taxable year from the sum of the following items does not exceed $150,000:

(1) The gross amount of income during the taxable year from:

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and the regulations thereunder.

(ii) Dividends, as described in § 1.61–9.

(iii) Rents and royalties, as described in § 1.61–8.

(iv) The entering into of any lease, mortgage, or other instrument or agreement from which the company may derive interest, rents, or royalties.

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph.

(2) The gross income from any trade or business (other than an insurance business) carried on by the company or association, or by a partnership of which the company or association is a partner.

(3) Premiums (including deposits and assessments).

(b) *Taxable years beginning after December 31, 1954, and before January 1, 1963.* An insurance company or association described in section 501(c)(15) and paragraph (a) of this section is exempt under section 501(a) if the gross amount received during the taxable year from the sum of the items described in paragraph (a) (1), (2), and (3) of this section does not exceed $75,000.

(c) *No double inclusion of income.* In computing the gross income from any trade or business (other than an insurance business) carried on by the company or association, or by a partnership of which the company or association is a partner, any item described in section 822(b)(1) (A), (B), or (C) and paragraph (a)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business, but shall be taken into account under section 822(b)(1) (A), (B), or (C) and paragraph (a)(1) of this section.

(d) *Taxable years beginning after December 31, 1953, and before January 1, 1955.* An insurance company or association described in section 501(c)(15) is exempt under section 501(a) if it is a mutual company or association (other than life or marine) or if it is a mutual interinsurer or reciprocal underwriter (other than life or marine) and if the gross amount received during the taxable year from the sum of the following items does not exceed $75,000:

(1) The gross amount of income during the taxable year from—

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and § 1.822–3.

(ii) Dividends, as described in § 1.61–9.

(iii) Rents (but excluding royalties), as described in § 1.61–8.

(2) Premiums (including deposits and assessments).

(e) *Exclusion of capital gains.* Gains from sales or exchanges of capital assets to the extent provided in subchapter P (section 1201 and following, relating to capital gains and losses), chapter 1 of the Code, shall be excluded from the amounts described in this section.

[T.D. 6662, 28 FR 6972, July 29, 1963]

§ 1.501(c)(16)–1 Corporations organized to finance crop operations.

A corporation organized by a farmers' cooperative marketing or purchasing association, or the members thereof, for the purpose of financing the ordinary crop operations of such members or other producers is exempt, provided the marketing or purchasing association is exempt under section 521 and the financing corporation is operated in conjunction with the marketing or purchasing association. The provisions of § 1.521–1 relating to a reserve or surplus and to capital stock shall also apply to corporations coming under this section.

§ 1.501(c)(17)–1 Supplemental unemployment benefit trusts.

(a) *Requirements for qualification.* (1) A supplemental unemployment benefit trust may be exempt as an organization described in section 501(c)(17) if the requirements of subparagraphs (2) through (6) of this paragraph are satisfied.

(2) The trust is a valid, existing trust under local law and is evidenced by an executed written document.

(3) The trust is part of a written plan established and maintained by an employer, his employees, or both the employer and his employees, solely for the purpose of providing supplemental unemployment compensation benefits (as defined in section 501(c)(17)(D) and paragraph (b)(1) of § 1.501(c)(17)–1).

(4) The trust is part of a plan which provides that the corpus and income of the trust cannot (in the taxable year, and at any time thereafter, before the satisfaction of all liabilities to employees covered by the plan) be used for, or diverted to, any purpose other than the providing of supplemental unemployment compensation benefits. Thus, if the plan provides for the payment of any benefits other than supplemental unemployment compensation benefits as defined in paragraph (b) of this section, the trust will not be entitled to exemption as an organization described in section 501(c)(17). However, the payment of any necessary or appropriate expenses in connection with the administration of a plan providing supplemental unemployment compensation benefits shall be considered a payment

to provide such benefits and shall not affect the qualification of the trust.

(5) The trust is part of a plan whose eligibility conditions and benefits do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. See sections 401(a)(3)(B) and 401(a)(4) and §§ 1.401–3 and 1.401–4. However, a plan is not discriminatory within the meaning of section 501(c)(17)(A)(iii), relating to the requirement that the benefits paid under the plan be nondiscriminatory, merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan. Accordingly, the benefits provided for highly paid employees may be greater than the benefits provided for lower paid employees if the benefits are determined by reference to their compensation; but, in such a case, the plan will not qualify if the benefits paid to the higher paid employees bear a larger ratio to their compensation than the benefits paid to the lower paid employees bear to their compensation. In addition, section 501(c)(17)(B) sets forth certain other instances in which a plan will not be considered discriminatory (see paragraph (c) of § 1.501(c)(17)–2).

(6) The trust is part of a plan which requires that benefits are to be determined according to objective standards. Thus, a plan may provide similarly situated employees with benefits which differ in kind and amount, but may not permit such benefits to be determined solely in the discretion of the trustees.

(b) *Meaning of terms*. The following terms are defined for purposes of section 501(c)(17):

(1) *Supplemental unemployment compensation benefits*. The term *supplemental unemployment compensation benefits* means only:

(i) Benefits paid to an employee because of his involuntary separation from the employment of the employer, whether or not such separation is temporary, but only when such separation is one resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions; and

(ii) Sick and accident benefits subordinate to the benefits described in subdivision (i) of this subparagraph.

(2) *Employee*. The term *employee* means an individual whose status is that of an employee under the usual common-law rules applicable in determining the employer-employee relationship. The term *employee* also includes an individual who qualifies as an *employee* under the State or Federal unemployment compensation law covering his employment, whether or not such an individual could qualify as an employee under such common-law rules.

(3) *Involuntary separation from the employment of the employer*. Whether a *separation from the employment of the employer* occurs is a question to be decided with regard to all the facts and circumstances. However, for purposes of section 501(c)(17), the term *separation* includes both a temporary separation and a permanent severance of the employment relationship. Thus, for example, an employee may be separated from the employment of his employer even though at the time of separation it is believed that he will be reemployed by the same employer. Whether or not an employee is *involuntarily* separated from the employment of the employer is a question of fact. However, normally, an employee will not be deemed to have separated himself voluntarily from the employment of his employer merely because his collective bargaining agreement provides for the termination of his services upon the happening of a condition subsequent and that condition does in fact occur. For example, if the collective bargaining agreement provides that the employer may automate a given department and thereby dislocate several employees, the fact that the employees' collective bargaining agent has consented to such a condition will not render any employee's subsequent unemployment for such cause voluntary.

(4) *Other similar conditions*. Involuntary separation directly resulting from *other similar conditions* includes, for example, involuntary separation from the employment of the employer resulting

from cyclical, seasonal, or technological causes. Some causes of involuntary separation from the employment of the employer which are not similar to those enumerated in section 501(c)(17)(D)(i) are separation for disciplinary reasons or separation because of age.

(5) *Subordinate sick and accident benefits.* In general, a sick and accident benefit payment is an amount paid to an employee in the event of his illness or personal injury (whether or not such illness or injury results in the employee's separation from the service of his employer). In addition, the phrase *sick and accident benefits* includes amounts provided under the plan to reimburse an employee for amounts he expends because of the illness or injury of his spouse or a dependent (as defined in section 152). Sick and accident benefits may be paid by a trust described in section 501(c)(17) only if such benefits are subordinate to the separation payments provided under the plan of which the trust forms a part. Whether the sick and accident benefits provided under a supplemental unemployment compensation benefit plan are subordinate to the separation benefits provided under such plan is a question to be decided with regard to all the facts and circumstances.

[T.D. 6972, 33 FR 12900, Sept. 12, 1968]

§ 1.501(c)(17)–2 General rules.

(a) *Supplemental unemployment compensation benefits.* Supplemental unemployment compensation benefits as defined in section 501(c)(17)(D) and paragraph (b)(1) of § 1.501(c)(17)–1 may be paid in a lump sum or installments. Such benefits may be paid to an employee who has, subsequent to his separation from the employment of the employer, obtained other part-time, temporary, or permanent employment. Furthermore, such payments may be made in cash, services, or property. Thus, supplemental unemployment compensation benefits provided to involuntarily separated employees may include, for example, the following: Furnishing of medical care at an established clinic, furnishing of food, job training and schooling, and job counseling. If such benefits are furnished in services or property, the fair market value of the benefits must satisfy the requirements of section 501(c)(17)(A)(iii), relating to nondiscrimination as to benefits. However, supplemental unemployment compensation benefits may be provided only to an employee and only under circumstances described in paragraph (b)(1) of § 1.501(c)(17)–1. Thus, a trust described in section 501(c)(17) may not provide, for example, for the payment of a death, vacation, or retirement benefit.

(b) *Sick and accident benefits.* If a trust described in section 501(c)(17) provides for the payment of sick and accident benefits, such benefits may only be provided for employees who are eligible for receipt of separation benefits under the plan of which the trust is a part. However, the sick and accident benefits need not be provided for all the employees who are eligible for receipt of separation benefits, so long as the plan does not discriminate in favor of persons with respect to whom discrimination is proscribed in section 501(c)(17)(A) (ii) and (iii). Furthermore, the portion of the plan which provides for the payment of sick and accident benefits must satisfy the nondiscrimination requirements of section 501(c)(17)(A) (ii) and (iii) without regard to the portion of the plan which provides for the payment of benefits because of involuntary separation.

(c) *Correlation with other plans.* (1) In determining whether a plan meets the requirements of section 501(c)(17)(A) (ii) and (iii), any benefits provided under any other plan shall not be taken into consideration except in the particular instances enumerated in section 501(c)(17)(B) (i), (ii), and (iii). In general, these three exceptions permit a plan providing for the payment of supplemental unemployment compensation benefits to satisfy the nondiscrimination requirements in section 501(c)(17)(A) (ii) and (iii) if the plan is able to satisfy such requirements when it is correlated with one or more of the plans described in section 501(c)(17)(B).

(2) Under section 501(c)(17)(B)(i), a plan will not be considered discriminatory merely because the benefits under the plan which are first determined in a nondiscriminatory manner (within the meaning of section 501(c)(17)(A))

are then reduced by any sick, accident, or unemployment compensation benefits received under State or Federal law, or are reduced by a portion of these benefits if determined in a nondiscriminatory manner. Under this exception, a plan may, for example, satisfy the requirements of section 501(c)(17)(A)(iii) if it provides for the payment of an unemployment benefit and the amount of such benefit is determined as a percentage of the employee's compensation which is then reduced by any unemployment benefit which the employee receives under a State plan. In addition, a plan could provide for the reduction of such a plan benefit by a percentage of the State benefit. Furthermore, a plan may also satisfy the requirements of section 501(c)(17)(A) if it provides for the payment to an employee of an amount which when added to any State unemployment benefit equals a percentage of the employee's compensation.

(3) Under section 501(c)(17)(B)(ii), a plan will not be considered discriminatory merely because the plan provides benefits only for employees who are not eligible to receive sick, accident, or unemployment compensation benefits under State or Federal law. In such a case, however, the benefits provided under the plan seeking to satisfy the requirements of section 501(c)(17) must be the same benefits, or a portion of the same benefits if determined in a nondiscriminatory manner, which such ineligible employees would receive under State or Federal law if they were eligible for such benefits. Under this exception, for example, an employer may establish a plan only for employees who have exhausted their benefits under the State law, and, if the plan provides for such employees the same benefits which they would receive under the State plan, the State plan and the plan of the employer will be considered as one plan in determining whether the requirements relating to nondiscrimination in section 501(c)(17)(A) are satisfied. Furthermore, such a plan could also qualify even though it does not provide all of the benefits provided under the State plan. Thus, a plan could provide for the payment of a reduced amount of the benefits, or for the payment of only certain of the types of benefits, provided by the State plan. For example, if the State plan provides for the payment of sick, accident, and separation benefits, the plan of the employer may provide for the payment of only separation benefits, or for the payment of an amount equal to only one-half of the State provided benefit. However, if a plan provides benefits for employees who are not eligible to receive the benefits provided under a State plan and such benefits are greater or of a different type than those under the State plan, the plan of the employer must satisfy the requirements of section 501(c)(17)(A) without regard to the benefits and coverage provided by the State plan.

(4) Under section 501(c)(17)(B)(iii), a plan is not considered discriminatory merely because the plan provides benefits only for employees who are not eligible to receive benefits under another plan which satisfies the requirements of section 501(c)(17)(A) and which is funded solely by contributions of the employer. In such a case, the plan seeking to qualify under section 501(c)(17) must provide the same benefits, or a portion of such benefits if determined in a nondiscriminatory manner, as are provided for the employees under the plan funded solely by employer contributions. Furthermore, this exception only applies if the employees eligible to receive benefits under both plans would satisfy the requirements in section 501(c)(17)(A)(ii), relating to nondiscrimination as to coverage. The plan of the employer which is being correlated with the plan seeking to satisfy the requirements of section 501(c)(17) may be a plan which forms part of a voluntary employees' beneficiary association described in section 501(c)(9), if such plan satisfies all the requirements of section 501(c)(17)(A). Under this exception, for example, if an employer has established a plan providing for the payment of supplemental unemployment compensation benefits for his hourly wage employees and such plan satisfies the requirements of section 501(c)(17)(A) (even though the plan forms part of a voluntary employees' beneficiary association described in section 501(c)(9)),

the salaried employees of such employee may establish a plan for themselves, and, if such plan provides for the same benefits as the plan covering hourly-wage employees, both plans may be considered as one plan in determining whether the plan covering the salaried employees satisfies the requirement that is be nondiscriminatory as to coverage. The foregoing example would also be applicable if the benefits provided for the salaried employees were funded solely or in part by employer contributions.

(d) *Permanency of the plan.* A plan providing for the payment of supplemental unemployment compensation benefits contemplates a permanent as distinguished from a temporary program. Thus, although there may be reserved the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the purpose of providing supplemental unemployment compensation benefits to employees. Whether or not a particular plan constitutes a permanent arrangement will be determined by all of the surrounding facts and circumstances. However, merely because a collective bargaining agreement provides that a plan may be modified at the termination of such agreement, or that particular provisions of the plan are subject to renegotiation during the duration of such agreement, does not necessarily imply that the plan is not a permanent arrangement. Moreover, the fact that the plan provides that the assets remaining in the trust after the satisfaction of all liabilities (including contingent liabilities) under the plan may be returned to the employer does not imply that the plan is not a permanent arrangement nor preclude the trust from qualifying under section 501(c)(17).

(e) *Portions of years.* A plan must satisfy the requirements of section 501(c)(17) throughout the entire taxable year of the trust in order for the trust to be exempt for such year. However, section 501(c)(17)(C) provides that a plan will satisfy the nondiscrimination as to classification requirements of section 501(c)(17)(A) if on at least one day in each quarter of the taxable year of the trust it satisfies such requirements.

(f) *Several trusts constituting one plan.* Several trusts may be designated as constituting part of one plan which is intended to satisfy the requirements of section 501(c)(17), in which case all of such trusts taken as a whole must meet the requirements of such section. The fact that a combination of trusts fails to satisfy the requirements of section 501(c)(17) as one plan does not prevent such of the trusts as satisfy the requirements of section 501(c)(17) from qualifying for exemption under that section.

(g) *Plan of several employers.* A trust forming part of a plan of several employers, or the employees of several employers, will be a supplemental unemployment benefit trust described in section 501(c)(17) if all the requirements of that section are otherwise satisfied.

(h) *Investment of trust funds.* No specific limitations are provided in section 501(c)(17) with respect to investments which may be made by the trustees of a trust qualifying under that section. Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law. However, the tax-exempt status of the trust will be forfeited if the investments made by the trustees constitute *prohibited transactions* within the meaning of section 503. See section 503 and the regulations thereunder. In addition, such a trust will be subject to tax under section 511 with respect to any *unrelated business taxable income* (as defined in section 512) realized by it from its investments. See sections 511 to 515, inclusive, and the regulations thereunder.

(i) *Allocations.* If a plan which provides sick and accident benefits is financed solely by employer contributions to the trust, and such sick and accident benefits are funded by payment of premiums on an accident or health insurance policy (whether on a group or individual basis) or by contributions to a separate fund which pays such sick and accident benefits,

the plan must specify that portion of the contributions to be used to fund such benefits. If a plan which is financed in whole or in part by employee contributions provides sick and accident benefits, the plan must specify the portion, if any, of employee contributions allocated to the cost of funding such benefits, and must allocate the cost of funding such benefits between employer contributions and employee contributions.

(j) *Required records and returns.* Every trust described in section 501(c)(17) must maintain records indicating the amount of separation benefits and sick and accident benefits which have been provided to each employee. If a plan is financed, in whole or in part, by employee contributions to the trust, the trust must maintain records indicating the amount of each employee's total contributions allocable to separation benefits. In addition, every trust described in section 501(c)(17) which makes one or more payments totaling $600 or more in 1 year to an individual must file an annual information return in the manner described in paragraph (b)(1) of § 1.6041–2. However, if the payments from such trust are subject to income tax withholding under section 3402(o) and the regulations thereunder, the trust must file, in lieu of such annual information return, the returns of income tax withheld from wages required by section 6011 and the regulations thereunder. In such circumstances, the trust must also furnish the statements to the recipients of trust distributions required by section 6051 and the regulations thereunder.

[T.D. 6972, 33 FR 12901, Sept. 12, 1968, as amended by T.D. 7068, 35 FR 17328, Nov. 11, 1970]

§ 1.501(c)(17)–3 Relation to other sections of the Code.

(a) *Taxability of benefit distributions*—(1) *Separation benefits.* If the separation benefits described in section 501(c)(17)(D)(i) are funded entirely by employer contributions, then the full amount of any separation benefit payment received by an employee is includible in his gross income under section 61(a). If any such separation benefit is funded by both employer and employee contributions, or solely by employee contributions, the amount of any separation benefit payment which is includible in the gross income of the employee is the amount by which such distribution and any prior distributions of such separation payments exceeds the employee's total contributions to fund such separation benefits.

(2) *Sick and accident benefits.* Any benefit payment received from the trust under the part of the plan, if any, which provides for the payment of sick and accident benefits must be included in gross income under section 61(a), unless specifically excluded under section 104 or 105 and the regulations thereunder. See section 105(b) and § 1.105–2 for benefit payments expended for medical care, benefit payments in excess of actual medical expenses, and benefit payments which an employee is entitled to receive irrespective of whether or not he incurs expenses for medical care. See section 213 and § 1.213–1(g) for benefit payments representing reimbursement for medical expenses paid in prior years. See § 1.501(c)(17)–2(i) for the requirement that a trust described in section 501(c)(17) which receives employee contributions must be part of a written plan which provides for the allocation of the cost of funding sick and accident benefits.

(b) *Exemption as a voluntary employees' beneficiary association.* Section 501(c)(17)(E) contemplates that a trust forming part of a plan providing for the payment of supplemental unemployment compensation benefits may, if it qualifies, apply for exemption from income tax under section 501(a) either as a voluntary employees' beneficiary association described in section 501(c)(9) or as a trust described in section 501(c)(17).

(c) *Returns.* A trust which is described in section 501(c)(17) and which is exempt from tax under section 501(a) must file a return in accordance with section 6033 and the regulations thereunder. If such a trust realizes any unrelated business taxable income, as defined in section 512, the trust is also required to file a return with respect to such income.

(d) *Effective date.* Section 501(c)(17) shall apply to taxable years beginning after December 31, 1959, and shall apply to supplemental unemployment benefit

trusts regardless of when created or organized.

[T.D. 6972, 33 FR 12902, Sept. 12, 1968]

§ 1.501(c)(18)–1 Certain funded pension trusts.

(a) *In general*. Organizations described in section 501(c)(18) are trusts created before June 25, 1959, forming part of a plan for the payment of benefits under a pension plan funded only by contributions of employees. In order to be exempt, such trusts must also meet the requirements set forth in section 501(c)(18) (A), (B), and (C), and in paragraph (b) of this section.

(b) *Requirements for qualification*. A trust described in section 501(c)(18) must meet the following requirements:

(1) *Local law*. The trust must be a valid, existing trust under local law, and must be evidenced by an executed written document.

(2) *Funding*. The trust must be funded solely from contributions of employees who are members of the plan. For purposes of this section, the term *contributions of employees* shall include earnings on, and gains derived from, the assets of the trust which were contributed by employees.

(3) *Creation before June 25, 1959*—(i) *In general*. The trust must have been created before June 25, 1959. A trust created before June 25, 1959 is described in section 501(c)(18) and this section even though changes in the makeup of the trust have occurred since that time so long as these are not fundamental changes in the character of the trust or in the character of the beneficiaries of the trust. Increases in the beneficiaries of the trust by the addition of employees in the same or related industries, whether such additions are of individuals or of units (such as local units of a union) will generally not be considered a fundamental change in the character of the trust. A merger of a trust created after June 25, 1959 into a trust created before such date is not in itself a fundamental change in the character of the latter trust if the two trusts are for the benefit of employees of the same or related industries.

(ii) *Examples*. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume that trust C, for the benefit of members of participating locals of National Union X, was established in 1950 and adopted by 29 locals before June 25, 1959. The subsequent adoption of trust C by additional locals of National Union X in 1962 will not constitute a fundamental change in the character of trust C, since such subsequent adoption is by employees in a related industry.

Example 2. Assume the facts as stated in example 1, except that in 1965 National Union X merged with National Union Y, whose members are engaged in trades related to those engaged in by X's members. Assume further that trust D, the employee funded pension plan and fund for employees of Y, was subsequently merged into trust C. The merger of trust D into trust C would not in itself constitute a fundamental change in the character of trust C, since both C and D are for the benefit of employees of related industries.

(4) *Payment of benefits*. The trust must provide solely for the payment of pension or retirement benefits to its beneficiaries. For purposes of this section, the term *retirement benefits* is intended to include customary and incidental benefits, such as death benefits within the limits permissible under section 401.

(5) *Diversion*. The trust must be part of a plan which provides that, before the satisfaction of all liabilities to employees covered by the plan, the corpus and income of the trust cannot (within the taxable year and at any time thereafter) be used for, or diverted to, any purpose other than the providing of pension or retirement benefits. Payment of expenses in connection with the administration of a plan providing pension or retirement benefits shall be considered a payment to provide such benefits and shall not affect the qualification of the trust.

(6) *Discrimination*. The trust must be part of a plan whose eligibility conditions and benefits do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. See sections 401(a)(3)(B) and 401(a)(4) and §§ 1.401–3

and 1.401–4. However, a plan is not discriminatory within the meaning of section 501(c)(18) merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan. Accordingly, the benefits provided for highly paid employees may be greater than the benefits provided for lower paid employees if the benefits are determined by reference to their compensation; but, in such a case, the plan will not qualify if the benefits paid to the higher paid employees are a larger portion of compensation than the benefits paid to lower paid employees.

(7) *Objective standards.* The trust must be part of a plan which requires that benefits be determined according to objective standards. Thus, while a plan may provide similarly situated employees with benefits which differ in kind and amount, these benefits may not be determined solely in the discretion of the trustees.

(c) *Effective date.* The provisions of section 501(c)(18) and this section shall apply with respect to taxable years beginning after December 31, 1969.

[T.D. 7172, 37 FR 5618, Mar. 17, 1972]

§ 1.501(c)(19)–1 War veterans organizations.

(a) *In general.* (1) For taxable years beginning after December 31, 1969, a veterans post or organization which is organized in the United States or any of its possessions may be exempt as an organization described in section 501(c)(19) if the requirements of paragraphs (b) and (c) of this section are met and if no part of its net earnings inures to the benefit of any private shareholder or individual. Paragraph (b) of this section contains the membership requirements such a post or organization must meet in order to qualify under section 501(c)(19). Paragraph (c) of this section outlines the purposes, at least one of which such a post or organization must have in order to so qualify.

(2) In addition, an auxiliary unit or society described in paragraph (d) of this section of such a veterans post or organization and a trust or foundation described in paragraph (e) of this section for such post or organization may be exempt as an organization described in section 501(c)(19).

(b) *Membership requirements.* (1) In order to be described in section 501(c)(19) under paragraph (a)(1) of this section, an organization must meet the membership requirements of section 501(c)(19)(B) and this paragraph. There are two requirements that must be met under this paragraph. The first requirement is that at least 75 percent of the members of the organization must be war veterans. For purposes of this section the term *war veterans* means persons, whether or not present members of the United States Armed Forces, who have served in the Armed Forces of the United States during a period of war (including the Korean and Vietnam conflicts).

(2) The second requirement of this paragraph is that at least 97.5 percent of all members of the organization must be described in one or more of the following categories:

(i) War veterans,

(ii) Present or former members of the United States Armed Forces,

(iii) Cadets (including only students in college or university ROTC programs or at Armed Services academies), or

(iv) Spouses, widows, or widowers of individuals referred to in paragraph (b)(2) (i), (ii) or (iii) of this section.

(c) *Exempt purposes.* In addition to the requirements of paragraphs (a)(1) and (b) of this section, in order to be described in section 501(c)(19) under paragraph (a)(1) of this section an organization must be operated exclusively for one or more of the following purposes:

(1) To promote the social welfare of the community as defined in § 1.501(c)(4)–1(a)(2).

(2) To assist disabled and needy war veterans and members of the United States Armed Forces and their dependents, and the widows and orphans of deceased veterans,

(3) To provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States,

(4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors,

(5) To conduct programs for religious, charitable, scientific, literary, or educational purposes,

(6) To sponsor or participate in activities of a patriotic nature,

(7) To provide insurance benefits for their members or dependents of their members or both, or

(8) To provide social and recreational activities for their members.

(d) *Auxiliary units or societies for war veterans organizations.* A unit or society may be exempt as an organization described in section 501(c)(19) and paragraph (a)(2) of this section if it is an auxiliary unit or society of a post or organization of war veterans described in paragraph (a)(1) of this section. A unit or society is an auxiliary unit or society or such a post or organization if it meets the following requirements:

(1) It is affiliated with, and organized in accordance with, the bylaws and regulations formulated by an organization described in paragraph (a)(1) of this section,

(2) At least 75 percent of its members are either war veterans, or spouses of war veterans, or are related to a war veteran within two degrees of consanguinity (i.e., grandparent, brother, sister, grandchild, represent the most distant allowable relationships),

(3) All of its members are either members of an organization described in paragraph (a)(1) of this section, or spouses of a member of such an organization or are related to a member of such an organization, within two degrees of consanguinity, and

(4) No part of its net earnings inures to the benefit of any private shareholder or individual.

(e) *Trusts or foundations.* A trust or foundation may be exempt as an organization described in section 501(c)(19) and paragraph (a)(2) of this section if it is a trust or foundation for a post or organization of war veterans described in paragraph (a)(1) of this section. A trust or foundation is a trust or foundation for such a post or organization if it meets the following requirements:

(1) The trust or foundation is in existence under local law and, if organized for charitable purposes, has a dissolution provision described in § 1.501(c)(3)–1(b)(4).

(2) The corpus or income cannot be diverted or used other than for the funding of a post or organization of war veterans described in paragraph (a)(1) of this section, for section 170(c)(4) purposes, or as an insurance set aside (as defined in § 1.512(a)–4(b)).

(3) The trust income is not unreasonably accumulated and, if the trust or foundation is not an insurance set aside, a substantial portion of the income is in fact distributed to such post or organization or for section 170(c)(4) charitable purposes, and

(4) It is organized exclusively for one or more of those purposes enumerated in paragraph (c) of this section.

[T.D. 7438, 41 FR 44392, Oct. 8, 1976]

§ 1.501(c)(21)–1 Black lung trusts—certain terms.

(a) *Created or organized in the United States.* A trust is not *created or organized in the United States* unless it is maintained at all times as a domestic trust in the United States. For this purpose, section 7701(a)(9) limits the term *United States* to the District of Columbia and States of the United States.

(b) *Insurance company.* The term *insurance company* means an insurance, surety, bonding or other company whose liability for the kinds of claims to which section 501(c)(21)(A)(i) applies is as an insurer or guarantor of the liabilities of another.

(c) *Black Lung Acts.* The term *Black Lung Acts* includes any State law providing compensation for disability or death due to pneumoconiosis even though the State law compensates for other kinds of injuries. In such a case, section 501(c)(21) applies only to the extent that the liability is attributable to disability or death due to pneumoconiosis. For this purpose, the term *pneumoconiosis* has the same meaning as it has under federal law. See 30 U.S.C. 902.

(d) *Insurance exclusively covering such liability.* The term *insurance exclusively covering such liability* includes insurance that covers risk for liabilities in addition to the liabilities to which section 501(c)(21)(A)(i) applies. In such a case, payment for premiums may be made from the trust only to the extent of that portion of the premiums that

has been separately allocated and stated by the insurer as attributable solely to coverage of the liabilities to which section 501(c)(21)(A)(i) applies.

(e) *Administrative and other incidental expenses*. The term *administrative and other incidental expenses* means expenditures that are appropriate and helpful to the trust making them in carrying out the purposes for which its assets may be used under section 501(c)(21)(B). The term includes any exicse tax imposed on the trust under section 4952 (relating to taxes on taxable expenditures) and reasonable expenses, such as legal expenses, incurred by the trust in connection with an assertion against the trust of liability for a taxable expenditure. The term does not include an excise tax imposed on the trustee or on other disqualified persons under section 4951 (relating to taxes on self-dealing) or under section 4953 (relating to tax on excess contributions to black lung benefit trusts) or any expenses incurred in connection with the assertion of these taxes other than expenses that are treated as part of reasonable compensation under section 4951(d)(2)(C). See §§ 53.4941 (d)–2(f)(3) and (d)–3(c) for interpretations of similar provisions under section 4941(d)(2)(E), relating to reasonable compensation for private foundation disqualified persons.

(f) *Public debt securities of the United States*. The term *public debt securities of the United States* means obligations that are taken into consideration for purposes of the public debt limit. See, for example 31 U.S.C. 757b.

(g) *Obligations of a State or local government*. The term *obligations of a State or local government* means the obligations of a State or local governmental unit the interest on which is exempt from tax under section 103(a). See § 1.103–1(a).

(h) *Time or demand deposits*. The term *time or demand deposits* includes checking accounts, savings accounts, certificates of deposit or other time or demand deposits. The term does not include common or collective trust funds such as a common trust fund as defined in section 584.

[44 FR 52197, Sept. 7, 1979]

§ 1.501(c)(21)–2 Same—trust instrument.

As trust does not meet the requirements of section 501(c)(21) if it is not established and maintained pursuant to a written instrument. The trust instrument must definitely and affirmatively prohibit a diversion or use of trust assets that is not permitted under section 501(c)(21)(B) or section 4953(c), whether by operation or natural termination of the trust, by power of revocation or amendment by the happening of a contingency by collateral arrangement, or by any other means. No particular form for the trust instrument is required. A trust may meet the requirements of section 501(c)921) although the trust instrument fails to contain provisions the effects of which are to prohibit acts that are subject to section 4951 (relating to taxes on self-dealing), section 4952 (relating to taxes on taxable expenditures) or the retention of contributions subject to section 4953 (relating to tax on excess contributions to black lung benefit trusts).

[44 FR 52197, Sept. 7, 1979]

§ 1.501(c)(29)–1 CO-OP Health Insurance Issuers.

(a) *Organizations must notify the Commissioner that they are applying for recognition of section 501(c)(29) status*. An organization will not be treated as described in section 501(c)(29) unless the organization has given notice to the Commissioner that it is applying for recognition as an organization described in section 501(c)(29) in the manner prescribed by the Commissioner in published guidance.

(b) *Effective date of recognition of section 501(c)(29) status*. An organization may be recognized as an organization described in section 501(c)(29) as of a date prior to the date of the notice required by paragraph (a) of this section if the notice is given in the manner and within the time prescribed by the Commissioner and the organization's purposes and activities prior to giving such notice were consistent with the requirements for exempt status under section 501(c)(29). However, an organization may not be recognized as an organization described in section

501(c)(29) before the later of its formation or March 23, 2010.

(c) *Effective/applicability date.* Paragraphs (a) and (b) of this section are applicable beginning February 7, 2012.

[T.D. 9709, 80 FR 4793, Jan. 29, 2015]

§ 1.501(d)–1 Religious and apostolic associations or corporations.

(a) Religious or apostolic associations or corporations are described in section 501(d) and are exempt from taxation under section 501(a) if they have a common treasury or community treasury, even though they engage in business for the common benefit of the members, provided each of the members includes (at the time of filing his return) in his gross income his entire pro rata share, whether distributed or not, of the net income of the association or corporation for the taxable year of the association or corporation ending with or during his taxable year. Any amount so included in the gross income of a member shall be treated as a dividend received.

(b) For annual return requirements of organizations described in section 501(d), see section 6033 and paragraph (a)(5) of § 1.6033–1.

§ 1.501(e)–1 Cooperative hospital service organizations.

(a) *General rule.* Section 501(e) is the exclusive and controlling section under which a cooperative hospital service organization can qualify as a charitable organization. A cooperative hospital service organization which meets the requirements of section 501(e) and this section shall be treated as an organization described in section 501(c)(3), exempt from taxation under section 501(a), and referred to in section 170(b)(1)(A) (iii) (relating to percentage limitations on charitable contributions). In order to qualify for tax exempt status, a cooperative hospital service organization must—

(1) Be organized and operated on a cooperative basis,

(2) Perform, on a centralized basis, only one or more specifically enumerated services which, if performed directly by a tax exempt hospital, would constitute activities in the exercise or performance of the purpose or function constituting the basis for its exemption, and

(3) Perform such service or services solely for two or more patron-hospitals as described in paragraph (d) of this section.

(b) *Organized and operated on a cooperative basis*—(1) *In general.* In order to meet the requirements of section 501(e), the organization must be organized and operated on a cooperative basis (whether or not under a specific statute on cooperatives) and must allocate or pay all of its net earnings within 8½ months after the close of the taxable year to its patron-hospitals on the basis of the percentage of its services performed for each patron. To *allocate* its net earnings to its patron-hospitals, the organization must make appropriate bookkeeping entries and provide timely written notice to each patron-hospital disclosing to the patron-hospital the amount allocated to it on the books of the organization. For the recordkeeping requirements of a section 501(e) organization, see § 1.521–1(a)(1).

(2) *Percentage of services defined.* The percentage of services performed for each patron-hospital may be determined on the basis of either the value or the quantity of the services provided by the organization to the patron-hospital, provided such basis is realistic in terms of the actual cost of the services to the organization.

(3) *Retention of net earnings.* Exemption will not be denied a cooperative hospital service organization solely because the organization, instead of paying all net earnings to its patron-hospitals, retains an amount for such purposes as retiring indebtedness, expanding the services of the organization, or for any other necessary purpose and allocates such amounts to its patrons. However, such funds may not be accumulated beyond the reasonably anticipated needs of the organization. See, § 1.537–1(b). Whether there is an improper accumulation of funds depends upon the particular circumstances of each case. Moreover, where an organization retains net earnings for necessary purposes, the organization's records must show each patron's rights and interests in the funds retained. For purposes of this paragraph, the term *net earnings* does not include capital

contributions to the organization and such contributions need not satisfy the allocation or payment requirements.

(4) *Nonpatronage and other income.* An organization described in section 501(e) may, in addition to net earnings, receive membership dues and related membership assessment fees, gifts, grants and income from nonpatronage sources such as investment of retained earnings. However, such an organization cannot be exempt if it engages in any business other than that of providing the specified services, described in paragraph (c), for the specified patron-hospitals, described in paragraph (d). Thus, an organization described in section 501(e) generally cannot have unrelated business taxable income as defined in section 512, although it may earn certain interest, annuities, royalties, and rents which are excluded from unrelated business taxable income because of the modifications contained in sections 512(b) (1), (2) or (3). An organization described in section 501(e) may, however, have debt-financed income which is treated as unrelated business taxable income solely because of the applicability of section 514. In addition, exempt status under section 501(e) will not be affected where rent from personal property leased with real property is treated as unrelated business taxable income under section 512(b)(3)(A)(ii) solely because the rent attributable to the personal property is more than incidental or under section 512(b)(3)(B)(i) solely because the rent attributable to the personal property exceeds 50 percent of the total rent received or accrued under the lease. Exemption will not be affected solely because the determination of the amount of rent depends in whole or in part on the income or profits derived from the property leased. See, section 512(b)(3)(B)(ii). An organization described in section 501(e) may also derive nonpatronage income from sources that are incidental to the conduct of its exempt purposes or functions. For example, income derived from the operation of a cafeteria or vending machines primarily for the convenience of its employees or the disposition of byproducts in substantially the same state they were in on completion of the exempt function (e.g., the sale of silver waste produced in the processing of x-ray film) will not be considered unrelated business taxable income. See, section 513(a)(2) and §1.513–1(d)(4)(ii). The nonpatronage and other income permitted under this subparagraph (4) must be allocated or paid as provided in subparagraph (1) or retained as provided in subparagraph (3).

(5) *Stock ownership*—(i) *Capital stock of organization.* An organization does not meet the requirements of section 501(e) unless all of the organization's outstanding capital stock, if there is such stock, is held solely by its patron-hospitals. However, no amount may be paid as dividends on the capital stock of the organization. For purposes of the preceding sentence, the term *capital stock* includes common stock (whether voting or nonvoting), preferred stock, or any other form evidencing a proprietary interest in the organization.

(ii) *Stock ownership as a condition for obtaining credit.* If by statutory requirement a cooperative hospital service organization must be a shareholder in a United States or state chartered corporation as a condition for obtaining credit from that corporate-lender, the ownership of shares and the payment of dividends thereon will not for such reason be a basis for the denial of exemption to the organization. See, e.g., National Consumer Cooperative Bank, 12 U.S.C. 3001 *et seq.*

(c) *Scope of services*—(1) *Permissible services.* An organization meets the requirements of section 501(e) only if the organization performs, on a centralized basis, one or more of the following services and only such services: data processing, purchasing (including the purchasing and dispensing of drugs and pharmaceuticals to patron-hospitals), warehousing, billing and collection, food, clinical (including radiology), industrial engineering (including the installation, maintenance and repair of biomedical and similar equipment), laboratory, printing, communications, record center, and personnel (including recruitment, selection, testing, training, education and placement of personnel) services. An organization is not described in section 501(e) if, in addition to or instead of one or more of these specified services, the organization performs any other service (other

than services referred to under paragraph (b)(4) that are incidental to the conduct of exempt purposes or functions).

(2) *Illustration*. The provisions of this subparagraph may be illustrated by the following example.

Example. An organization performs industrial engineering services on a cooperative basis solely for patron-hospitals each of which is an organization described in section 501(c)(3) and exempt from taxation under section 501(a). However, in addition to this service, the organization operates laundry services for its patron-hospitals. This cooperative organization does not meet the requirements of this paragraph because it performs laundry services not specified in this paragraph.

(d) *Patron-hospitals*—(1) *Defined*. Section 501(e) only applies if the organization performs its services solely for two or more patron-hospitals each of which is—

(i) An organization described in section 501(c)(3) which is exempt from taxation under section 501(a),

(ii) A constituent part of an organization described in section 501(c)(3) which is exempt from taxation under section 501(a) and which, if organized and operated as a separate entity, would constitute an organization described in section 501(c)(3), or

(iii) Owned and operated by the United States, a State, the District of Columbia, or a possession of the United States, or a political subdivision or an agency or instrumentality of any of the foregoing.

(2) *Business with nonvoting patron-hospitals*. Exemption will not be denied a cooperative hospital service organization solely because the organization (whether organized on a stock or membership basis) transacts business with patron-hospitals which do not have voting rights in the organization and therefore do not participate in the decisions affecting the operation of the organization. Where the organization has both patron-hospitals with voting rights and patron-hospitals without such rights, the organization must provide at least 50 percent of its services to patron-hospitals with voting rights in the organization. Thus, the percentage of services provided to nonvoting patrons may not exceed the percentage of such services provided to voting patrons. A patron-hospital will be deemed to have voting rights in the cooperative hospital service organization if the patron-hospital may vote directly on matters affecting the operation of the organization or if the patron-hospital may vote in the election of cooperative board members. Notwithstanding that an organization may have both voting and nonvoting patron-hospitals, patronage refunds must nevertheless be allocated or paid to all patron-hospitals solely on the basis specified in paragraph (b) of this section.

(3) *Services to other organizations*. An organization does not meet the requirements of section 501(e) if, in addition to performing services for patron-hospitals (entities described in subdivisions (i), (ii) or (iii) of subparagraph (1)), the organization performs any service for any other organization. For example, a cooperative hospital service organization is not exempt if it performs services for convalescent homes for children or the aged, vocational training facilities for the handicapped, educational institutions which do not provide hospital care in their facilities, and proprietary hospitals. However, the provision of the specified services between or among cooperative hospital service organizations meeting the requirements of section 501(e) and this section is permissible. Also permissible is the provision of the specified services to entities which are not patron-hospitals, but only if such services are de minimis and are mandated by a governmental unit as, for example, a condition for licensing.

(e) *Effective dates*. An organization, other than an organization performing clinical services, may meet the requirements of section 501(e) and be a tax exempt organization for taxable years ending after June 28, 1968. An organization performing clinical services may meet the requirements of section 501(e) and be a tax exempt organization for taxable years ending after December 31, 1976. However, pursuant to the authority contained in section 7805(b) of the Internal Revenue Code, these regulations shall not become effective with respect to an organization which has received a ruling or determination

letter from the Internal Revenue Service recognizing its exemption under section 501(e) until January 2, 1987.

[T.D. 8100, 51 FR 31615, Sept. 4, 1986; 51 FR 33593, Sept. 22, 1986]

§ 1.501(h)–1 Application of the *expenditure test* to expenditures to influence legislation; introduction.

(a) *Scope*. (1) There are certain requirements an organization must meet in order to be a *charity* described in section 501(c)(3). Among other things, section 501(c)(3) states that ''no substantial part of the activities of [a charity may consist of] carrying on propaganda, or otherwise attempting to influence legislation, (except as otherwise provided in subsection (h)).'' This requirement is called the *substantial part test*.

(2) Under section 501(h), many public charities may elect the *expenditure test* as a substitute for the substantial part test. The expenditure test is described in section 501(h) and this §1.501(h). A public charity is any charity that is not a private foundation under section 509(a). (Unlike a public charity, a private foundation may not make any lobbying expenditures: If a private foundation does make a lobbying expenditure, it is subject to an excise tax under section 4945). Section 1.501(h)–2 lists which public charities are eligible to make the expenditure test election. Section 1.501(h)–2 also provides information about how a public charity makes and revokes the election to be covered by the expenditure test.

(3) A public charity that makes the election may make lobbying expenditures within specified dollar limits. If an electing public charity's lobbying expenditures are within the dollar limits determined under section 4911(c), the electing public charity will not owe tax under section 4911 nor will it lose its tax exempt status as a charity by virtue of section 501(h). If, however, that electing public charity's lobbying expenditures exceed its section 4911 lobbying limit, the organization is subject to an excise tax on the excess lobbying expenditures. Further, under section 501(h), if an electing public charity's lobbying expenditures normally are more than 150 percent of its section 4911 lobbying limit, the organization will cease to be a charity described in section 501(c)(3).

(4) A public charity that elects the expenditure test may nevertheless lose its tax exempt status if it is an action organization under §1.501(c)(3)–1(c)(3)(iii) or (iv). A public charity that does not elect the expenditure test remains subject to the substantial part test. The substantial part test is applied without regard to the provisions of section 501(h) and 4911 and the related regulations.

(b) *Effective date*. The provisions of §1.501(h)–1 through §1.501(h)–3, are effective for taxable years beginning after August 31, 1990. An election made before August 31, 1990, under the provisions of §7.0(c)(4) or the instructions to Form 5768, will be effective under these regulations without again filing Form 5768.

[T.D. 8308, 55 FR 35588, Aug. 31, 1990]

§ 1.501(h)–2 Electing the expenditure test.

(a) *In general*. The election to be governed by section 501(h) may be made by an eligible organization (as described in paragraph (b) of this section) for any taxable year of the organization beginning after December 31, 1976, other than the first taxable year for which a voluntary revocation of the election is effective (see paragraph (d) of this section). The election is made by filing a completed Form 5768, Election/Revocation of Election by an Eligible Section 501(c)(3) Organization to Make Expenditures to Influence Legislation, with the appropriate Internal Revenue Service Center listed on that form. Under section 501(h)(6), the election is effective with the beginning of the taxable year in which the form is filed. For example, if an eligible organization whose taxable year is the calendar year files Form 5768 on December 31, 1979, the organization is governed by section 501(h) for its taxable year beginning January 1, 1979. Once made, the expenditure test election is effective (without again filing Form 5768) for each succeeding taxable year for which the organization is an eligible organization and which begins before a notice of revocation is filed under paragraph (d) of this section.

(b) *Organizations eligible to elect the expenditure test*—(1) *In general*. For purposes of section 501(h) and the regulations thereunder, an organization is an eligible organization for a taxable year if, for that taxable year, it is—

(i) Described in section 501(c)(3) (determined, in any year for which an election is in effect, without regard to the substantial part test of section 501(c)(3)),

(ii) Described in section 501(h)(4) and paragraph (b)(2) of this section, and

(iii) Not a disqualified organization described in section 501(h)(5) and paragraph (b)(3) of this section.

(2) *Certain organizations listed*. An organization is described in section 501(h)(4) and this paragraph (b)(2) if it is an organization described in—

(i) Section 170(b)(1)(A)(ii) (relating to educational institutions),

(ii) Section 170(b)(1)(A)(iii) (relating to hospitals and medical research organizations),

(iii) Section 170(b)(1)(A)(iv) (relating to organizations supporting government schools),

(iv) Section 170(b)(1)(A)(vi) (relating to organizations publicly supported by charitable contributions),

(v) Section 509(a)(2) (relating to organizations publicly supported by admissions, sales, etc.), or

(vi) Section 509(a)(3) (relating to organizations supporting public charities), except that for purposes of this paragraph (b)(2), section 509(a)(3) shall be applied without regard to the last sentence of section 509(a).

(3) *Disqualified organizations*. An organization is a disqualified organization described in section 501(h)(5) and this paragraph (b)(3) if the organization is—

(i) Described in section 170(b)(1)(A)(i) (relating to churches),

(ii) An integrated auxiliary of a church or of a convention or association of churches see (§ 1.6033–2(g)(5)), or

(iii) Described in section 501(c)(3) and affiliated (within the meaning of § 56.4911–7) with one or more organizations described in paragraph (b)(3) (i) or (ii) of this section.

(4) *Other organizations ineligible to elect*. Under section 501(h)(4), certain organizations, although not disqualified organizations, are not eligible to elect the expenditure test. For example, organizations described in section 509(a)(4) are not listed in section 501(h)(4) and therefore are not eligible to elect. Similarly, private foundations (within the meaning of section 509(a)) are not eligible to elect. For the treatment of expenditures by a private foundation for the purpose of carrying on propaganda, or otherwise attempting, to influence legislation, see § 53.4945–2.

(c) *New organizations*. A newly created organization may submit Form 5768 to elect the expenditure test under section 501(h) before it is determined to be an eligible organization and may submit Form 5768 at the time it submits its application for recognition of exemption (Form 1023). If the newly created organization is determined to be an eligible organization, the election will be effective under the provisions of paragraph (a) of this section, that is, with the beginning of the taxable year in which the Form 5768 is filed by the eligible organization. However, if a newly created organization is determined by the Service not to be an eligible organization, the organization's election will not be effective and the substantial part test will apply from the effective date of its section 501(c)(3) classification.

(d) *Voluntary revocation of expenditure test election*—(1) *Revocation effective*. An organization may voluntarily revoke an expenditure test election by filing a notice of voluntary revocation with the appropriate Internal Revenue Service Center listed on Form 5768. Under section 501(h)(6)(B), a voluntary revocation is effective with the beginning of the first taxable year after the taxable year in which the notice is filed. If an organization voluntarily revokes its election, the substantial part test of section 501(c)(3) will apply with respect to the organization's activities in attempting to influence legislation beginning with the taxable year for which the voluntary revocation is effective.

(2) *Re-election of expenditure test*. If an organization's expenditure test election is voluntarily revoked, the organization may again make the expenditure test election, effective no earlier than for the taxable year following the first taxable year for which the revocation is effective.

(3) *Example*. X, an organization whose taxable year is the calendar year, plans to voluntarily revoke its expenditure test election effective beginning with its taxable year 1985. X must file its notice of voluntary revocation on Form 5768 after December 31, 1983, and before January 1, 1985. If X files a notice of voluntary revocation on December 31, 1984, the revocation is effective beginning with its taxable year 1985. The organization may again elect the expenditure test by filing Form 5768. Under paragraph (d)(2) of this section, the election may not be made for taxable year 1985. Under paragraph (a) of this section, a new expenditure test election will be effective for taxable years beginning with taxable year 1986, if the Form 5768 is filed after December 31, 1985, and before January 1, 1987.

(e) *Involuntary revocation of expenditure test election*. If, while an election by an eligible organization is in effect, the organization ceases to be an eligible organization, its election is automatically revoked. The revocation is effective with the beginning of the first full taxable year for which it is determined that the organization is not an eligible organization. If an organization's expenditure test election is involuntarily revoked under this paragraph (e) but the organization continues to be described in section 501(c)(3), the substantial part test of section 501(c)(3) will apply with respect to the organization's activities in attempting to influence legislation beginning with the first taxable year for which the involuntary revocation is effective.

(f) *Supersession*. This section supersedes § 7.0(c)(4) of the Temporary Income Tax Regulations under the Tax Reform Act of 1976, effective August 31, 1990.

[T.D. 8308, 55 FR 35588, Aug. 31, 1990]

§ 1.501(h)–3 Lobbying or grass roots expenditures normally in excess of ceiling amount.

(a) *Scope*. This section provides rules under section 501(h) for determining whether an organization that has elected the expenditure test and that is not a member of an affiliated group of organizations (as defined in § 56.4911–7(e)) either normally makes lobbying expenditures in excess of its lobbying ceiling amount or normally makes grass roots expenditures in excess of its grass roots ceiling amount. Under section 501(h) and this section, an organization that has elected the expenditure test and that normally makes expenditures in excess of the corresponding ceiling amount will cease to be exempt from tax under section 501(a) as an organization described in section 501(c)(3). For similar rules relating to members of an affiliated group of organizations, see § 56.4911–9.

(b) *Loss of exemption*—(1) *In general*. Under section 501(h)(1), an organization that has elected the expenditure test shall be denied exemption from taxation under section 501(a) as an organization described in section 501(c)(3) for the taxable year following a determination year if—

(i) The sum of the organization's lobbying expenditures for the base years exceeds 150 percent of the sum of its lobbying nontaxable amounts for the base years, or (ii) The sum of the organization's grass roots expenditures for its base years exceeds 150 percent of the sum of its grass roots nontaxable amounts for the base years.

The organization thereafter shall not be exempt from tax under section 501(a) as an organization described in section 501(c)(3) unless, pursuant to paragraph (d) of this section, the organization reapplies for recognition of exemption and is recognized as exempt.

(2) *Special exception for organization's first election*. For the first, second, or third consecutive determination year for which an organization's first expenditure test election is in effect, no determination is required under paragraph (b)(1) of this section, and the organization will not be denied exemption from tax by reason of section 501(h) and this section if, taking into account as base years only those years for which the expenditure test election is in effect—

(i) The sum of the organization's lobbying expenditures for such base years does not exceed 150 percent of the sum of its lobbying nontaxable amounts for the same base years, and

(ii) The sum of the organization's grass roots expenditure for those base years does not exceed 150 percent of the

sum of its grass roots nontaxable amounts for such base years. If an organization does not satisfy the requirements of this paragraph (b)(2), paragraph (b)(1) of this section will apply.

(c) *Definitions*. For purposes of this section—

(1) The term *lobbying expenditures* means lobbying expenditures as defined in section 4911(c)(1) or section 4911(f)(4)(A) and § 56.4911–2(a).

(2) The term *lobbying nontaxable amount* is defined in § 56.4911–1(c)(1).

(3) An organization's *lobbying ceiling amount* is 150 percent of the organization's lobbying nontaxable amount for a taxable year.

(4) The term *grass roots expenditures* means expenditures for grass roots lobbying communications as defined in section 4911(c)(3) or section 4911(f)(4)(A) and §§ 56.4911–2 and 56.4911–3.

(5) The term *grass roots nontaxable amount* is defined in § 56.4911–1(c)(2).

(6) An organization's *grass roots ceiling amount* is 150 percent of the organization's grass roots nontaxable amount for a taxable year.

(7) In general, the term *base years* means the determination year and the three taxable years immediately preceding the determination year. The base years, however, do not include any taxable year preceding the taxable year for which the organization is first treated as described in section 501(c)(3).

(8) A taxable year is a *determination year* if it is a year for which the expenditure test election is in effect, other than the taxable year for which the organization is first treated as described in section 501(c)(3).

(d) *Reapplication for recognition of exemption*—(1) *Time of application*. An organization that is denied exemption from taxation under section 501(a) by reason of section 501(h) and this section may apply on Form 1023 for recognition of exemption as an organization described in section 501(c)(3) for any taxable year following the first taxable year for which exemption is so denied. See paragraphs (d)(2) and (d)(3) of this section for material to be included with an application described in the preceding sentence.

(2) *Section 501(h) calculation*. An application described in paragraph (d)(1) of this section must demonstrate that the organization would not be denied exemption from taxation under section 501(a) by reason of section 501(h) if the expenditure test election has been in effect for all of its last taxable year ending before the application is made by providing the calculations, described either in paragraphs (b)(1) (i) and (ii) of this section or in § 56.4911–9(b), that would have applied to the organization for that year.

(3) *Operations not disqualifying*. An application described in paragraph (d)(1) of this section must include information that demonstrates to the satisfaction of the Commissioner that the organization will not knowingly operate in a manner that would disqualify the organization for tax exemption under section 501(c)(3) by reason of attempting to influence legislation.

(4) *Reelection of expenditure test*. If an organization is denied exemption from tax for a taxable year by reason of section 501(h) and this section, and thereafter is again recognized as an organization described in section 501(c)(3) pursuant to this paragraph (d), it may again elect the expenditure test under section 501(h) in accordance with § 1.501(h)–2(a).

(e) *Examples*. The provisions of this section are illustrated by the following examples, which also illustrate the operation of the tax imposed by section 4911.

Example 1. (1) The following table contains information used in this example concerning organization X.

Year	Exempt purpose expenditures (EPE)	Calculation	Lobbying	
			Nontaxable amount (LNTA)	Lobbying expenditures (LE)
1979	$400,000	(20% of $400,000=)	$80,000	$100,000
1980	300,000	(20% of $300,000=)	60,000	100,000
1981	600,000	(20% of $500,000 + 15% of $100,000=)	115,000	120,000
1982	500,000	(20% of $500,000=)	100,000	100,000

Year	Exempt purpose expenditures (EPE)	Calculation	Lobbying	
			Nontaxable amount (LNTA)	Lobbying expenditures (LE)
Totals	1,800,000	.....	355,000	420,000

(2) Organization X, whose taxable year is the calendar year, was organized in 1971. X first made the expenditure test election under section 501(h) effective for taxable years beginning with 1979 and has not revoked the election. None of X's lobbying expenditures for its taxable years 1979 through 1982 are grass roots expenditures. Under section 4911(a) and § 56.4911–1(a), X must determine for each year for which the expenditure test election is effective whether it is liable for the 25 percent excise tax imposed by section 4911(a) on excess lobbying expenditures. X is liable for this tax for each of its taxable years 1979, 1980, and 1981, because in each year its lobbying expenditures exceeded its lobbying nontaxable amount for the year. For 1979, the tax imposed by section 4911(a) is $5,000 {25% × ($100,000 − $80,000) = $5,000}. For 1980, the tax is $10,000. For 1981, the tax is $1,250.

(3) The taxable years 1979 through 1981 are all determination years under paragraph (c)(8) of this section. On its annual return for determination year 1979, the first year of its first election, X can demonstrate, under paragraph (b)(2) of this section, that its lobbying expenditures during 1979 ($100,000) do not exceed 150 percent of its lobbying nontaxable amount for 1979 ($120,000). For determination year 1980, under paragraph (b)(2), X can demonstrate that the sum of its lobbying expenditures for 1979 and 1980 ($200,000) does not exceed 150 percent of the sum of its lobbying nontaxable amounts for 1979 and 1980 ($210,000). For 1981, under paragraph (b)(2), X can demonstrate that the sum of its lobbying expenditures for 1979, 1980, and 1981 ($320,000) does not exceed 150 percent of the sum of its lobbying nontaxable amounts for 1979, 1980, and 1981 ($382,500). For each of the determination years 1979, 1980, and 1981, the first three years of its first election, X satisfies the requirements of paragraph (b)(2). Accordingly, no determination under paragraph (b)(1) of this section is required for those years, and X is not denied tax exemption by reason of section 501(h).

(4) Under paragraph (b)(1) of this section, X must determine for its determination year 1982 whether it has normally made lobbying expenditures in excess of the lobbying ceiling amount. This determination takes into account expenditures in base years 1979 through 1982. The sum of X's lobbying expenditures for the base years ($420,000) does not exceed 150 percent of the sum of the lobbying nontaxable amounts for the base years (150% × $355,000 = $532,500). Accordingly, X is not denied tax exemption by reason of section 501(h).

Example 2. (1) The following table contains information used in this example concerning W.

Year	Exempt purpose expenditures (EPE) (dollars)	Calculation	Lobbying nontaxable amount (LNTA) (dollars)	Lobbying expenditures (LE) (dollars)	Grass roots nontaxable amount (25 percent of LNTA) (dollars)	Grass roots expenditures (dollars)
1979	700,000	(20% of $500,000 + 15% of $200,000=).	130,000	120,000	32,500	30,000
1980	800,000	(20% of $500,000 + 15% of $300,000=).	145,000	100,000	36,250	60,000
1981	800,000	(20% of $500,000 + 15% of $300,000=).	145,000	100,000	36,250	65,000
1982	900,000	(20% of $500,000 + 15% of $400,000=).	160,000	150,000	40,000	65,000
Total	3,200,000	.....	580,000	470,000	145,000	220,000

(2) Organization W, whose taxable year is the calendar year, made the expenditure test election under section 501(h) effective for taxable years beginning with 1979 and has not revoked the election. W has been treated as an organization described in section 501(c)(3) for each of its taxable years beginning within its taxable year 1974.

(3) Under section 4911(a) and § 56.4911–1(a), W must determine for each year for which the expenditure test election is effective whether it is liable for the 25 percent excise tax imposed by section 4911(a) on excess lobbying expenditures. In 1980, 1981, and 1982, W has excess lobbying expenditures because its grass roots expenditures in each of those

years exceeded its grass roots nontaxable amount for the year. Therefore, W is liable for the excise tax under section 4911(a) for those years. The tax imposed by section 4911(a) for 1980 is $5,937.50 {25% × ($60,000 − $36,250)= $5,937.50}. For 1981, the tax is $7,187.50. For 1982, the tax is $6,250.

(4) On its annual return for its determination years 1979, 1980, and 1981, the first three years of its first election, W demonstrates that it satisfies the requirements of paragraph (b)(2) of this section. Accordingly, no determination under paragraph (b)(1) of this section is required for those years, and W is not denied tax exemption by reason of section 501(h).

(5) On its annual return for its determination year 1982, W must determine under paragraph (b)(1) whether it has normally made lobbying expenditures or grass roots expenditures in excess of the corresponding ceiling amount. This determination takes into account expenditures in base years 1979 through 1982. The sum of W's lobbying expenditures for the base years ($470,000) does not exceed 150% of the sum of W's lobbying nontaxable amounts for those years (150% × $580,000 = $870,000). However, the sum of W's grass roots expenditures for the base years ($220,000) does exceed 150% of the sum of W's grass roots nontaxable amonts for those years (150% × $145,000 = $217,500). Under section 501(h), W is denied tax exemption under section 501(a) as an organization described in section 501(c)(3) for its taxable year 1983. For its taxable year 1984 and any taxable year thereafter, W is exempt from tax as an organization described in section 501(c)(3) only if W applies for recognition of its exempt status under paragraph (d) of this section and is recognized as exempt from tax.

Example 3. (1) The following table contains information used in this example concerning organization Y.

Taxable Year	Exempt purpose expenditures (EPE) (dollars)	Calculation	Lobbying nontaxable amount (LNTA) (dollars)	Lobbying expenditures (LE)(dollars)	Grass roots nontaxable amount (25 percent of LNTA)(dollars)	Grass roots expenditures (dollars)
1977	700,000	(20% of $500,000 + 15% of $200,000=).	130,000	182,000	32,500	30,000
1978	800,000	(20% of $500,000 + 15% of $300,000=).	145,000	224,750	36,250	35,000
Subtotal	1,500,000		275,000	406,750	68,750	65,000
1979	900,000	(20% of $500,000 + 15% of $400,000=).	160,000	264,000	40,000	50,000
Totals:	2,400,000		435,000	670,750	108,750	115,000

(2) Organization Y, whose taxable year is the calendar year, was first treated as an organization described in section 501(c)(3) on February 1, 1977. Y made the expenditure test election under section 501(h) effective for taxable years beginning with 1977 and has not revoked the election.

(3) For 1977, Y has excess lobbying expenditures of $52,000 because its lobbying expenditures ($182,000) exceed its lobbying nontaxable amount ($130,000) for the taxable year. Accordingly, Y is liable for the 25 percent excise tax imposed by section 4911(a). The amount of the tax is $13,000 [25% × ($182,000 − $130,000) = $13,000].

(4) For 1978, Y again has excess lobbying expenditures and is again liable for the 25 percent excise tax imposed by section 4911(a). The amount of the tax is $19,937.50 [25% × ($224,750 − $145,000) = $19,937.50].

(5) For 1979, Y's lobbying expenditures ($264,000) exceed its lobbying nontaxable amount ($160,000) by $104,000, and its grass roots expenditures ($50,000) exceed its grass roots nontaxable amount ($40,000) by $10,000. Under § 56.4911–1(b), Y's excess lobbying expenditures are the greater of $104,000 or $10,000. The amount of the tax, therefore, is $26,000 [25% × $104,000 = $26,000].

(6) Under paragraph (c)(8) of this section, 1977 is not a determination year because it is the first year for which the organization is treated as described in section 501(c)(3). For 1977, Y need not determine whether it has normally made lobbying expenditures or grass roots expenditures in excess of the corresponding ceiling amount for purposes of determining whether it is denied exemption under section 501(h) for its taxable year 1978.

(7) For determination year 1978, Y must determine whether it has normally made lobbying or grass roots expenditures in excess of the corresponding ceiling amount, taking into account expenditures for the base years 1977 and 1978. For Y, the determination under paragraph (b)(2) of this section considers the same base years as the determination under paragraph (b)(1) of this section and is, therefore, redundant. Accordingly, Y proceeds to determine, under (b)(1), whether it is denied exemption. Y's grass roots expenditures for 1977 and 1978 ($65,000) did not exceed 150 percent of the sum of its grass roots nontaxable

amounts for those years ($103,125). Y's lobbying expenditures for 1977 and 1978 ($406,750) did not exceed 150% of its lobbying nontaxable amount for those years (150% × $275,000 = $412,500). Therefore, Y is not denied tax exemption under section 501(h) for its taxable year 1979.

(8) For determination year 1979, the sum of Y's grass roots expenditures in base years 1977, 1978, and 1979 does not exceed 150 percent of its grass roots nontaxable amount (calculation omitted). However, the sum of Y's lobbying expenditures for the base years ($670,750) does exceed 150% of the sum of the lobbying nontaxable amounts for those years (150% × $435,000 = $652,500). Since Y was not described in section 501(c)(3) prior to 1977, only the years 1977, 1978, and 1979 may be considered in determining whether Y has normally made lobbying expenditures in excess of its lobbying ceiling. Therefore, Y determines that it has normally made lobbying expenditures in excess of its lobbying ceiling. Under section 501(h), Y is denied tax exemption under section 501(a) as an organization described in section 501(c)(3) for its taxable year 1980. For its taxable year 1981, and any taxable year thereafter, Y is exempt from tax as an organization described in section 501(c)(3) only if Y applies for recognition of its exempt status under paragraph (d) of this section and is recognized as exempt from tax.

Example 4. Organization M made the expenditure test election under section 501(h) effective for taxable years beginning with 1977 and has not revoked the election. M has $500,000 of exempt purpose expenditures during each of the years 1981 through 1984. In addition, during each of those years, M spends $75,000 for direct lobbying and $25,000 for grass roots lobbying. Since the amount expended for M's lobbying (both total lobbying and grass roots lobbying) is within the respective nontaxable expenditure limitations, M is not liable for the 25 percent excise tax imposed under section 4911(a) upon excess lobbying expenditures, nor is M denied tax-exempt status by reason of section 501 (h).

Example 5. Assume the same facts as in Example 4, except that, on behalf of M, numerous unpaid volunteers conduct substantial lobbying activities with no reimbursement. Since the substantial lobbying activities of the unpaid volunteers are not counted towards the expenditure limitations and the amount expended for M's lobbying is within the respective nontaxable expenditure limitations, M is not liable for the 25 percent excise tax under section 4911, nor is M denied tax-exempt status by reason of section 501(h).

[T.D. 8308, 55 FR 35589, Aug. 31, 1990]

§ 1.501(k)–1 Communist-controlled organizations.

Under section 11(b) of the Internal Security Act of 1950 (50 U.S.C. 790(b)), as amended, which is made applicable to the Code by section 7852(b) of that Code, no organization is entitled to exemption under sections 501(a) or 521(a) for any taxable year if at any time during such year such organization is registered under section 7 of such Act or if there is in effect a final order of the Subversive Activities Control Board established by section 12 of such Act requiring such organization to register under section 7 of such Act, or determining that it is a Communist-infiltrated organization.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; redesignated by T.D. 8100, 51 FR 31615, Sept. 4, 1986]

§ 1.501(r)–0 Outline of regulations.

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[T.D. 9708, 79 FR 78997, Dec. 31, 2014; 80 FR 12762, Mar. 11, 2015]

§ 1.501(r)–1 Definitions.

(a) *Application.* The definitions set forth in this section apply to §§ 1.501(r)–2 through 1.501(r)–7.

(b) *Definitions*—(1) *Amounts generally billed* (*AGB*) means the amounts generally billed for emergency or other medically necessary care to individuals who have insurance covering such care, determined in accordance with § 1.501(r)–5(b).

(2) *AGB percentage* means a percentage of gross charges that a hospital facility uses under § 1.501(r)–5(b)(3) to determine the AGB for any emergency or other medically necessary care it provides to an individual who is eligible for assistance under its financial assistance policy (FAP).

(3) *Application period* means the period during which a hospital facility must accept and process an application for financial assistance under its FAP submitted by an individual in order to have made reasonable efforts to determine whether the individual is FAP-eligible under § 1.501(r)–6(c). A hospital facility may accept and process an individual's FAP application submitted outside of the application period. With respect to any care provided by a hospital facility to an individual, the application period begins on the date the care is provided and ends on the later of the 240th day after the date that the first post-discharge billing statement for the care is provided or either—

(i) In the case of an individual who the hospital facility is notifying as described in § 1.501(r)–6(c)(4), the deadline specified by a written notice described in § 1.501(r)–6(c)(4); or

(ii) In the case of an individual who the hospital facility has presumptively determined to be eligible for less than the most generous assistance available under the FAP as described in § 1.501(r)–6(c)(2), the end of the reasonable period of time described in § 1.501(r)–6(c)(2)(i)(B).

(4) *Authorized body of a hospital facility* means—

(i) The governing body (that is, the board of directors, board of trustees, or equivalent controlling body) of the hospital organization that operates the hospital facility or a committee of, or other party authorized by, that governing body to the extent such committee or other party is permitted under state law to act on behalf of the governing body; or

(ii) The governing body of an entity that is disregarded or treated as a partnership for federal tax purposes that operates the hospital facility or a committee of, or other party authorized by, that governing body to the extent such committee or other party is permitted under state law to act on behalf of the governing body.

(5) *Billing and collections policy* means a written policy that includes all of the elements described in § 1.501(r)–4(b)(4)(i).

(6) *Date provided* means, in the case of any billing statement, written notice, or other written communication that is mailed, the date of mailing. The date that a billing statement, written notice, or other written communication is provided can also be the date such communication is sent electronically or delivered by hand.

(7) *Discharge* means to release from a hospital facility after the care at issue has been provided, regardless of whether that care has been provided on an inpatient or outpatient basis. Thus, a billing statement for care is considered ''post-discharge'' if it is provided to an individual after the care has been provided and the individual has left the hospital facility.

(8) *Disregarded entity* means an entity that is generally disregarded as separate from its owner for federal tax purposes under § 301.7701–3 of this chapter. One example of a disregarded entity is a domestic single member limited liability company that does not elect to be classified as an association taxable as a corporation for federal tax purposes.

(9) *Emergency medical care* means care provided by a hospital facility for emergency medical conditions.

(10) *Emergency medical conditions* means emergency medical conditions as defined in section 1867 of the Social Security Act (42 U.S.C. 1395dd).

(11) *Extraordinary collection action* (*ECA*) means an action described in § 1.501(r)–6(b)(1).

(12) *Financial assistance policy* (*FAP*) means a written policy that meets the requirements described in § 1.501(r)–4(b).

(13) *FAP application* means the information and accompanying documentation that an individual submits to

apply for financial assistance under a hospital facility's FAP. An individual is considered to have submitted a complete FAP application if he or she provides information and documentation sufficient for the hospital facility to determine whether the individual is FAP-eligible and an incomplete FAP application if he or she provides some, but not sufficient, information and documentation to determine FAP-eligibility. The term ''FAP application'' does not refer only to written submissions, and a hospital facility may obtain information from an individual in writing or orally (or a combination of both).

(14) *FAP application form* means the application form (and any accompanying instructions) that a hospital facility makes available for individuals to submit as part of a FAP application.

(15) *FAP-eligible* means eligible for financial assistance under a hospital facility's FAP for care covered by the FAP, without regard to whether an individual has applied for assistance under the FAP.

(16) *Gross charges,* or the *chargemaster rate,* means a hospital facility's full, established price for medical care that the hospital facility consistently and uniformly charges patients before applying any contractual allowances, discounts, or deductions.

(17) *Hospital facility* means a facility that is required by a state to be licensed, registered, or similarly recognized as a hospital. Multiple buildings operated under a single state license are considered to be a single hospital facility. For purposes of this paragraph (b)(17), the term ''state'' includes only the 50 states and the District of Columbia and not any U.S. territory or foreign country. References to a hospital facility taking actions include instances in which the hospital organization operating the hospital facility takes actions through or on behalf of the hospital facility.

(18) *Hospital organization* means an organization recognized (or seeking to be recognized) as described in section 501(c)(3) that operates one or more hospital facilities. If the section 501(c)(3) status of such an organization is revoked, the organization will, for purposes of section 4959, continue to be treated as a hospital organization during the taxable year in which such revocation becomes effective.

(19) *Medicaid* means any medical assistance program administered by the state in which a hospital facility is licensed in accordance with Title XIX of the Social Security Act (42 U.S.C. 1396 through 1396w–5), including programs in which such medical assistance is provided through a contract between the state and a Medicaid managed care organization or a prepaid inpatient health plan.

(20) *Medicare fee-for-service* means health insurance available under Medicare Part A and Part B of Title XVIII of the Social Security Act (42 U.S.C. 1395c through 1395w–5).

(21) *Noncompliant facility income* means income that a hospital organization operating more than one hospital facility derives from a hospital facility that fails to meet one or more of the requirements of section 501(r) during a taxable year as determined in accordance with § 1.501(r)–2(d).

(22) *Operating a hospital facility*—(i) *In general.* Operating a hospital facility includes operating the facility through the organization's own employees or contracting out to another organization to operate the facility. For example, if an organization hires a management company to operate the facility, the hiring organization is considered to operate the facility. An organization also operates a hospital facility if it is the sole member or owner of a disregarded entity that operates the hospital facility. In addition, an organization operates a hospital facility if it owns a capital or profits interest in an entity treated as a partnership for federal tax purposes that operates the hospital facility, unless paragraph (b)(22)(ii) of this section applies. For purposes of this paragraph (b)(22), an organization is considered to own a capital or profits interest in an entity treated as a partnership for federal tax purposes if it owns such an interest directly or indirectly through one or more lower-tier entities treated as partnerships for federal tax purposes.

(ii) *Exception for certain partnerships.* An organization does not operate a hospital facility despite owning a capital or profits interest in an entity

treated as a partnership for federal tax purposes that operates the hospital facility if—

(A) The organization does not have control over the operation of the hospital facility operated by the partnership sufficient to ensure that the operation of the hospital facility furthers an exempt purpose described in section 501(c)(3) and thus treats the operation of the hospital facility, including the facility's provision of medical care, as an unrelated trade or business described in section 513 with respect to the hospital organization; or

(B) At all times since March 23, 2010, the organization has been organized and operated primarily for educational or scientific purposes and has not engaged primarily in the operation of one or more hospital facilities and, pursuant to a partnership agreement entered into before March 23, 2010—

(*1*) Does not own more than 35 percent of the capital or profits interest in the partnership (determined in accordance with section 707(b)(3));

(*2*) Does not own a general partner interest, managing-member interest, or similar interest in the partnership; and

(*3*) Does not have control over the operation of the hospital facility sufficient to ensure that the hospital facility complies with the requirements of section 501(r).

(23) *Partnership agreement* means, for purposes of paragraph (b)(22)(ii)(B) of this section, all written agreements among the partners, or between one or more partners and the partnership, and concerning affairs of the partnership and responsibilities of the partners, whether or not embodied in a document referred to by the partners as the partnership agreement. A partnership agreement also includes any modifications to the agreement agreed to by all partners, or adopted in any other manner provided by the partnership agreement, except for modifications adopted on or after March 23, 2010, that affect whether or not the agreement is described in paragraph (b)(22)(ii)(B) of this section. In addition, a partnership agreement includes provisions of federal, state, or local law that were in effect before March 23, 2010, and continue to be in effect that govern the affairs of the partnership or are considered under such law to be part of the partnership agreement.

(24) *Plain language summary of the FAP* means a written statement that notifies an individual that the hospital facility offers financial assistance under a FAP and provides the following additional information in language that is clear, concise, and easy to understand:

(i) A brief description of the eligibility requirements and assistance offered under the FAP.

(ii) A brief summary of how to apply for assistance under the FAP.

(iii) The direct Web site address (or URL) and physical locations where the individual can obtain copies of the FAP and FAP application form.

(iv) Instructions on how the individual can obtain a free copy of the FAP and FAP application form by mail.

(v) The contact information, including telephone number and physical location, of the hospital facility office or department that can provide information about the FAP and of either—

(A) The hospital facility office or department that can provide assistance with the FAP application process; or

(B) If the hospital facility does not provide assistance with the FAP application process, at least one nonprofit organization or government agency that the hospital facility has identified as an available source of assistance with FAP applications.

(vi) A statement of the availability of translations of the FAP, FAP application form, and plain language summary of the FAP in other languages, if applicable.

(vii) A statement that a FAP-eligible individual may not be charged more than AGB for emergency or other medically necessary care.

(25) *Presumptive FAP-eligibility determination* means a determination that an individual is FAP-eligible based on information other than that provided by the individual or based on a prior FAP-eligibility determination, as described in § 1.501(r)–6(c)(2).

(26) *Private health insurer* means any organization that is not a governmental unit that offers health insurance, including nongovernmental organizations administering a health insurance plan under Medicare Advantage (Part C of Title XVIII of the Social Security Act, 42 U.S.C. 1395w–21 through 1395w–29). For purposes of § 1.501(r)–5(b), medical assistance provided through a contract between the state and a Medicaid managed care organization or a prepaid inpatient health plan is not considered to be a reimbursement from or a claim allowed by a private health insurer.

(27) *Referring* an individual's debt to a debt collection agency or other party means contracting with, delegating to, or otherwise using the debt collection agency or other party to collect amounts owed by the individual to the hospital facility while still maintaining ownership of the debt.

(28) *Substantially-related entity* means, with respect to a hospital facility operated by a hospital organization, an entity treated as a partnership for federal tax purposes in which the hospital organization owns a capital or profits interest, or a disregarded entity of which the hospital organization is the sole member or owner, that provides emergency or other medically necessary care in the hospital facility, unless the provision of such care is an unrelated trade or business described in section 513 with respect to the hospital organization. Notwithstanding the preceding sentence, a partnership that qualifies for the exception described in paragraph (b)(22)(ii)(B) of this section is not considered a substantially-related entity within the meaning of this paragraph (b)(28).

(29) *Widely available on a Web site* means—

(i) The hospital facility conspicuously posts a complete and current version of the document on—

(A) The hospital facility's Web site;

(B) If the hospital facility does not have its own Web site separate from the hospital organization that operates it, the hospital organization's Web site; or

(C) A Web site established and maintained by another entity, but only if the Web site of the hospital facility or hospital organization (if the facility or organization has a Web site) provides a conspicuously-displayed link to the Web page where the document is posted, along with clear instructions for accessing the document on that Web site;

(ii) Individuals with access to the Internet can access, download, view, and print a hard copy of the document from the Web site—

(A) Without requiring special computer hardware or software (other than software that is readily available to members of the public without payment of any fee);

(B) Without paying a fee to the hospitality facility, hospital organization, or other entity maintaining the Web site; and

(C) Without creating an account or being otherwise required to provide personally identifiable information; and

(iii) The hospital facility provides individuals who ask how to access a copy of the document online with the direct Web site address, or URL, of the Web page where the document is posted.

[T.D. 9708, 79 FR 78998, Dec. 31, 2014; 80 FR 12762, Mar. 11, 2015]

§ 1.501(r)–2 Failures to satisfy section 501(r).

(a) *Revocation of section 501(c)(3) status.* Except as otherwise provided in paragraphs (b) and (c) of this section, a hospital organization failing to meet one or more of the requirements of section 501(r) separately with respect to one or more hospital facilities it operates may have its section 501(c)(3) status revoked as of the first day of the taxable year in which the failure occurs. In determining whether to continue to recognize the section 501(c)(3) status of a hospital organization that fails to meet one or more of the requirements of section 501(r) with respect to one or more hospital facilities, the Commissioner will consider all relevant facts and circumstances including, but not limited to, the following:

(1) Whether the organization has previously failed to meet the requirements of section 501(r), and, if so, whether the same type of failure previously occurred.

(2) The size, scope, nature, and significance of the organization's failure(s).

(3) In the case of an organization that operates more than one hospital facility, the number, size, and significance of the facilities that have failed to meet the section 501(r) requirements relative to those that have complied with these requirements.

(4) The reason for the failure(s).

(5) Whether the organization had, prior to the failure(s), established practices or procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with the section 501(r) requirements.

(6) Whether the practices or procedures had been routinely followed and the failure(s) occurred through an oversight or mistake in applying them.

(7) Whether the organization has implemented safeguards that are reasonably calculated to prevent similar failures from occurring in the future.

(8) Whether the organization corrected the failure(s) as promptly after discovery as is reasonable given the nature of the failure(s).

(9) Whether the organization took the measures described in paragraphs (a)(7) and (a)(8) of this section before the Commissioner discovered the failure(s).

(b) *Minor omissions and errors*—(1) *In general*. A hospital facility's omission of required information from a policy or report described in §1.501(r)–3 or §1.501(r)–4, or error with respect to the implementation or operational requirements described in §§1.501(r)–3 through 1.501(r)–6, will not be considered a failure to meet a requirement of section 501(r) if the following conditions are satisfied:

(i) Such omission or error was minor and either inadvertent or due to reasonable cause.

(ii) The hospital facility corrects such omission or error as promptly after discovery as is reasonable given the nature of the omission or error. Such correction must include establishment (or review and, if necessary, revision) of practices or procedures (formal or informal) that are reasonably designed to promote and facilitate overall compliance with the requirements of section 501(r).

(2) *Minor*. In the case of multiple omissions or errors, the omissions or errors are considered minor for purposes of this paragraph (b) only if they are minor in the aggregate.

(3) *Inadvertent*. For purposes of this paragraph (b), the fact that the same omission or error has been made and corrected previously is a factor tending to show that an omission or error is not inadvertent.

(4) *Reasonable cause*. For purposes of this paragraph (b), the fact that a hospital facility has established practices or procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with the section 501(r) requirements prior to the occurrence of an omission or error is a factor tending to show that the omission or error is due to reasonable cause.

(c) *Excusing certain failures if hospital facility corrects and discloses*. A hospital facility's failure to meet one or more of the requirements described in §§1.501(r)–3 through 1.501(r)–6 that is neither willful nor egregious shall be excused for purposes of this section if the hospital facility corrects and makes disclosure in accordance with rules set forth by revenue procedure, notice, or other guidance published in the Internal Revenue Bulletin. For purposes of this paragraph (c), a ''willful'' failure includes a failure due to gross negligence, reckless disregard, or willful neglect, and an ''egregious'' failure includes only a very serious failure, taking into account the severity of the impact and the number of affected persons. Whether a failure is willful or egregious will be determined based on all of the facts and circumstances. A hospital facility's correction and disclosure of a failure in accordance with the relevant guidance is a factor tending to show that the failure was not willful.

(d) *Taxation of noncompliant hospital facilities*—(1) *In general*. Except as otherwise provided in paragraphs (b) and (c) of this section, if a hospital organization that operates more than one hospital facility fails to meet one or more of the requirements of section 501(r) separately with respect to a hospital facility during a taxable year, the income derived from the noncompliant

hospital facility (''noncompliant facility income'') during that taxable year will be subject to tax computed as provided in section 11 (or as provided in section 1(e) if the hospital organization is a trust described in section 511(b)(2)), but substituting the term ''noncompliant facility income'' for ''taxable income,'' if—

(i) The hospital organization continues to be recognized as described in section 501(c)(3) during the taxable year; but

(ii) The hospital organization would not continue to be recognized as described in section 501(c)(3) during the taxable year based on the facts and circumstances described in paragraph (a) of this section (but disregarding paragraph (a)(3) of this section) if the noncompliant hospital facility were the only hospital facility operated by the organization.

(2) *Noncompliant facility income*—(i) *In general*. For purposes of this paragraph (d), the noncompliant facility income derived from a hospital facility during a taxable year will be the gross income derived from that hospital facility during the taxable year, less the deductions allowed by chapter 1 that are directly connected to the operation of that hospital facility during the taxable year, excluding any gross income and deductions taken into account in computing any unrelated business taxable income described in section 512 that is derived from the facility during the taxable year.

(ii) *Directly connected deductions*. For purposes of this paragraph (d), to be directly connected with the operation of a hospital facility that has failed to meet the requirements of section 501(r), an item of deduction must have proximate and primary relationship to the operation of the hospital facility. Expenses, depreciation, and similar items attributable solely to the operation of a hospital facility are proximately and primarily related to such operation, and therefore qualify for deduction to the extent that they meet the requirements of section 162, section 167, or other relevant provisions of the Internal Revenue Code (Code). Where expenses, depreciation, and similar items are attributable to a noncompliant hospital facility and other hospital facilities operated by the hospital organization (and/or to other activities of the hospital organization unrelated to the operation of hospital facilities), such items shall be allocated among the hospital facilities (and/or other activities) on a reasonable basis. The portion of any such item so allocated to a noncompliant hospital facility is proximately and primarily related to the operation of that facility and shall be allowable as a deduction in computing the facility's noncompliant facility income in the manner and to the extent it would meet the requirements of section 162, section 167, or other relevant provisions of the Code.

(3) *No aggregation*. In computing the noncompliant facility income of a hospital facility, the gross income from (and the deductions allowed with respect to) the hospital facility may not be aggregated with the gross income from (and the deductions allowed with respect to) the hospital organization's other noncompliant hospital facilities subject to tax under this paragraph (d) or its unrelated trade or business activities described in section 513.

(4) *Interaction with other Code provisions*—(i) *Hospital organization operating a noncompliant hospital facility continues to be treated as tax-exempt*. A hospital organization operating a noncompliant hospital facility subject to tax under this paragraph (d) shall continue to be treated as an organization that is exempt from tax under section 501(a) because it is described in section 501(c)(3) for all purposes of the Code. In addition, the application of this paragraph (d) shall not, by itself, result in the operation of the noncompliant hospital facility being considered an unrelated trade or business described in section 513 with respect to the hospital organization. Thus, for example, the application of this paragraph (d) shall not, by itself, affect the tax-exempt status of bonds issued to finance the noncompliant hospital facility.

(ii) *Noncompliant hospital facility operated by a tax-exempt hospital organization is subject to tax*. A noncompliant hospital facility described in paragraph (d)(1) of this section is subject to tax

under this paragraph (d), notwithstanding the fact that the hospital organization operating the hospital facility is otherwise exempt from tax under section 501(a) and subject to tax under section 511(a) and that § 1.11–1(a) of this chapter states such organizations are not liable for the tax imposed under section 11.

(iii) *Noncompliant hospital facility not a business entity.* A noncompliant hospital facility subject to tax under this paragraph (d) is not considered a business entity for purposes of § 301.7701–2(b)(7) of this chapter.

(e) *Instances in which a hospital organization is not required to meet section 501(r).* A hospital organization is not required to meet the requirements of section 501(r) (and, therefore, is not subject to any consequence described in this section for failing to meet the requirements of section 501(r)) with respect to—

(1) Any hospital facility it is not ''operating'' within the meaning of § 1.501(r)–1(b)(22);

(2) The operation of a facility that is not required by a state to be licensed, registered, or similarly recognized as a hospital; or

(3) Any activities that constitute an unrelated trade or business described in section 513 with respect to the hospital organization.

[T.D. 9708, 79 FR 78998, Dec. 31, 2014; 80 FR 12762, Mar. 11, 2015]

§ 1.501(r)–3 Community health needs assessments.

(a) *In general.* With respect to any taxable year, a hospital organization meets the requirements of section 501(r)(3) with respect to a hospital facility it operates only if—

(1) The hospital facility has conducted a community health needs assessment (CHNA) that meets the requirements of paragraph (b) of this section in such taxable year or in either of the two taxable years immediately preceding such taxable year (except as provided in paragraph (d) of this section); and

(2) An authorized body of the hospital facility (as defined in § 1.501(r)–1(b)(4)) has adopted an implementation strategy to meet the community health needs identified through the CHNA, as described in paragraph (c) of this section, on or before the 15th day of the fifth month after the end of such taxable year.

(b) *Conducting a CHNA*—(1) *In general.* To conduct a CHNA for purposes of paragraph (a) of this section, a hospital facility must complete all of the following steps:

(i) Define the community it serves.

(ii) Assess the health needs of that community.

(iii) In assessing the health needs of the community, solicit and take into account input received from persons who represent the broad interests of that community, including those with special knowledge of or expertise in public health.

(iv) Document the CHNA in a written report (CHNA report) that is adopted for the hospital facility by an authorized body of the hospital facility.

(v) Make the CHNA report widely available to the public.

(2) *Date a CHNA is conducted.* For purposes of this section, a hospital facility will be considered to have conducted a CHNA on the date it has completed all of the steps described in paragraph (b)(1) of this section. Solely for purposes of determining the taxable year in which a CHNA has been conducted under this paragraph (b)(2), a hospital facility will be considered to have completed the step of making a CHNA report widely available to the public on the date it first makes the CHNA report widely available to the public as described in paragraph (b)(7)(i) of this section.

(3) *Community served by a hospital facility.* In defining the community it serves for purposes of paragraph (b)(1)(i) of this section, a hospital facility may take into account all of the relevant facts and circumstances, including the geographic area served by the hospital facility, target population(s) served (for example, children, women, or the aged), and principal functions (for example, focus on a particular specialty area or targeted disease). However, a hospital facility may not define its community to exclude medically underserved, low-income, or minority populations who live in the geographic areas from which the hospital facility draws its patients (unless

such populations are not part of the hospital facility's target patient population(s) or affected by its principal functions) or otherwise should be included based on the method the hospital facility uses to define its community. In addition, in determining its patient populations for purposes of defining its community, a hospital facility must take into account all patients without regard to whether (or how much) they or their insurers pay for the care received or whether they are eligible for assistance under the hospital facility's financial assistance policy. In the case of a hospital facility consisting of multiple buildings that operate under a single state license and serve different geographic areas or populations, the community served by the hospital facility is the aggregate of such areas or populations.

(4) *Assessing community health needs.* To assess the health needs of the community it serves for purposes of paragraph (b)(1)(ii) of this section, a hospital facility must identify significant health needs of the community, prioritize those health needs, and identify resources (such as organizations, facilities, and programs in the community, including those of the hospital facility) potentially available to address those health needs. For these purposes, the health needs of a community include requisites for the improvement or maintenance of health status both in the community at large and in particular parts of the community (such as particular neighborhoods or populations experiencing health disparities). These needs may include, for example, the need to address financial and other barriers to accessing care, to prevent illness, to ensure adequate nutrition, or to address social, behavioral, and environmental factors that influence health in the community. A hospital facility may determine whether a health need is significant based on all of the facts and circumstances present in the community it serves. In addition, a hospital facility may use any criteria to prioritize the significant health needs it identifies, including, but not limited to, the burden, scope, severity, or urgency of the health need; the estimated feasibility and effectiveness of possible interventions; the health disparities associated with the need; or the importance the community places on addressing the need.

(5) *Persons representing the broad interests of the community*—(i) *In general.* For purposes of paragraph (b)(1)(iii) of this section, a hospital facility must solicit and take into account input received from all of the following sources in identifying and prioritizing significant health needs and in identifying resources potentially available to address those health needs:

(A) At least one state, local, tribal, or regional governmental public health department (or equivalent department or agency), or a State Office of Rural Health described in section 338J of the Public Health Service Act (42 U.S.C. 254r), with knowledge, information, or expertise relevant to the health needs of that community.

(B) Members of medically underserved, low-income, and minority populations in the community served by the hospital facility, or individuals or organizations serving or representing the interests of such populations. For purposes of this paragraph (b), medically underserved populations include populations experiencing health disparities or at risk of not receiving adequate medical care as a result of being uninsured or underinsured or due to geographic, language, financial, or other barriers.

(C) Written comments received on the hospital facility's most recently conducted CHNA and most recently adopted implementation strategy.

(ii) *Additional sources of input.* In addition to the sources described in paragraph (b)(5)(i) of this section, a hospital facility may solicit and take into account input received from a broad range of persons located in or serving its community, including, but not limited to, health care consumers and consumer advocates, nonprofit and community-based organizations, academic experts, local government officials, local school districts, health care providers and community health centers, health insurance and managed care organizations, private businesses, and labor and workforce representatives.

(6) *Documentation of a CHNA*—(i) *In general.* For purposes of paragraph

(b)(1)(iv) of this section, the CHNA report adopted for the hospital facility by an authorized body of the hospital facility must include—

(A) A definition of the community served by the hospital facility and a description of how the community was determined;

(B) A description of the process and methods used to conduct the CHNA;

(C) A description of how the hospital facility solicited and took into account input received from persons who represent the broad interests of the community it serves;

(D) A prioritized description of the significant health needs of the community identified through the CHNA, along with a description of the process and criteria used in identifying certain health needs as significant and prioritizing those significant health needs;

(E) A description of the resources potentially available to address the significant health needs identified through the CHNA; and

(F) An evaluation of the impact of any actions that were taken, since the hospital facility finished conducting its immediately preceding CHNA, to address the significant health needs identified in the hospital facility's prior CHNA(s).

(ii) *Process and methods used to conduct the CHNA.* A hospital facility's CHNA report will be considered to describe the process and methods used to conduct the CHNA for purposes of paragraph (b)(6)(i)(B) of this section if the CHNA report describes the data and other information used in the assessment, as well as the methods of collecting and analyzing this data and information, and identifies any parties with whom the hospital facility collaborated, or with whom it contracted for assistance, in conducting the CHNA. In the case of data obtained from external source material, the CHNA report may cite the source material rather than describe the method of collecting the data.

(iii) *Input from persons who represent the broad interests of the community served by the hospital facility.* A hospital facility's CHNA report will be considered to describe how the hospital facility took into account input received from persons who represent the broad interests of the community it serves for purposes of paragraph (b)(6)(i)(C) of this section if the CHNA report summarizes, in general terms, any input provided by such persons and how and over what time period such input was provided (for example, whether through meetings, focus groups, interviews, surveys, or written comments and between what approximate dates); provides the names of any organizations providing input and summarizes the nature and extent of the organization's input; and describes the medically underserved, low-income, or minority populations being represented by organizations or individuals that provided input. A CHNA report does not need to name or otherwise identify any specific individual providing input on the CHNA. In the event a hospital facility solicits, but cannot obtain, input from a source described in paragraph (b)(5)(i) of this section, the hospital facility's CHNA report also must describe the hospital facility's efforts to solicit input from such source.

(iv) *Separate CHNA reports.* While a hospital facility may conduct its CHNA in collaboration with other organizations and facilities (including, but not limited to, related and unrelated hospital organizations and facilities, for-profit and government hospitals, governmental departments, and nonprofit organizations), every hospital facility must document the information described in this paragraph (b)(6) in a separate CHNA report to satisfy paragraph (b)(1)(iv) of this section unless it adopts a joint CHNA report as described in paragraph (b)(6)(v) of this section. However, if a hospital facility is collaborating with other facilities and organizations in conducting its CHNA or if another organization (such as a state or local public health department) has conducted a CHNA for all or part of the hospital facility's community, portions of the hospital facility's CHNA report may be substantively identical to portions of a CHNA report of a collaborating hospital facility or other organization conducting a CHNA, if appropriate under the facts and circumstances. For example, if two hospital facilities with overlapping, but

not identical, communities are collaborating in conducting a CHNA, the portions of each hospital facility's CHNA report relevant to the shared areas of their communities might be identical. Similarly, if the state or local public health department with jurisdiction over the community served by a hospital facility conducts a CHNA for an area that includes the hospital facility's community, the hospital facility's CHNA report might include portions of the state or local public health department's CHNA report that are relevant to its community.

(v) *Joint CHNA reports*—(A) *In general.* A hospital facility that collaborates with other hospital facilities or other organizations (such as state or local public health departments) in conducting its CHNA will satisfy paragraph (b)(1)(iv) of this section if an authorized body of the hospital facility adopts for the hospital facility a joint CHNA report produced for the hospital facility and one or more of the collaborating facilities and organizations, provided that the following conditions are met:

(*1*) The joint CHNA report meets the requirements of paragraph (b)(6)(i) of this section.

(*2*) The joint CHNA report is clearly identified as applying to the hospital facility.

(*3*) All of the collaborating hospital facilities and organizations included in the joint CHNA report define their community to be the same.

(B) *Example.* The following example illustrates this paragraph (b)(6)(v):

Example. P is one of 10 hospital facilities located in and serving the populations of a particular Metropolitan Statistical Area (MSA). P and seven other facilities in the MSA, some of which are unrelated to P, decide to collaborate in conducting a CHNA for the MSA and to each define their community as constituting the entire MSA. The eight hospital facilities work together with the state and local health departments of jurisdictions in the MSA to assess the health needs of the MSA and collaborate in conducting surveys and holding public forums to solicit and receive input from the MSA's residents, including its medically underserved, low-income, and minority populations. The hospital facilities also consider the written comments received on their most recently conducted CHNAs and most recently adopted implementation strategies. The hospital facilities then work together to prepare a joint CHNA report documenting this joint CHNA process that contains all of the elements described in paragraph (b)(6)(i) of this section. The joint CHNA report identifies all of the collaborating hospital facilities included in the report, including P, by name, both within the report itself and on the cover page. The board of directors of the hospital organization operating P adopts the joint CHNA report for P. P has complied with the requirements of this paragraph (b)(6)(v) and, accordingly, has satisfied paragraph (b)(1)(iv) of this section.

(7) *Making the CHNA report widely available to the public*—(i) *In general.* For purposes of paragraph (b)(1)(v) of this section, a hospital facility's CHNA report is made widely available to the public only if the hospital facility—

(A) Makes the CHNA report widely available on a Web site, as defined in § 1.501(r)–1(b)(29), at least until the date the hospital facility has made widely available on a Web site its two subsequent CHNA reports; and

(B) Makes a paper copy of the CHNA report available for public inspection upon request and without charge at the hospital facility at least until the date the hospital facility has made available for public inspection a paper copy of its two subsequent CHNA reports.

(ii) *Making draft CHNA reports widely available.* Notwithstanding paragraph (b)(7)(i) of this section, if a hospital facility makes widely available on a Web site (and/or for public inspection) a version of the CHNA report that is expressly marked as a draft on which the public may comment, the hospital facility will not be considered to have made the CHNA report widely available to the public for purposes of determining the date on which the hospital facility has conducted a CHNA under paragraph (b)(2) of this section.

(c) *Implementation strategy*—(1) *In general.* For purposes of paragraph (a)(2) of this section, a hospital facility's implementation strategy to meet the community health needs identified through the hospital facility's CHNA is a written plan that, with respect to each significant health need identified through the CHNA, either—

(i) Describes how the hospital facility plans to address the health need; or

(ii) Identifies the health need as one the hospital facility does not intend to

address and explains why the hospital facility does not intend to address the health need.

(2) *Description of how the hospital facility plans to address a significant health need.* A hospital facility's implementation strategy will have described a plan to address a significant health need identified through a CHNA for purposes of paragraph (c)(1)(i) of this section if the implementation strategy—

(i) Describes the actions the hospital facility intends to take to address the health need and the anticipated impact of these actions;

(ii) Identifies the resources the hospital facility plans to commit to address the health need; and

(iii) Describes any planned collaboration between the hospital facility and other facilities or organizations in addressing the health need.

(3) *Description of why a hospital facility is not addressing a significant health need.* In explaining why it does not intend to address a significant health need for purposes of paragraph (c)(1)(ii) of this section, a brief explanation of the hospital facility's reason for not addressing the health need is sufficient. Such reasons may include, for example, resource constraints, other facilities or organizations in the community addressing the need, a relative lack of expertise or competency to effectively address the need, the need being a relatively low priority, and/or a lack of identified effective interventions to address the need.

(4) *Joint implementation strategies.* A hospital facility may develop an implementation strategy in collaboration with other hospital facilities or other organizations, including, but not limited to, related and unrelated hospital organizations and facilities, for-profit and government hospitals, governmental departments, and nonprofit organizations. In general, a hospital facility that collaborates with other facilities or organizations in developing its implementation strategy must still document its implementation strategy in a separate written plan that is tailored to the particular hospital facility, taking into account its specific resources. However, a hospital facility that adopts a joint CHNA report described in paragraph (b)(6)(v) of this section may also adopt a joint implementation strategy that, with respect to each significant health need identified through the joint CHNA, either describes how one or more of the collaborating facilities or organizations plan to address the health need or identifies the health need as one the collaborating facilities or organizations do not intend to address and explains why they do not intend to address the health need. For a collaborating hospital facility to meet the requirements of paragraph (a)(2) of this section, such a joint implementation strategy adopted for the hospital facility must—

(i) Be clearly identified as applying to the hospital facility;

(ii) Clearly identify the hospital facility's particular role and responsibilities in taking the actions described in the implementation strategy and the resources the hospital facility plans to commit to such actions; and

(iii) Include a summary or other tool that helps the reader easily locate those portions of the joint implementation strategy that relate to the hospital facility.

(5) *When the implementation strategy must be adopted*—(i) *In general.* For purposes of paragraph (a)(2) of this section, an authorized body of the hospital facility must adopt the implementation strategy on or before the 15th day of the fifth month after the end of the taxable year in which the hospital facility completes the final step for the CHNA described in paragraph (b)(1) of this section, regardless of whether the hospital facility began working on the CHNA in a prior taxable year.

(ii) *Example.* The following example illustrates this paragraph (c)(5):

Example. M is a hospital facility that last conducted a CHNA and adopted an implementation strategy in Year 1. In Year 3, M defines the community it serves, assesses the significant health needs of that community, and solicits and takes into account input received from persons who represent the broad interests of that community. In Year 4, M documents its CHNA in a CHNA report that is adopted by an authorized body of M, makes the CHNA report widely available on a Web site, and makes paper copies of the CHNA report available for public inspection. To meet the requirements of paragraph (a)(2) of this section, an authorized body of M must adopt an implementation strategy to meet the health needs identified through the

CHNA completed in Year 4 by the 15th day of the fifth month of Year 5.

(d) *Exception for acquired, new, and terminated hospital facilities*—(1) *Acquired hospital facilities.* A hospital organization that acquires a hospital facility (whether through merger or acquisition) must meet the requirements of section 501(r)(3) with respect to the acquired hospital facility by the last day of the organization's second taxable year beginning after the date on which the hospital facility was acquired. In the case of a merger between two organizations that results in the liquidation of one organization and the survival of the other organization, the hospital facility or facilities formerly operated by the liquidated organization will be considered ''acquired'' for purposes of this paragraph (d)(1).

(2) *New hospital organizations.* An organization that becomes newly subject to the requirements of section 501(r) because it is recognized as described in section 501(c)(3) and is operating a hospital facility must meet the requirements of section 501(r)(3) with respect to any hospital facility by the last day of the second taxable year beginning after the later of the effective date of the determination letter or ruling recognizing the organization as described in section 501(c)(3) or the first date that a facility operated by the organization was licensed, registered, or similarly recognized by a state as a hospital.

(3) *New hospital facilities.* A hospital organization must meet the requirements of section 501(r)(3) with respect to a new hospital facility it operates by the last day of the second taxable year beginning after the date the facility was licensed, registered, or similarly recognized by its state as a hospital.

(4) *Transferred or terminated hospital facilities.* A hospital organization is not required to meet the requirements of section 501(r)(3) with respect to a hospital facility in a taxable year if, before the end of that taxable year, the hospital organization transfers all ownership of the hospital facility to another organization or otherwise ceases its operation of the hospital facility or the facility ceases to be licensed, registered, or similarly recognized as a hospital by a state.

(e) *Transition rule for CHNAs conducted in taxable years beginning before March 23, 2012.* A hospital facility that conducted a CHNA described in section 501(r)(3) in either its first taxable year beginning after March 23, 2010, or its first taxable year beginning after March 23, 2011, does not need to meet the requirements of section 501(r)(3) again until the third taxable year following the taxable year in which the hospital facility conducted that CHNA, provided that the hospital facility adopted an implementation strategy to meet the community health needs identified through that CHNA on or before the 15th day of the fifth calendar month following the close of its first taxable year beginning after March 23, 2012.

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§ 1.501(r)–4 Financial assistance policy and emergency medical care policy.

(a) *In general.* A hospital organization meets the requirements of section 501(r)(4) with respect to a hospital facility it operates only if the hospital organization establishes for that hospital facility—

(1) A written financial assistance policy (FAP) that meets the requirements of paragraph (b) of this section; and

(2) A written emergency medical care policy that meets the requirements of paragraph (c) of this section.

(b) *Financial assistance policy*—(1) *In general.* To satisfy paragraph (a)(1) of this section, a hospital facility's FAP must—

(i) Apply to all emergency and other medically necessary care provided by the hospital facility, including all such care provided in the hospital facility by a substantially-related entity (as defined in § 1.501(r)–1(b)(28));

(ii) Be widely publicized as described in paragraph (b)(5) of this section; and

(iii) Include—

(A) The eligibility criteria for financial assistance and whether such assistance includes free or discounted care;

(B) The basis for calculating amounts charged to patients;

(C) The method for applying for financial assistance;

(D) In the case of a hospital facility that does not have a separate billing and collections policy, the actions that may be taken in the event of nonpayment;

(E) If applicable, any information obtained from sources other than an individual seeking financial assistance that the hospital facility uses, and whether and under what circumstances it uses prior FAP-eligibility determinations, to presumptively determine that the individual is FAP-eligible, as described in § 1.501(r)–6(c)(2); and

(F) A list of any providers, other than the hospital facility itself, delivering emergency or other medically necessary care in the hospital facility that specifies which providers are covered by the hospital facility's FAP and which are not.

(2) *Eligibility criteria and basis for calculating amounts charged to patients*—(i) *In general*. To satisfy paragraphs (b)(1)(iii)(A) and (b)(1)(iii)(B) of this section, the FAP must specify the following:

(A) All financial assistance available under the FAP, including all discounts and free care available under the FAP and, if applicable, the amount(s) (for example, gross charges) to which any discount percentages available under the FAP will be applied.

(B) The eligibility criteria that an individual must satisfy to receive each discount, free care, or other level of assistance available under the FAP.

(C) The method under § 1.501(r)–5(b) the hospital facility uses to determine the amounts generally billed to individuals who have insurance covering emergency or other medically necessary care (AGB). If the hospital facility uses the look-back method described in § 1.501(r)–5(b)(3), the FAP also must state the AGB percentage(s) that the hospital facility uses to determine AGB and describe how the hospital facility calculated such percentage(s) or, alternatively, explain how members of the public may readily obtain such percentage(s) and accompanying description of the calculation in writing and free of charge. In addition, the FAP must indicate that, following a determination of FAP-eligibility, a FAP-eligible individual may not be charged more than AGB for emergency or other medically necessary care.

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

Example 1. (i) Q is a hospital facility that establishes a FAP that provides assistance to all uninsured and underinsured individuals whose family income is less than or equal to x% of the Federal Poverty Level (FPL), with the level of discount for which an individual is eligible under Q's FAP determined based upon the individual's family income as a percentage of FPL. Q's FAP defines the meaning of ''uninsured,'' ''underinsured,'' ''family income,'' and ''Federal Poverty Level.'' Q's FAP also states that Q determines AGB by multiplying the gross charges for any emergency or other medically necessary care it provides to a FAP-eligible individual by an AGB percentage of 56%. The FAP states, further, that Q calculated the AGB percentage of 56% based on all claims allowed by Medicare and private health insurers over a specified 12-month period, divided by the associated gross charges for those claims. Q's FAP contains the following chart, specifying each discount available under the FAP, the amounts (gross charges) to which these discounts will be applied, and the specific eligibility criteria for each such discount:

Family income as % of FPL	Discount off of gross charges
>y% – x%	50%.
>z% – y%	75%.
≤z%	Free.

(ii) Q's FAP also contains a statement that no FAP-eligible individual will be charged more for emergency or other medically necessary care than AGB because Q's AGB percentage is 56% of gross charges and the most a FAP-eligible individual will be charged is 50% of gross charges. Q's FAP satisfies the requirements of this paragraph (b)(2).

Example 2. (i) R is a hospital facility that establishes a FAP that provides assistance based on household income. R's FAP defines the meaning of ''household income.'' R's FAP contains the following chart specifying the assistance available under the FAP and the specific eligibility criteria for each level of assistance offered, which R updates occasionally to account for inflation:

Household income	Maximum amount individual will be responsible for paying
>$b – $a	40% of gross charges, up to the lesser of AGB or x% of household income.
>$c – $b	20% of gross charges, up to the lesser of AGB or y% of household income.
≤$c	$0 (free).

(ii) R's FAP contains a statement that no FAP-eligible individual will be charged more for emergency or other medically necessary

care than AGB. R's FAP also states that R determines AGB by multiplying the gross charges for any emergency or other medically necessary care it provides by AGB percentages, which are based on claims allowed under Medicare. In addition, the FAP provides a Web site address individuals can visit, and a telephone number they can call, if they would like to obtain an information sheet stating R's AGB percentages and explaining how these AGB percentages were calculated. This information sheet, which R makes available on its Web site and provides to any individual who requests it, states that R's AGB percentages are 35% of gross charges for inpatient care and 61% of gross charges for outpatient care. It also states that these percentages were based on all claims allowed for R's emergency or other medically necessary inpatient and outpatient care by Medicare over a specified 12-month period, divided by the associated gross charges for those claims. R's FAP satisfies the requirements of this paragraph (b)(2).

(3) *Method for applying for financial assistance*—(i) *In general.* To satisfy paragraph (b)(1)(iii)(C) of this section, a hospital facility's FAP must describe how an individual applies for financial assistance under the FAP. In addition, either the hospital facility's FAP or FAP application form (including accompanying instructions) must describe the information and documentation the hospital facility may require an individual to provide as part of his or her FAP application and provide the contact information described in §1.501(r)–1(b)(24)(v). A hospital facility may not deny financial assistance under its FAP based on an applicant's failure to provide information or documentation unless that information or documentation is described in the FAP or FAP application form. However, a hospital facility may grant financial assistance under its FAP notwithstanding an applicant's failure to provide information or documentation described in the FAP or FAP application form and may, for example, rely on other evidence of eligibility or an attestation by the applicant to determine that the applicant is FAP-eligible.

(ii) *Example.* The following example illustrates this paragraph (b)(3):

Example. S is a hospital facility with a FAP that bases eligibility solely on an individual's household income. S's FAP provides that an individual may apply for financial assistance by completing and submitting S's FAP application form. S's FAP also describes how individuals can obtain copies of the FAP application form. S's FAP application form contains lines on which the applicant lists all items of household income received by the applicant's household over the last month and the names of the applicant's household members. The instructions to S's FAP application form tell applicants where to submit the application and provide that an applicant must attach to his or her FAP application form proof of household income in the form of payroll check stubs from the last month or, if last month's wages are not representative of the applicant's annual income, a copy of the applicant's most recent federal tax return. Alternatively, the instructions state that an applicant may provide documentation of his or her qualification for certain specified state means-tested programs. The instructions also state that if an applicant does not have any of the listed documents proving household income, he or she may call S's financial assistance office and discuss other evidence that may be provided to demonstrate eligibility. S does not deny financial assistance to FAP applicants based on a failure to submit any information or documentation not mentioned in the FAP application form or instructions. S's FAP application form instructions also provide the contact information of the hospital facility office that can provide an applicant with information about the FAP and assistance with the FAP application process. S's FAP satisfies the requirements of this paragraph (b)(3).

(4) *Actions that may be taken in the event of nonpayment*—(i) *In general.* To satisfy paragraph (b)(1)(iii)(D) of this section, either a hospital facility's FAP or a separate written billing and collections policy established for the hospital facility must describe—

(A) Any actions that the hospital facility (or other authorized party) may take related to obtaining payment of a bill for medical care, including, but not limited to, any extraordinary collection actions (ECAs) described in §1.501(r)–6(b);

(B) The process and time frames the hospital facility (or other authorized party) uses in taking the actions described in paragraph (b)(4)(i)(A) of this section, including, but not limited to, the reasonable efforts it will make to determine whether an individual is FAP-eligible before engaging in any ECAs, as described in §1.501(r)–6(c); and

(C) The office, department, committee, or other body with the final authority or responsibility for determining that the hospital facility has made reasonable efforts to determine whether an individual is FAP-eligible and may therefore engage in ECAs against the individual.

(ii) *Separate billing and collections policy*. In the case of a hospital facility that satisfies paragraph (b)(1)(iii)(D) of this section by establishing a separate written billing and collections policy, the hospital facility's FAP must state that the actions the hospital facility may take in the event of nonpayment are described in a separate billing and collections policy and explain how members of the public may readily obtain a free copy of this separate policy.

(5) *Widely publicizing the FAP*—(i) *In general*. To satisfy the requirement in paragraph (b)(1)(ii) of this section to widely publicize its FAP, a hospital facility must—

(A) Make the FAP, FAP application form, and plain language summary of the FAP (as defined in §1.501(r)–1(b)(24)) widely available on a Web site (as defined in §1.501(r)–1(b)(29));

(B) Make paper copies of the FAP, FAP application form, and plain language summary of the FAP available upon request and without charge, both by mail and in public locations in the hospital facility, including, at a minimum, in the emergency room (if any) and admissions areas;

(C) Notify and inform members of the community served by the hospital facility about the FAP in a manner reasonably calculated to reach those members who are most likely to require financial assistance from the hospital facility; and

(D) Notify and inform individuals who receive care from the hospital facility about the FAP by—

(*1*) Offering a paper copy of the plain language summary of the FAP to patients as part of the intake or discharge process;

(*2*) Including a conspicuous written notice on billing statements that notifies and informs recipients about the availability of financial assistance under the hospital facility's FAP and includes the telephone number of the hospital facility office or department that can provide information about the FAP and FAP application process and the direct Web site address (or URL) where copies of the FAP, FAP application form, and plain language summary of the FAP may be obtained; and

(*3*) Setting up conspicuous public displays (or other measures reasonably calculated to attract patients' attention) that notify and inform patients about the FAP in public locations in the hospital facility, including, at a minimum, the emergency room (if any) and admissions areas.

(ii) *Accessibility to limited English proficient individuals*. To widely publicize its FAP, a hospital facility must accommodate all significant populations that have limited English proficiency (LEP) by translating its FAP, FAP application form, and plain language summary of the FAP into the primary language(s) spoken by such populations. A hospital facility will satisfy this translation requirement in a taxable year if it makes available translations of its FAP, FAP application form, and plain language summary of the FAP in the language spoken by each LEP language group that constitutes the lesser of 1,000 individuals or 5 percent of the community served by the hospital facility or the population likely to be affected or encountered by the hospital facility. For purposes of this paragraph (b)(5)(ii), a hospital facility may determine the percentage or number of LEP individuals in the hospital facility's community or likely to be affected or encountered by the hospital facility using any reasonable method.

(iii) *Meaning of notify and inform*. For purposes of paragraphs (b)(5)(i)(C) and (b)(5)(i)(D)(*3*) of this section, a measure will notify and inform members of a community or patients about the hospital facility's FAP if the measure, at a minimum, notifies the reader or listener that the hospital facility offers financial assistance under a FAP and informs him or her about how or where to obtain more information about the FAP and FAP application process and to obtain copies of the FAP, FAP application form, and plain language summary of the FAP.

(iv) *Meaning of reasonably calculated.* Whether one or more measures to widely publicize a hospital facility's FAP are reasonably calculated to notify and inform members of a community or patients about the hospital facility's FAP in the manner described in paragraphs (b)(5)(i)(C) and (b)(5)(i)(D)(*3*) of this section will depend on all of the facts and circumstances, including the primary language(s) spoken by the members of the community served by the hospital facility and other attributes of the community and the hospital facility.

(v) *Examples.* The following examples illustrate this paragraph (b)(5):

Example 1. (i) Z is a hospital facility. The home page and main billing page of Z's Web site conspicuously display the following message: ''Need help paying your bill? You may be eligible for financial assistance. Click *here* for more information.'' When readers click on the link, they are taken to a Web page that explains the various discounts available under Z's FAP and the specific eligibility criteria for each such discount. This Web page also provides all of the other information required to be included in a plain language summary of the FAP (as defined in §1.501(r)–1(b)(24)), including a telephone number of Z that individuals can call and a room number of Z that individuals can visit for more information about the FAP and assistance with FAP applications. In addition, the Web page contains prominently-displayed links that allow readers to download PDF files of the FAP and the FAP application form, free of charge and without being required to create an account or provide personally identifiable information. Z provides any individual who asks how to access a copy of the FAP, FAP application form, or plain language summary of the FAP online with the URL of this Web page. By implementing these measures, Z has made its FAP widely available on a Web site within the meaning of paragraph (b)(5)(i)(A) of this section.

(ii) Z distributes copies of the plain language summary of its FAP and its FAP application form to all of its referring staff physicians and to the community health centers serving its community. Z also distributes copies of these documents to the local health department and to numerous public agencies and nonprofit organizations in its community that address the health issues and other needs of low-income populations, in quantities sufficient to meet demand. In addition, every issue of the quarterly newsletter that Z mails to the individuals in its customer database contains a prominently-displayed advertisement informing readers that Z offers financial assistance and that people having trouble paying their hospital bills may be eligible for financial assistance. The advertisement provides readers with the URL of the Web page where Z's FAP and FAP application form can be accessed and a telephone number of Z that individuals can call and a room number of Z that individuals can visit with questions about the FAP or assistance with the FAP application process. By implementing these measures, Z notifies and informs members of its community about the FAP within the meaning of paragraph (b)(5)(i)(C) of this section.

(iii) Z makes paper copies of the FAP, FAP application form, and plain language summary of the FAP available upon request and without charge, both by mail and in its admissions areas and emergency room. Z also conspicuously displays a sign in large font regarding the FAP in its admissions areas and emergency room. The sign says: ''Uninsured? Having trouble paying your hospital bill? You may be eligible for financial assistance.'' The sign also provides the URL of the Web page where Z's FAP and FAP application form can be accessed. In addition, the sign provides a telephone number of Z that individuals can call and a room number of Z that individuals can visit with questions about the FAP or assistance with the FAP application process. Underneath each sign, Z conspicuously displays copies of a brochure that contains all of the information required to be included in a plain language summary of the FAP (as defined in §1.501(r)–1(b)(24)). Z makes these brochures available in quantities sufficient to meet visitor demand. Z also offers a plain language summary of the FAP as part of its intake process. Z's billing statements include a conspicuously-placed statement in large font containing the same information that Z includes on its signs. By implementing these measures, Z makes a paper copy of the FAP, FAP application form, and plain language summary of the FAP available upon request within the meaning of paragraph (b)(5)(i)(B) of this section and notifies and informs individuals who receive care from the hospital facility about the FAP within the meaning of paragraph (b)(5)(i)(D) of this section.

(iv) Because Z takes measures to widely publicize the FAP described in paragraphs (b)(5)(i)(A), (b)(5)(i)(B), (b)(5)(i)(C), and (b)(5)(i)(D) of this section, Z meets the requirement to widely publicize its FAP under paragraph (b)(1)(ii) of this section.

Example 2. Assume the same facts as *Example 1,* except that Z serves a community in which 6% of the members speak Spanish and have limited proficiency in English. Z translates its FAP, FAP application form, and FAP brochure (which constitutes a plain language summary of the FAP) into Spanish, and displays and distributes both Spanish and English versions of these documents in

its hospital facility using all of the measures described in *Example 1*. Z also distributes Spanish versions of its FAP application form and FAP brochure to organizations serving Spanish-speaking members of its community. Moreover, the home page and main billing page of Z's Web site conspicuously display an ''¿Habla Español?'' link that takes readers to a Web page that summarizes the FAP in Spanish and contains links that allow readers to download PDF files of the Spanish versions of the FAP and FAP application form, free of charge and without being required to create an account or provide personally identifiable information. Z meets the requirement to widely publicize its FAP under paragraph (b)(1)(ii) of this section.

(6) *Readily obtainable information*. For purposes of paragraphs (b)(2)(i)(C) and (b)(4)(ii) of this section, information is readily obtainable by members of the public if a hospital facility—

(i) Makes the information available free of charge on a Web site and via a paper copy upon request in a manner similar to that described in paragraphs (b)(5)(i)(A) and (b)(5)(i)(B) of this section; and

(ii) Provides translations of the information as described in paragraph (b)(5)(ii) of this section.

(7) *Providing documents electronically*. A hospital facility may provide electronically (for example, on an electronic screen, by email, or by providing the direct Web site address, or URL, of the Web page where the document or information is posted) any document or information that is required by this paragraph (b) to be provided in the form of a paper copy to any individual who indicates he or she prefers to receive or access the document or information electronically.

(8) *Medically necessary care*. For purposes of meeting the requirements of this section, a hospital facility may (but is not required to) use a definition of medically necessary care applicable under the laws of the state in which it is licensed, including the Medicaid definition, or a definition that refers to the generally accepted standards of medicine in the community or to an examining physician's determination.

(c) *Emergency medical care policy*—(1) *In general*. To satisfy paragraph (a)(2) of this section, a hospital organization must establish a written policy for a hospital facility that requires the hospital facility to provide, without discrimination, care for emergency medical conditions to individuals regardless of whether they are FAP-eligible.

(2) *Interference with provision of emergency medical care*. A hospital facility's emergency medical care policy will not be described in paragraph (c)(1) of this section unless it prohibits the hospital facility from engaging in actions that discourage individuals from seeking emergency medical care, such as by demanding that emergency department patients pay before receiving treatment for emergency medical conditions or by permitting debt collection activities that interfere with the provision, without discrimination, of emergency medical care.

(3) *Relation to federal law governing emergency medical care*. Subject to paragraph (c)(2) of this section, a hospital facility's emergency medical care policy will be described in paragraph (c)(1) of this section if it requires the hospital facility to provide the care for emergency medical conditions that the hospital facility is required to provide under Subchapter G of Chapter IV of Title 42 of the Code of Federal Regulations (or any successor regulations).

(4) *Examples*. The following examples illustrate this paragraph (c):

Example 1. F is a hospital facility with a dedicated emergency department that is subject to the Emergency Medical Treatment and Labor Act (EMTALA) and is not a critical access hospital. F establishes a written emergency medical care policy requiring F to comply with EMTALA by providing medical screening examinations and stabilizing treatment and referring or transferring an individual to another facility, when appropriate, and providing emergency services in accordance with 42 CFR 482.55 (or any successor regulation). F's emergency medical care policy also states that F prohibits any actions that would discourage individuals from seeking emergency medical care, such as by demanding that emergency department patients pay before receiving treatment for emergency medical conditions or permitting debt collection activities that interfere with the provision, without discrimination, of emergency medical care. F's emergency medical care policy is described in paragraph (c)(1) of this section.

Example 2. G is a rehabilitation hospital facility. G does not have a dedicated emergency department, nor does it have specialized capabilities that would make it appropriate to accept transfers of individuals who need stabilizing treatment for an emergency

medical condition. G establishes a written emergency medical care policy that addresses how it appraises emergencies, provides initial treatment, and refers or transfers an individual to another facility, when appropriate, in a manner that complies with 42 CFR 482.12(f)(2) (or any successor regulation). G's emergency medical care policy also prohibits G from engaging in actions that discourage individuals from seeking emergency medical care, such as by demanding that patients pay before receiving initial treatment for emergency medical conditions or permitting debt collection activities that interfere with the facility's appraisal and provision, without discrimination, of such initial treatment. G's emergency medical care policy is described in paragraph (c)(1) of this section.

(d) *Establishing the FAP and other policies*—(1) *In general*. A hospital organization has established a FAP, a billing and collections policy, or an emergency medical care policy for a hospital facility only if an authorized body of the hospital facility (as defined in § 1.501(r)–1(b)(4)) has adopted the policy for the hospital facility and the hospital facility has implemented the policy.

(2) *Implementing a policy*. For purposes of this paragraph (d), a hospital facility will be considered to have implemented a policy if the hospital facility has consistently carried out the policy.

(3) *Establishing a policy for more than one hospital facility*. A hospital organization may establish a FAP, billing and collections policy, and/or emergency medical care policy for a hospital facility that is identical to that of other hospital facilities or a joint policy that is shared with multiple hospital facilities provided that any joint policy clearly identifies each facility to which it applies. However, hospital facilities that have different AGB percentages or use different methods to determine AGB must include in their FAPs (or, in the case of information related to AGB percentages, otherwise make readily obtainable) different information regarding AGB to meet the requirements of paragraph (b)(2)(i)(C) of this section.

[T.D. 9708, 79 FR 78998, Dec. 31, 2014]

§ 1.501(r)–5 Limitation on charges.

(a) *In general*. A hospital organization meets the requirements of section 501(r)(5) with respect to a hospital facility it operates only if the hospital facility (and any substantially-related entity, as defined in § 1.501(r)–1(b)(28)) limits the amount charged for care it provides to any individual who is eligible for assistance under its financial assistance policy (FAP) to—

(1) In the case of emergency or other medically necessary care, not more than the amounts generally billed to individuals who have insurance covering such care (AGB), as determined under paragraph (b) of this section; and

(2) In the case of all other medical care covered under the FAP, less than the gross charges for such care, as described in paragraph (c) of this section.

(b) *Amounts generally billed*—(1) *In general*. For purposes of meeting the requirements of paragraph (a)(1) of this section, a hospital facility must determine AGB for emergency or other medically necessary care using a method described in paragraph (b)(3) or (b)(4) of this section or any other method specified in regulations or other guidance published in the Internal Revenue Bulletin. A hospital facility may use only one of these methods to determine AGB at any one time, but different hospital facilities operated by the same hospital organization may use different methods. A hospital facility may change the method it uses to determine AGB at any time.

(2) *Meaning of charged*. For purposes of paragraph (a)(1) of this section, a FAP-eligible individual is considered to be ''charged'' only the amount he or she is personally responsible for paying, after all deductions, discounts (including discounts available under the FAP), and insurance reimbursements have been applied. Thus, in the case of a FAP-eligible individual who has health insurance coverage, a hospital facility will meet the requirements of paragraph (a)(1) of this section if the FAP-eligible individual is not personally responsible for paying (for example, in the form of co-payments, co-insurance, and deductibles) more than AGB for the care after all reimbursements by the health insurer have been applied, even if the total amount paid by the FAP-eligible individual and his or her health insurer together exceeds AGB.

(3) *Look-back method*—(i) *In general.* A hospital facility may determine AGB for any emergency or other medically necessary care it provides to a FAP-eligible individual by multiplying the hospital facility's gross charges for the care by one or more percentages of gross charges (AGB percentage(s)). A hospital facility using this method must calculate its AGB percentage(s) at least annually by dividing the sum of the amounts of all of its claims for emergency and other medically necessary care that have been allowed by health insurers described in paragraph (b)(3)(ii) of this section during a prior 12-month period by the sum of the associated gross charges for those claims. Whether a claim is used in calculating a hospital facility's AGB percentage(s) depends on whether the claim was allowed by a health insurer during the 12-month period used in the calculation, not on whether the care resulting in the claim was provided during that 12-month period. If the amount a health insurer will allow for a claim has not been finally determined as of the last day of the 12-month period used to calculate the AGB percentage(s), a hospital facility should exclude the amount of the claim from that calculation and include it in the subsequent 12-month period during which the amount allowed is finally determined. When including allowed claims in calculating its AGB percentage(s), the hospital facility should include the full amount that has been allowed by the health insurer, including both the amount the insurer will pay or reimburse and the amount (if any) the individual is personally responsible for paying in the form of co-payments, co-insurance, and deductibles, regardless of whether or when the full amount allowed is actually paid and disregarding any discounts applied to the individual's portion.

(ii) *Health insurers used in calculating AGB percentage(s).* In calculating its AGB percentage(s), a hospital facility must include the claims allowed during a prior 12-month period by—

(A) Medicare fee-for-service;

(B) Medicare fee-for-service and all private health insurers that pay claims to the hospital facility; or

(C) Medicaid, either alone or in combination with the insurer(s) described in paragraph (b)(3)(ii)(A) or (b)(3)(ii)(B) of this section.

(iii) *One or multiple AGB percentages.* A hospital facility's AGB percentage that is calculated using the method described in this paragraph (b)(3) may be one average percentage of gross charges for all emergency and other medically necessary care provided by the hospital facility. Alternatively, a hospital facility may calculate multiple AGB percentages for separate categories of care (such as inpatient and outpatient care or care provided by different departments) or for separate items or services, as long as the hospital facility calculates AGB percentages for all emergency and other medically necessary care provided by the hospital facility.

(iv) *Start date for applying AGB percentages.* For purposes of determining AGB under this paragraph (b)(3), with respect to any AGB percentage that a hospital facility has calculated, the hospital facility must begin applying the AGB percentage by the 120th day after the end of the 12-month period the hospital facility used in calculating the AGB percentage.

(v) *Use of all claims for medical care.* A hospital facility determining AGB under this paragraph (b)(3) may use claims allowed for all medical care during a prior 12-month period rather than just those allowed for emergency and other medically necessary care.

(vi) *Determining AGB percentages for more than one hospital facility.* Although generally a hospital organization must calculate AGB percentage(s) separately for each hospital facility it operates, hospital facilities that are covered under the same Medicare provider agreement (as defined in 42 CFR 489.3 or any successor regulations) may calculate one AGB percentage (or multiple AGB percentages for separate categories of care or for separate items or services) using the method described in this paragraph (b)(3) based on the claims and gross charges for all such hospital facilities and implement the AGB percentage(s) across all such hospital facilities.

(4) *Prospective Medicare or Medicaid method.* A hospital facility may determine AGB for any emergency or other medically necessary care provided to a FAP-eligible individual by using the billing and coding process the hospital facility would use if the FAP-eligible individual were a Medicare fee-for-service or Medicaid beneficiary and setting AGB for the care at the amount the hospital facility determines would be the total amount Medicare or Medicaid would allow for the care (including both the amount that would be reimbursed by Medicare or Medicaid and the amount the beneficiary would be personally responsible for paying in the form of co-payments, co-insurance, and deductibles). A hospital facility using the method described in this paragraph (b)(4) may base AGB on Medicare fee-for-service or Medicaid or both, provided that, if it uses both, its FAP describes the circumstance under which it will use Medicare fee-for-service or Medicaid in determining AGB.

(5) *Examples.* The following examples illustrate this paragraph (b):

Example 1. On March 15 of Year 1, Y, a hospital facility, generates data on the amount of all of Y's claims for emergency and other medically necessary care that were allowed by all private health insurers and Medicare fee-for-service over the immediately preceding calendar year. Y determines that the private health insurers allowed a total amount of $250 million and Medicare fee-for-service allowed a total amount of $150 million, with the total allowed amounts including both the portion the insurers agreed to reimburse and the portion that the insured patients were personally responsible for paying. Y's gross charges for these claims totaled $800 million. Y calculates that its AGB percentage is 50% of gross charges ($400 million/$800 million). Y updates its FAP to reflect the new AGB percentage of 50% and makes the updated FAP widely available (both on its Web site and via paper copies upon request) on April 1 of Year 1. Between April 1 of Year 1 (less than 120 days after the end of the preceding calendar year) and March 31 of Year 2, Y determines AGB for any emergency or other medically necessary care it provides to a FAP-eligible individual by multiplying the gross charges for the care provided to the individual by 50%. Y has determined AGB between April 1 of Year 1 and March 31 of Year 2 in accordance with this paragraph (b) by using the look-back method described in paragraph (b)(3) of this section.

Example 2. On August 20 of Year 1, X, a hospital facility, generates data on the amount of all of X's claims for emergency and other medically necessary care that were allowed by Medicare fee-for-service over the 12 months ending on July 31 of Year 1. X determines that, of these claims for inpatient services, Medicare allowed a total amount of $100 million (including both the portion Medicare agreed to reimburse and the portion Medicare beneficiaries were personally responsible for paying). X's gross charges for these inpatient claims totaled $250 million. Of the claims for outpatient services, Medicare allowed a total amount of $125 million. X's gross charges for these outpatient claims totaled $200 million. X calculates that its AGB percentage for inpatient services is 40% of gross charges ($100 million/$250 million) and its AGB percentage for outpatient services is 62.5% of gross charges ($125 million/$200 million). Y discloses its AGB percentages and describes how they were calculated on the Web page where its FAP can be accessed, and it updates this Web page to reflect the new AGB percentages on November 1. Y also starts making an updated information sheet with the new AGB percentages available upon request on and after November 1. Between November 1 of Year 1 (less than 120 days after the end of the 12-month claim period) and October 31 of Year 2, X determines AGB for any emergency or other medically necessary inpatient care it provides to a FAP-eligible individual by multiplying the gross charges for the inpatient care it provides to the individual by 40% and AGB for any emergency or other medically necessary outpatient care it provides to a FAP-eligible individual by multiplying the gross charges for the outpatient care it provides to the individual by 62.5%. X has determined AGB between November 1 of Year 1 and October 31 of Year 2 in accordance with this paragraph (b) by using the look-back method described in paragraph (b)(3) of this section.

Example 3. Whenever Z, a hospital facility, provides emergency or other medically necessary care to a FAP-eligible individual, Z determines the AGB for the care by using the billing and coding process it would use if the individual were a Medicare fee-for-service beneficiary and setting AGB for the care at the amount it determines Medicare and the Medicare beneficiary together would be expected to pay for the care. Z has determined AGB in accordance with this paragraph (b) by using the prospective Medicare method described in paragraph (b)(4) of this section.

Example 4. Using the look-back method described in paragraph (b)(3) of this section, W, a hospital facility, calculates that its AGB percentage for Year 1 is 60% of gross charges. Under W's FAP, which applies to all emergency and other medically necessary care provided by W and which has been updated to reflect the AGB percentage for Year 1, the

most that W charges a FAP-eligible individual is 50% of gross charges. W properly implements its FAP and charges no FAP-eligible individual more for emergency or other medically necessary care than 50% of gross charges in Year 1. W has met the requirements of paragraphs (a)(1) and (b) of this section in Year 1.

Example 5. A, an individual, receives medically necessary care from hospital facility V for which the AGB is $3y. A is insured by U, a health insurer. Under U's contracts with V and A, the amount allowed for the care V provided to A is $5y. Of that amount allowed, A is personally responsible for paying $1y (in co-payments and deductibles) while U is responsible for paying $4y. Based on the eligibility criteria specified in its FAP, V determines that A is FAP-eligible. Pursuant to paragraph (b)(2) of this section, V may charge U and A collectively $5y while still meeting the requirements of paragraph (a)(1) of this section because the amount A is personally responsible for paying in co-payments and deductibles ($1y) is less than the AGB for the care ($3y).

Example 6. Assume the same facts as *Example 5,* except that under U's contracts with V and A, A is personally responsible for paying $4y (in co-payments and deductibles) for the care while U is responsible for paying V $1y. Because A is FAP-eligible under V's FAP, paragraph (a)(1) of this section requires that A not be personally responsible for paying V more than $3y (the AGB for the care provided).

(c) *Gross charges.* A hospital facility must charge a FAP-eligible individual less than the gross charges for any medical care covered under the hospital facility's FAP. A billing statement issued by a hospital facility to a FAP-eligible individual for medical care covered under the FAP may state the gross charges for such care and apply contractual allowances, discounts, or deductions to the gross charges, provided that the actual amount the individual is personally responsible for paying is less than the gross charges for such care.

(d) *Safe harbor for certain charges in excess of AGB.* A hospital facility will be deemed to meet the requirements of paragraph (a) of this section, even if it charges more than AGB for emergency or other medically necessary care (or gross charges for any medical care covered under the FAP) provided to a FAP-eligible individual, if—

(1) The charge in excess of AGB was not made or requested as a pre-condition of providing medically necessary care to the FAP-eligible individual (for example, an upfront payment that a hospital facility requires before providing medically necessary care);

(2) As of the time of the charge, the FAP-eligible individual has not submitted a complete FAP application to the hospital facility to obtain financial assistance for the care or has not otherwise been determined by the hospital facility to be FAP-eligible for the care; and

(3) If the individual subsequently submits a complete FAP application and is determined to be FAP-eligible for the care, the hospital facility refunds any amount the individual has paid for the care (whether to the hospital facility or any other party to whom the hospital facility has referred or sold the individual's debt for the care) that exceeds the amount he or she is determined to be personally responsible for paying as a FAP-eligible individual, unless such excess amount is less than $5 (or such other amount set by notice or other guidance published in the Internal Revenue Bulletin).

(e) *Medically necessary care.* For purposes of meeting the requirements of this section, a hospital facility may (but is not required to) use a definition of medically necessary care applicable under the laws of the state in which it is licensed, including the Medicaid definition, or a definition that refers to the generally accepted standards of medicine in the community or to an examining physician's determination.

[T.D. 9708, 79 FR 78998, Dec. 31, 2014]

§ 1.501(r)–6 Billing and collection.

(a) *In general.* A hospital organization meets the requirements of section 501(r)(6) with respect to a hospital facility it operates only if the hospital facility does not engage in extraordinary collection actions (ECAs), as defined in paragraph (b) of this section, against an individual to obtain payment for care before the hospital facility has made reasonable efforts to determine whether the individual is eligible for assistance for the care under its financial assistance policy (FAP), as described in paragraph (c) of this section. For purposes of this section, with

respect to any debt owed by an individual for care provided by a hospital facility—

(1) ECAs against the individual include ECAs to obtain payment for the care against any other individual who has accepted or is required to accept responsibility for the individual's hospital bill for the care; and

(2) The hospital facility will be deemed to have engaged in an ECA against the individual to obtain payment for the care, or to have taken one or more of the steps necessary to have made reasonable efforts to determine whether the individual is FAP-eligible for the care, if any purchaser of the individual's debt, any debt collection agency or other party to which the hospital facility has referred the individual's debt, or any substantially-related entity (as defined in §1.501(r)–1(b)(28)) has engaged in such an ECA or taken such steps (whichever is applicable).

(b) *Extraordinary collection actions*—(1) *In general.* Except as otherwise provided in this paragraph (b), the following actions taken by a hospital facility against an individual related to obtaining payment of a bill for care covered under the hospital facility's FAP are ECAs:

(i) Selling an individual's debt to another party (other than debt sales described in paragraph (b)(2) of this section).

(ii) Reporting adverse information about the individual to consumer credit reporting agencies or credit bureaus.

(iii) Deferring or denying, or requiring a payment before providing, medically necessary care because of an individual's nonpayment of one or more bills for previously provided care covered under the hospital facility's FAP (which is considered an ECA to obtain payment for the previously provided care, not the care being potentially deferred or denied). If a hospital facility requires a payment before providing medically necessary care to an individual with one or more outstanding bills for previously provided care, such a requirement for payment will be presumed to be because of the individual's nonpayment of such bill(s) unless the hospital facility can demonstrate that it required the payment from the individual based on factors other than, and without regard to, the individual's nonpayment of past bills.

(iv) Actions that require a legal or judicial process, including but not limited to—

(A) Placing a lien on an individual's property (other than a lien described in paragraph (b)(3) of this section);

(B) Foreclosing on an individual's real property;

(C) Attaching or seizing an individual's bank account or any other personal property;

(D) Commencing a civil action against an individual;

(E) Causing an individual's arrest;

(F) Causing an individual to be subject to a writ of body attachment; and

(G) Garnishing an individual's wages.

(2) *Certain debt sales that are not ECAs.* A hospital facility's sale of an individual's debt for care provided by the hospital facility will not be considered an ECA if, prior to the sale, the hospital facility has entered into a legally binding written agreement with the purchaser of the debt pursuant to which—

(i) The purchaser is prohibited from engaging in any ECAs to obtain payment for the care;

(ii) The purchaser is prohibited from charging interest on the debt in excess of the rate in effect under section 6621(a)(2) at the time the debt is sold (or such other interest rate set by notice or other guidance published in the Internal Revenue Bulletin);

(iii) The debt is returnable to or recallable by the hospital facility upon a determination by the hospital facility or the purchaser that the individual is FAP-eligible; and

(iv) If the individual is determined to be FAP-eligible and the debt is not returned to or recalled by the hospital facility, the purchaser is required to adhere to procedures specified in the agreement that ensure that the individual does not pay, and has no obligation to pay, the purchaser and the hospital facility together more than he or she is personally responsible for paying as a FAP-eligible individual.

(3) *Liens on certain judgments, settlements, or compromises.* Any lien that a hospital facility is entitled to assert under state law on the proceeds of a judgment, settlement, or compromise

owed to an individual (or his or her representative) as a result of personal injuries for which the hospital facility provided care is not an ECA.

(4) *Bankruptcy claims*. The filing of a claim in any bankruptcy proceeding is not an ECA.

(c) *Reasonable efforts*—(1) *In general*. A hospital facility will have made reasonable efforts to determine whether an individual is FAP-eligible for care only if the hospital facility meets the requirements described in paragraph (c)(2) or (c)(3) of this section.

(2) *Presumptive FAP-eligibility determinations based on third-party information or prior FAP-eligibility determinations*—(i) *In general*. With respect to any care provided by a hospital facility to an individual, the hospital facility will have made reasonable efforts to determine whether the individual is FAP-eligible for the care if it determines that the individual is FAP-eligible for the care based on information other than that provided by the individual or based on a prior FAP-eligibility determination and, if the individual is presumptively determined to be eligible for less than the most generous assistance available under the FAP, the hospital facility—

(A) Notifies the individual regarding the basis for the presumptive FAP-eligibility determination and the way to apply for more generous assistance available under the FAP;

(B) Gives the individual a reasonable period of time to apply for more generous assistance before initiating ECAs to obtain the discounted amount owed for the care; and

(C) If the individual submits a complete FAP application seeking more generous assistance during the application period (as defined in §1.501(r)–1(b)(3)), determines whether the individual is eligible for a more generous discount and otherwise meets the requirements described in paragraph (c)(6) of this section with respect to that complete FAP application.

(ii) *Examples*. The following examples illustrate this paragraph (c)(2):

Example 1. V is a hospital facility with a FAP under which the specific assistance for which an individual is eligible depends exclusively upon that individual's household income. The most generous assistance offered for care under V's FAP is free care. V's FAP states that V uses enrollment in certain specified means-tested public programs to presumptively determine that individuals are FAP-eligible. D, an individual, receives care from V. Although D does not submit a FAP application to V, V learns that D is eligible for certain benefits under a state program that bases eligibility on household income. Based on this knowledge, V presumptively determines that D is eligible to receive free care under its FAP. V notifies D that it has determined he is eligible for free care based on his eligibility for the benefits under the state program and therefore does not owe V anything for the care he received. V has made reasonable efforts to determine whether D is FAP-eligible under this paragraph (c)(2).

Example 2. X is a hospital facility with a FAP that describes the data, including both hospital and publicly-available data, X uses to make presumptive FAP-eligibility determinations. On January 16, F, an individual, receives care from X. Using the hospital and publicly-available data described in its FAP, X presumptively determines that F is eligible for a 50% discount under its FAP, a discount that is not the most generous discount available under the FAP. The first billing statement that X sends to F indicates that F has been given a 50% discount under X's FAP, explains the basis for this presumptive FAP-eligibility determination, and informs F that she may apply for financial assistance if she believes she is eligible for a more generous discount. The billing statement indicates that F may call 1–800–888–xxxx or visit X's Web site at *www.hospitalX.org/FAP* to learn more about the FAP or the FAP application process. X sends F three more billing statements, each of which contains the standard written notice about the FAP that X includes on all of its billing statements in accordance with §1.501(r)–4(b)(5), but F neither pays the amount she is personally responsible for paying nor applies for more generous financial assistance. The time between the first and fourth billing statement constitutes a reasonable period of time for F to apply for more generous assistance. V has made reasonable efforts to determine whether D is FAP-eligible under this paragraph (c)(2).

(3) *Reasonable efforts based on notification and processing of applications*. With respect to any care provided by a hospital facility to an individual, the hospital facility will have made reasonable efforts to determine whether the individual is FAP-eligible for the care if it—

(i) Notifies the individual about the FAP as described in paragraph (c)(4) of this section before initiating any ECAs

to obtain payment for the care and refrains from initiating such ECAs (with the exception of an ECA described in paragraph (b)(1)(iii) of this section) for at least 120 days from the date the hospital facility provides the first post-discharge billing statement for the care;

(ii) In the case of an individual who submits an incomplete FAP application during the application period, notifies the individual about how to complete the FAP application and gives the individual a reasonable opportunity to do so as described in paragraph (c)(5) of this section; and

(iii) In the case of an individual who submits a complete FAP application during the application period, determines whether the individual is FAP-eligible for the care and otherwise meets the requirements described in paragraph (c)(6) of this section.

(4) *Notification*—(i) *In general.* With respect to any care provided by a hospital facility to an individual and except as provided in paragraph (c)(4)(iii) of this section, a hospital facility will have notified an individual about its FAP for purposes of paragraph (c)(3)(i) of this section only if the hospital facility does the following at least 30 days before first initiating one or more ECA(s) to obtain payment for the care:

(A) Provides the individual with a written notice that indicates financial assistance is available for eligible individuals, that identifies the ECA(s) that the hospitality facility (or other authorized party) intends to initiate to obtain payment for the care, and that states a deadline after which such ECA(s) may be initiated that is no earlier than 30 days after the date that the written notice is provided.

(B) Provides the individual with a plain language summary of the FAP (as defined in § 1.501(r)–1(b)(24)) with the written notice described in paragraph (c)(4)(i)(A) of this section (or, if applicable, paragraph (c)(4)(iii) of this section).

(C) Makes a reasonable effort to orally notify the individual about the hospital facility's FAP and about how the individual may obtain assistance with the FAP application process.

(ii) *Notification in the event of multiple episodes of care.* A hospital facility may satisfy the notification requirements described in paragraph (c)(4)(i) of this section simultaneously for multiple episodes of care and notify the individual about the ECA(s) the hospital facility intends to initiate to obtain payment for multiple outstanding bills for care. However, if a hospital facility aggregates an individual's outstanding bills for multiple episodes of care before initiating one or more ECAs to obtain payment for those bills, it will have not have made reasonable efforts to determine whether the individual is FAP-eligible under paragraph (c)(3) of this section unless it refrains from initiating the ECA(s) until 120 days after it provided the first post-discharge billing statement for the most recent episode of care included in the aggregation.

(iii) *Notification before deferring or denying care due to nonpayment for prior care.* In the case of an ECA described in paragraph (b)(1)(iii) of this section, a hospital facility may notify the individual about its FAP less than 30 days before initiating the ECA, provided that the hospital facility does the following:

(A) Otherwise meets the requirements of paragraph (c)(4)(i) of this section but, instead of the notice described in paragraph (c)(4)(i)(A) of this section, provides the individual with a FAP application form and a written notice indicating that financial assistance is available for eligible individuals and stating the deadline, if any, after which the hospital facility will no longer accept and process a FAP application submitted (or, if applicable, completed) by the individual for the previously provided care at issue. This deadline must be no earlier than the later of 30 days after the date that the written notice is provided or 240 days after the date that the first post-discharge billing statement for the previously provided care was provided.

(B) If the individual submits a FAP application for the previously provided care on or before the deadline described in paragraph (c)(4)(iii)(A) of this section (or at any time, if the hospital facility didn't provide any such deadline to the individual), processes the FAP application on an expedited basis.

(iv) *Examples*. The following example illustrates this paragraph (c)(4):

Example 1. A, an individual, receives care from T, a hospital facility, in February. T provides A with the first post-discharge billing statement for that care on March 3. This and subsequent billing statements that T sends to A contain the standard written notice about the FAP that X includes on all of its billing statements in accordance with §1.501(r)–4(b)(5). A has not paid her bill or submitted a FAP application when T provides her with the third billing statement for the care, postmarked June 1. With this third billing statement, T includes a plain language summary of the FAP and a letter informing A that if she does not pay the amount owed or submit a FAP application by July 1, T intends to report A's delinquency to credit reporting agencies. T also calls A and informs her about the financial assistance available to eligible patients under T's FAP and about how to obtain assistance with the FAP application process. A does not pay her bill or submit a FAP application by July 1. T has made reasonable efforts to determine whether A is FAP-eligible, and thus may report A's delinquency to credit reporting agencies, as of July 2.

Example 2. G, an individual, receives care from Y, a hospital facility, on May 25 of Year 1. Y also makes numerous attempts to encourage G to apply for financial assistance, including by calling G to inform her about the financial assistance available to eligible patients under Y's FAP and to offer assistance with the FAP application process. By June 24 of Year 2, Y, which had not previously initiated any ECAs against G to obtain payment for the care, notifies G in writing that if G does not pay or complete a FAP application by July 24 of Year 2, Y intends to file a lawsuit seeking a judgment for the amount G owes for the care and to seek court permission to enforce the judgment by either seizing G's bank account or garnishing G's wages. The written notice also includes a plain language summary of the FAP. G fails to pay or submit a FAP application by July 24 of Year 2. Y has made reasonable efforts to determine whether G is FAP-eligible, and may seek a judgment for the amount G owes and court permission to enforce the judgment by seizing G's bank account or garnishing G's wages, as of July 25 of Year 2.

(5) *Incomplete FAP applications*—(i) *In general*. With respect to any care provided by a hospital facility to an individual, if an individual submits an incomplete FAP application during the application period, the hospital facility will have notified the individual about how to complete the FAP application and given the individual a reasonable opportunity to do so for purposes of paragraph (c)(3)(ii) of this section only if the hospital facility—

(A) Suspends any ECAs to obtain payment for the care as described in paragraph (c)(8) of this section; and

(B) Provides the individual with a written notice that describes the additional information and/or documentation required under the FAP or FAP application form that must be submitted to complete the FAP application and that includes the contact information described in §1.501(r)–1(b)(24)(v).

(ii) *FAP application completed*. If an individual who has submitted an incomplete FAP application during the application period subsequently completes the FAP application during the application period (or, if later, within a reasonable timeframe given to respond to requests for additional information and/or documentation), the individual will be considered to have submitted a complete FAP application during the application period, and the hospital facility will have made reasonable efforts to determine whether the individual is FAP-eligible only if it meets the requirements for complete FAP applications described in paragraph (c)(6) of this section.

(iii) *Examples*. The following examples illustrate this paragraph (c)(5):

Example 1. (i) Assume the same facts as *Example 1* in paragraph (c)(4)(iv) of this section and the following additional facts: A submits an incomplete FAP application to T on July 15, which is before the last day of the application period on October 29 but after T has already initiated ECAs. Eligibility for assistance under T's FAP is based solely on an individual's family income and the instructions to T's FAP application form require applicants to attach to their application forms certain documentation verifying family income. The FAP application form that A submits to T on July 15 includes all of the required income information, but A fails to attach the required documentation verifying her family income. On July 22, a member of T's staff calls A to inform her that she failed to attach any of the required documentation of her family income and explains what kind of documentation A needs to submit and how she can submit it. T indicates that the documentation should be provided by September 22. T also sends A a letter that describes the missing documentation that A must submit by September 22 (and how to submit it) and

provides a telephone number A can call and room number she can visit to get assistance with the FAP application process. T does not initiate any new ECAs against A and does not take any further action on the ECAs T previously initiated against A between July 15 and September 22. A does not respond to T's letter and does not submit any missing documentation by September 22. T has made reasonable efforts to determine whether A is FAP-eligible, and may initiate or resume ECAs against A, as of September 23.

(ii) On October 10, before the last day of the application period on October 29, A provides T with the missing documentation. Because A has submitted a complete FAP application during the application period, to meet the requirements of paragraph (a) of this section, T must process the FAP application documentation to determine whether A is FAP-eligible and otherwise meet the requirements for complete FAP applications described in paragraph (c)(6) of this section.

Example 2. (i) B, an individual, receives care from U, a hospital facility, on January 10. U has established a FAP that provides assistance to all individuals whose household income is less than $y, and the instructions to U's FAP application form specify the documentation that applicants must provide to verify their household income. Shortly after receiving care, B submits a FAP application form to U indicating that he has household income of less than $y. B's FAP application form includes all of the required income information, but B fails to attach the required documentation verifying household income.

(ii) On February 9, U sends B the first post-discharge billing statement for the care that contains the standard written notice about the FAP that U includes on all of its billing statements in accordance with §1.501(r)–4(b)(5). With this first post-discharge billing statement, U includes a letter informing B that the income information he provided on his FAP application form indicates that he may be eligible to pay only x% of the amount stated on the billing statement if he can provide documentation that verifies his household income. In addition, this letter describes the type of documentation (which is also described in the instructions to U's FAP application form) that B needs to provide to complete his FAP application and provides a telephone number that B may call and room number he may visit if he has questions or needs assistance with the FAP application process. By the time U is getting ready to send B a third billing statement for the care, B has not provided any response to U's request for the missing documentation. Accordingly, with the third billing statement postmarked May 10, U includes a plain language summary of the FAP plus a written notice informing B that U intends to report B's delinquency to credit reporting agencies if B does not submit the missing documentation or pay the amount due by June 9. U also calls B to inform B about the impending ECA and to see if he has questions about the missing documentation that U has requested. B does not provide any response to U's request for the missing documentation by June 9. U has made reasonable efforts to determine whether B is FAP-eligible, and thus may report B's delinquency to credit reporting agencies, as of June 10.

(6) *Complete FAP applications*—(i) *In general.* With respect to any care provided by a hospital facility to an individual, if an individual submits a complete FAP application during the application period, the hospital facility will have made reasonable efforts to determine whether the individual is FAP-eligible for the care only if the hospital facility does the following in a timely manner:

(A) Suspends any ECAs to obtain payment for the care as described in paragraph (c)(8) of this section.

(B) Makes a determination as to whether the individual is FAP-eligible for the care and notifies the individual in writing of this eligibility determination (including, if applicable, the assistance for which the individual is eligible) and the basis for this determination.

(C) If the hospital facility determines the individual is FAP-eligible for the care, does the following:

(*1*) If the individual is determined to be eligible for assistance other than free care, provides the individual with a billing statement that indicates the amount the individual owes for the care as a FAP-eligible individual and how that amount was determined and that states, or describes how the individual can get information regarding, the AGB for the care.

(*2*) Refunds to the individual any amount he or she has paid for the care (whether to the hospital facility or any other party to whom the hospital facility has referred or sold the individual's debt for the care) that exceeds the amount he or she is determined to be personally responsible for paying as a FAP-eligible individual, unless such excess amount is less than $5 (or such other amount set by notice or other guidance published in the Internal Revenue Bulletin).

(*3*) Takes all reasonably available measures to reverse any ECA (with the

exception of a sale of debt and an ECA described in paragraph (b)(1)(iii) of this section) taken against the individual to obtain payment for the care. Such reasonably available measures generally include, but are not limited to, measures to vacate any judgment against the individual, lift any levy or lien (other than a lien described in paragraph (b)(3) of this section) on the individual's property, and remove from the individual's credit report any adverse information that was reported to a consumer reporting agency or credit bureau.

(ii) *Anti-abuse rule for complete FAP applications.* A hospital facility will not have made reasonable efforts to determine whether an individual is FAP-eligible if the hospital facility bases its determination that the individual is not FAP-eligible on information that the hospital facility has reason to believe is unreliable or incorrect or on information obtained from the individual under duress or through the use of coercive practices. For purposes of this paragraph (c)(6)(ii), a coercive practice includes delaying or denying emergency medical care to an individual until the individual has provided information requested to determine whether the individual is FAP-eligible for the care being delayed or denied.

(iii) *Determination based on complete FAP applications sufficient for reasonable efforts.* A hospital facility will have made reasonable efforts to determine whether an individual is FAP-eligible with respect to any ECAs it initiates to obtain payment for care if, before initiating any such ECAs, it determines whether the individual is FAP-eligible for the care based on a complete FAP application and otherwise meets the requirements described in this paragraph (c)(6). If these conditions are satisfied, the hospital facility will have made reasonable efforts to determine whether the individual is FAP-eligible for the care regardless of whether it has notified the individual as described in paragraph (c)(4) of this section or, if applicable, in paragraph (c)(5)(i)(B) of this section.

(iv) *Determining Medicaid eligibility.* A hospital facility will not fail to have made reasonable efforts to determine whether an individual is FAP-eligible for care if, upon receiving a complete FAP application from an individual who the hospital facility believes may qualify for Medicaid, the hospital facility postpones determining whether the individual is FAP-eligible for the care until after the individual's Medicaid application has been completed and submitted and a determination as to the individual's Medicaid eligibility has been made.

(v) *Examples.* The following examples illustrate this paragraph (c)(6):

Example 1. C, an individual, receives care from W, a hospital facility, on September 1. W has established a FAP that provides assistance only to individuals whose family income is less than or equal to x% of the Federal Poverty Level (FPL), which, in the case of C's family size, is $y. Upon discharge, W's staff gives C a plain language summary of the FAP and informs C that if she needs assistance filling out a FAP application form, W has a social worker on staff who can assist her. C expresses interest in getting assistance with a FAP application while she is still on site and is directed to K, one of W's social workers. K explains the eligibility criteria in W's FAP to C, and C realizes that to determine her family income as a percentage of FPL she needs to look at her prior year's tax returns. On September 20, after returning home and obtaining the necessary information, C submits a FAP application to W that contains all of the information and documentation required in the FAP application form instructions. W's staff promptly examines C's FAP application and, based on the information and documentation therein, determines that C's family income is well in excess of $y. On October 1, W sends C her first post-discharge billing statement for the care she received on September 1. With the billing statement, W includes a letter informing C that she is not eligible for financial assistance because her FAP application indicates that she has family income in excess of x% of FPL ($y for a family the size of C's family) and W only provides financial assistance to individuals with family income that is less than x% of FPL. W has made reasonable efforts to determine whether C is FAP-eligible as of October 1.

Example 2. E, an individual, receives care from P, a hospital facility, from February 24 to 28. E pays a co-payment of $30 at discharge and is determined by her insurer to be personally responsible for paying another $550 in deductibles. P sends E several billing statements starting on March 20 indicating that E owes $550. By July 30, E has not paid the $550 or submitted a FAP application. On July 30, P notifies E in writing that if E does not pay or complete a FAP application by

August 30, P intends to report B's delinquency to credit reporting agencies. The written notice also includes a plain language summary of the FAP. In addition, P calls E and informs her about the financial assistance available to eligible patients under P's FAP and about how to obtain assistance with the FAP application process. E fails to pay or submit a FAP application by August 30. P subsequently reports E's delinquency to credit reporting agencies. E then provides a complete FAP application to P on November 10, before the last day of the application period on November 15. P promptly examines the application and determines that E is eligible for free care under P's FAP. P contacts the credit reporting agencies to which it had reported E's delinquency and asks them to remove the adverse information from E's credit report. P also sends E a letter that informs her that she is eligible for free care under P's FAP and explains the basis for this eligibility determination and includes with this letter a check for $30 (the co-payment E had paid). P has made reasonable efforts to determine whether E is FAP-eligible.

Example 3. R, a hospital facility, has established a FAP that provides financial assistance only to individuals whose family income is less than or equal to x% of the Federal Poverty Level (FPL), based on their prior year's federal tax return. L, an individual, receives care from R. While L is being discharged from R, she is approached by M, an employee of a debt collection company that has a contract with R to handle all of R's patient billing. M asks L for her family income information, telling L that this information is needed to determine whether L is eligible for financial assistance. L tells M that she does not know what her family income is and would need to consult her tax returns to determine it. M tells L that she can just provide a ''rough estimate'' of her family income. L states that her family income may be around $y, an amount slightly above the amount that would allow her to qualify for financial assistance. M enters $y on the income line of a FAP application form with L's name on it and marks L as not FAP-eligible. Based on M's information collection, R determines that L is not FAP-eligible and notifies L of this determination with her first billing statement. Because M had reason to believe that the income estimate provided by L was unreliable, R has violated the anti-abuse rule described in paragraph (c)(6)(ii) of this section. Thus, R has not made reasonable efforts to determine whether L is FAP-eligible.

(7) *When no FAP application is submitted.* Unless and until an individual submits a FAP application during the application period, any paragraphs of this section that are conditioned on an individual's submitting a FAP application (namely, paragraphs (c)(2)(i)(C), (c)(3)(ii), and (c)(3)(iii) of this section) do not apply, and the hospital facility will have made reasonable efforts to determine whether the individual is FAP-eligible for care, and may initiate one or more ECAs to obtain payment for the care, once it has met the requirements of this section that are not contingent on an individual's submission of a FAP application. For example, unless and until a hospital facility receives a FAP application from an individual during the application period, the hospital facility has made reasonable efforts to determine whether the individual is FAP-eligible for care (and thus may initiate ECAs to obtain payment for the care) once it has notified the individual about the FAP as described in paragraph (c)(3)(i) of this section.

(8) *Suspending ECAs while a FAP application is pending.* With respect to any care provided by a hospital facility to an individual, if an individual submits a FAP application during the application period, the hospital facility (or other authorized party) will have suspended ECAs for purposes of this paragraph (c) only if, after receiving the application, the hospital facility (or other authorized party) does not initiate, or take further action on any previously-initiated, ECAs (with the exception of an ECA described in paragraph (b)(1)(iii) of this section) to obtain payment for the care until either—

(i) The hospital facility has determined whether the individual is FAP-eligible based on a complete FAP application and otherwise met the requirements of paragraph (c)(6) of this section; or

(ii) In the case of an incomplete FAP application, the individual has failed to respond to requests for additional information and/or documentation within a reasonable period of time given to respond to such requests.

(9) *Waiver does not constitute reasonable efforts.* For purposes of this paragraph (c), obtaining a signed waiver from an individual, such as a signed statement that the individual does not wish to apply for assistance under the

FAP or receive the information described in paragraphs (c)(4) or (c)(5) of this section, will not itself constitute a determination that the individual is not FAP-eligible and will not satisfy the requirement to make reasonable efforts to determine whether the individual is FAP-eligible before engaging in ECAs against the individual.

(10) *Agreements with other parties.* With the exception of sales described in paragraph (b)(2) of this section, if a hospital facility sells or refers an individual's debt related to care to another party, the hospital facility will have made reasonable efforts to determine whether the individual is FAP-eligible for the care only if it first enters into (and, to the extent applicable, enforces) a legally binding written agreement with the party that is reasonably designed to ensure that no ECAs are taken to obtain payment for the care until reasonable efforts have been made to determine whether the individual is FAP-eligible for the care. At a minimum, such an agreement must provide the following:

(i) If the individual submits a FAP application after the referral or sale of the debt but before the end of the application period, the party will suspend ECAs to obtain payment for the care as described in paragraph (c)(8) of this section.

(ii) If the individual submits a FAP application after the referral or sale of the debt but before the end of the application period and is determined to be FAP-eligible for the care, the party will do the following in a timely manner:

(A) Adhere to procedures specified in the agreement that ensure that the individual does not pay, and has no obligation to pay, the party and the hospital facility together more than he or she is required to pay for the care as a FAP-eligible individual.

(B) If applicable and if the party (rather than the hospital facility) has the authority to do so, take all reasonably available measures to reverse any ECA (other than the sale of a debt or an ECA described in paragraph (b)(1)(iii) of this section) taken against the individual as described in paragraph (c)(6)(i)(C)(*3*) of this section.

(iii) If the party refers or sells the debt to yet another party during the application period, the party will obtain a written agreement from that other party including all of the elements described in this paragraph (c)(10).

(11) *Clear and conspicuous placement.* A hospital facility may print any written notice or communication described in this paragraph (c), including any plain language summary of the FAP, on a billing statement or along with other descriptive or explanatory matter, provided that the required information is conspicuously placed and of sufficient size to be clearly readable.

(12) *Providing documents electronically.* A hospital facility may provide any written notice or communication described in this paragraph (c) electronically (for example, by email) to any individual who indicates he or she prefers to receive the written notice or communication electronically.

[T.D. 9708, 79 FR 78998, Dec. 31, 2014; 80 FR 12762, Mar. 11, 2015]

§ 1.501(r)–7 Effective/applicability dates.

(a) *Effective/applicability date.* The rules of §§1.501(r)–1 through 1.501(r)–6 apply to taxable years beginning after December 29, 2015.

(b) *Reasonable interpretation for taxable years beginning on or before* December 29, 2015. For taxable years beginning on or before December 29, 2015, a hospital facility may rely on a reasonable, good faith interpretation of section 501(r). A hospital facility will be deemed to have operated in accordance with a reasonable, good faith interpretation of section 501(r) if it has complied with the provisions of the proposed or final regulations under section 501(r) (REG–130266–11 and/or REG–106499–12). Accordingly, a hospital facility may rely on §1.501(r)–3 of the proposed or final regulations, or another reasonable interpretation of section 501(r)(3), for any CHNA conducted or implementation strategy adopted before the first day of the hospital organization's first taxable year beginning after December 29, 2015.

[T.D. 9708, 79 FR 78998, Dec. 31, 2014]

§ 1.502–1 Feeder organizations.

(a) In the case of an organization operated for the primary purpose of carrying on a trade or business for profit, exemption is not allowed under section 501 on the ground that all the profits of such organization are payable to one or more organizations exempt from taxation under section 501. In determining the primary purpose of an organization, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of those activities of such organization which are specified in the applicable paragraph of section 501.

(b) If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations. For purposes of this paragraph, organizations are related only if they consist of:

(1) A parent organization and one or more of its subsidiary organizations; or

(2) Subsidiary organizations having a common parent organization

An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities.

(c) In certain cases an organization which carries on a trade or business for profit but is not operated for the primary purpose of carrying on such trade or business is subject to the tax imposed under section 511 on its unrelated business taxable income.

(d) *Exception*—(1) *Taxable years beginning before January 1, 1970.* For purposes of section 502 and this section, for taxable years beginning before January 1, 1970, the term *trade or business* does not include the rental by an organization of its real property (including personal property leased with the real property).

(2) *Taxable years beginning after December 31, 1969.* For purposes of section 502 and this section, for taxable years beginning after December 31, 1969, the term *trade or business* does not include:

(i) The deriving of rents described in section 512(b)(3)(A),

(ii) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation, or

(iii) Any trade or business (such as a *thrift shop*) which consists of the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions

For purposes of the exception described in subdivision (i) of this subparagraph, if the rents derived by an organization would not be excluded from unrelated business income pursuant to section 512(b)(3) and the regulations thereunder, the deriving of such rents shall be considered a *trade or business.*

(3) *Cross references and special rules.* (i) For determination of when rents are excluded from the tax on unrelated business income see section 512(b)(3) and the regulations thereunder.

(ii) The rules contained in § 1.513–1(e)(1) shall apply in determining

whether a trade or business is described in section 502(b)(2) and subparagraph (2)(ii) of this paragraph.

(iii) The rules contained in §1.513–1(e)(3) shall apply in determining whether a trade or business is described in section 502(b)(3) and subparagraph (2)(iii) of this paragraph.

[T.D. 6500, 25 FR 11737, No. 26, 1960, as amended by T.D. 6662, 28 FR 6973, July 29, 1963; T.D. 7033, 35 FR 19997, Dec. 31, 1970]

§ 1.503(a)–1 Denial of exemption to certain organizations engaged in prohibited transactions.

(a)(1) Prior to January 1, 1970, section 503 applies to those organizations described in sections 501(c)(3), 501(c)(17), and section 401(a) except:

(i) A religious organization (other than a trust);

(ii) An educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on;

(iii) An organization which normally receives a substantial part of its support (exclusive or income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a)) from the United States or any State or political subdivision thereof or from direct of indirect contributions from the general public,

(iv) An organization which is operated, supervised, controlled or principally supported by a religious organization (other than a trust) which is itself not subject to the provisions of this section; and

(v) An organization the principal purposes or functions of which are the providing of medical or hospital care or medical education or medical research or agricultural research.

(2) Effective January 1, 1907, and prior to January 1, 1975, section 503 shall apply only to organizations described in section 501(c) (17) or (18) or section 401(a).

(3) Effective January 1, 1975, section 503 shall apply only to organization described in section 501(c) (17) or (18) or described in section 401(a) and referred to in section 4975(g) (2) or (3).

(b) The prohibited transactions enumerated in section 503(b) are in addition to and not in limitation of the restrictions contained in section 501(c) (3), (17), or (18) or section 401(a). Even though an organization has not engaged in any of the prohibited transactions referred to in section 503(b), it still may not qualify for tax exemptions in view of the general provisions of section 501(c) (3), (17), or (18) or section 401(a). Thus, if a trustee or other fiduciary of the organization (whether or not he is also a creater or such organization) enters into a transaction with the organization, such transaction will be closely scrutinized in the light of the fiduciary principle requiring undivided loyalty to ascertain whether the organization is in fact being operated for the stated exempt purpose.

(c) An organization—(1) Described in section 501(c)(3) which after July 1, 1950, but before January 1, 1970, has engaged in any prohibited transaction as defined in section 503(b), unless it is excepted by the provisions of paragraph (a)(1) of this section;

(2) Described in section 401(a) and referred to in section 4975(g) (2) or (3) which after March 1, 1954, has engaged in any prohibited transaction as defined in section 503(b);

(3) Described in section 401(a) and not referred to in section 4975(g) (2) or (3) which after March 1, 1954, but before January 1, 1975, has engaged in any prohibited transaction as defined in section 503(b) or which after December 31, 1962, but before January 1, 1975, has engaged in any prohibited transaction as defined in section 503(g) prior to its repeal by section 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978);

(4) Described in section 501(c)(17) which after December 31, 1959, has engaged in any prohibited transaction as defined in section 503(b); or

(5) Described in section 501(c)(18) which after December 31, 1969, has engaged in any prohibited transaction described in section 503(b)

Shall not be exempt from taxation under section 501(a) for any taxable year subsequent to the taxable year in

which there is mailed to it a notice in writing by the Commissioner that it has engaged in such prohibited transactions. Such notification by the Commissioner shall be by registered or certified mail to the last known name and address of the organization. However, notwithstanding the requirement of notification by the Commissioner, the exemption shall be denied with respect to any taxable year if such organization during or prior to such taxable year commenced the prohibited transaction with the purpose of diverting income or corpus from its exempt purposes and such transaction involved a substantial party of the income or corpus of such organization. For the purpose of this section, the term *taxable year* means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the *taxable year* of the organizations means a calendar year. See 26 CFR §1.503(j)–1 (rev. as of Apr. 1, 1974) for provisions relating to the definition of prohibited transactions in the case of trusts benefitting certain owner-employees after December 31, 1962, but prior to January 1, 1975. See also section 2003 (c)(1)(B) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978) in the case of an organization described in section 401(a) with respect to which a disqualified person elects to pay a tax in the amount and manner provided with respect to the tax imposed by section 4975 of the Code so that the organization may avoid denial of exemption under section 503. For further guidance regarding the definition of last known address, see §301.6212–2 of this chapter.

(d) The application of section 503(b) may be illustrated by the following examples:

Example 1. A creates a foundation in 1954 ostensibly for educational purposes. B, a trustee, accumulates the foundation's income from 1957 until 1959 and then uses a substantial part of this accumulated income to send A's children to college. The foundation would lose its exemption for the taxable years 1957 through 1959 and for subsequent taxable years until it regains its exempt status.

Example 2. If under the facts in Example 1 such private benefit was the purpose of the foundation from its inception, such foundation is not exempt by reason of the general provisions of section 501(c)(3), without regard to the provisions of section 503, for all years since its inception, that is, for the taxable years 1954 through 1959 and subsequent taxable years, since under section 501(c)(3) the organization must be organized and operated exclusively for exempt purposes. See §1.501(c)(3)–1.

[T.D. 7428, 41 FR 34621, Aug. 16, 1976, as amended by T.D. 8939, 66 FR 2819, Jan. 12, 2001]

§1.503(b)–1 Prohibited transactions.

(a) *In general.* The term *prohibited transaction* means any transaction set forth in section 503(b) engaged in by any organization described in paragraph (a) of §1.503(a)–1. Whether a transaction is a prohibited transaction depends on the facts and circumstances of the particular case. This section is intended to deny tax-exempt status to such organizations which engage in certain transactions which inure to the private advantage of (1) the creator of such organization (if it is a trust); (2) any substantial contributor to such organization; (3) a member of the family (as defined in section 267(c)(4) of an individual who is such creator of or such substantial contributor to such organization; or (4) a corporation controlled, as set forth in section 503(b), by such creator or substantial contributor.

(b) *Loans as prohibited transactions under section 503(b)(1)*—(1) *Adequate security.* For the purposes of section 503(b)(1), which treats as prohibited transactions certain loans by an organization without receipt of adequate security and a reasonable rate of interest, the term *adequate security* means something in addition to and supporting a promise to pay, which is so pledged to the organization that it may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan. Mortgages or liens on property, accommodation endorsements of those financially capable of meeting the indebtedness, and stock or securities issued by corporations other than the borrower may constitute security for a loan to the persons or organizations described in section 503(b). Stock of a borrowing corporation does

not constitute adequate security. A borrower's evidence of indebtedness, irrespective of its name, is not security for a loan, whether or not it was issued directly to the exempt organization. However, if any such evidence of indebtedness provides for security that may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, there may be adequate security for such loan. If an organization subject to section 503(b) purchases debentures issued by a person specified in section 503(b), the purchase is considered, for purposes of section 503(b)(1), as a loan made by the purchaser to the issuer on the date of such purchase. For example, if an exempt organization subject to section 503(b) makes a purchase through a registered security exchange of debentures issued by a person described in section 503(b), and owned by an unknown third party, the purchase will be considered as a loan to the issuer by the purchaser. For rules relating to loan of funds to, or investment of funds in stock or securities of, persons described in section 503(b) by an organization described in section 401(a), see paragraph (b)(5) of § 1.401–1.

(2) *Effective dates.* The effective dates for the application of the definition of adequate security in paragraph (b)(1) of this paragraph are:

(i) March 15, 1956, for loans (other than debentures) made after March 15, 1956;

(ii) January 31, 1957, for loans (other than debentures) made before March 16, 1956, and continued after January 31, 1957;

(iii) November 8, 1956, for debentures which were purchased after November 8, 1956;

(iv) December 1, 1958, for debentures which were purchased before November 9, 1956, and held after December 1, 1958;

(v) If an employees' pension, stock bonus, or profit-sharing trust described in section 401(a) made a loan before March 1, 1954, repayable by its terms after December 31, 1955, and which would constitute a prohibited transaction if made on or after March 1, 1954, the loan shall not constitute a prohibited transaction if held until maturity (determined without regard to any extension or renewal thereof);

(vi) January 1, 1960, for loans (including the purchase of debentures) made by supplemental unemployment benefit trusts, described in section 501 (c)(17);

(vii) January 1, 1970, for loans (including the purchase of debentures) made by employees' contribution pension plan trusts described in section 501(c)(18).

(3) *Certain exceptions to section 503(b)(1).* See section 503(e) and § 1.503(e)–1, 1.503(e)–2, and 1.503(e)–3 for special rules providing that certain obligations acquired by trusts described in section 401(a) or section 501(c) (17) or (18) shall not be treated as loans made without the receipt of adequate security for purposes of section 503(b)(1). See section 503(f) and § 1.503(f)–1 for an exception to the application of sections 503(b)(1) for certain loans made by employees' trusts described in section 401(a).

(c) *Examples.* The principles of this section are illustrated by the following examples: (Assume that section 503 (e) and (f) are not applicable.)

Example 1. A, creator of an exempt trust subject to section 503, borrows $100,000 from such trust in 1960, giving his unsecured promissory note. The net worth of A is $1,000,000. The net worth of A is not *security* for such loan and the transaction is a prohibited transaction. If, however, the note is secured by a mortgage on property of sufficient value, or is accompanied by acceptable collateral of sufficient value, or carries with it the secondary promise of repayment by an accommodation endorser financially capable of meeting the indebtedness, it may be adequately secured. However, subordinated debentures bonds of a partnership which are guaranteed by the general partners are not adequately secured since the general partners are liable for the firm's debt and their guaranty adds no additional security.

Example 2. Assume the same facts as in example 1 except that A's promissory note in the amount of $100,000 to the trust is secured by property which has a fair market value of $75,000. A's promissory note secured to the extent of $75,000 is not adequately secured within the meaning of section 503(b)(1) since the security at the time of the transaction must be sufficient to repay the indebtedness, interest, and charges which may pertain thereto.

Example 3. Corporation M, a substantial contributor to an exempt organization subject to section 503, borrows $150,000 from such organization in 1960, giving its promissory note accompanied by stock of the borrowing

corporation with a fair market value of $200,000. Since promissory notes and debentures have priority over stock in the event of liquidation of the corporation, stock of a borrowing corporation is not adequate security. Likewise, debenture bonds which are convertible on default into voting stock of the issuing corporation do not constitute *adequate security* under section 503(b)(1).

Example 4. B, creator of an exempt trust subject to section 503, borrows $100,000 from such trust in 1960, giving his secured promissory note at the rate of 3 percent interest. The prevailing rate of interest charged by financial institutions in the community where the transaction takes place is 5 percent for a loan of the same duration and similarly secured. The loan by the trust to the grantor is a prohibited transaction since section 503(b)(1) requires both adequate security and a reasonable rate of interest. Further, a promise to repay the loan plus a percentage of future profits which may be greater than the prevailing rate of interest does not meet the reasonable rate of interest requirement.

Example 5. N Corporation, a substantial contributor to an exempt organization subject to section 503 borrows $50,000 on or after March 16, 1956, from the organization. If the loan is not adequately secured, the organization has committed a prohibited transaction at the time the loan was made. If the loan had been made on or before March 15, 1956, and is continued after January 31, 1957, it must be adequately secured on February 1, 1957, or it will be considered a prohibited transaction on that date. However, if the exempt organization were an employees' trust, described in section 401(a), and the loan were made before March 1, 1954, repayable by its terms after December 31, 1955, it would not have to be adequately secured on February 1, 1957. Moreover, if the exempt organization were a supplemental unemployment benefit trust, described in section 501(c)(17), and the loan were made before January 1, 1960, repayable by its terms after December 31, 1959, it would not have to be adequately secured on January 1, 1960.

Example 6. An exempt organization subject to section 503 purchases a debenture issued by O Corporation, which is a substantial contributor to the organization. The organization purchases the debenture in an arm's length transaction from a third person on or after November 9, 1956. The purchase is considered as a loan by the organization to O Corporation. The loan must be adequately secured when it is made, or it is considered as a prohibited transaction at that time. If the organization purchased the debenture before November 9, 1956, and holds it after December 1, 1958, the debenture must be adequately secured on December 2, 1958, or it will then be considered as a prohibited transaction. However, if the organization were an employees' trust described in section 401(a), and if the debenture were purchased before March 1, 1954, and its maturity date is after December 31, 1955, the debenture does not have to be adequately secured. Moreover, if the organization were an employees' contribution pension plan trust described in section 501(c)(18), and if the debenture were purchased before January 1, 1970, and its maturity date is after December 31, 1969, the debenture does not have to be adequately secured.

[T.D. 7428, 41 FR 34621, Aug. 16, 1976]

§ 1.503(c)–1 Future status of organizations denied exemption.

(a) Any organization described in section 501(c) (3), (17), or (18), or an employees' trust described in section 401(a), which is denied exemption under section 501(a) by reason of the provisions of section 503(a), may file, in any taxable year following the taxable year in which notice of denial was issued, a claim for exemption. In the case of organizations described in section 501(c) (3), (17), or (18), the appropriate exemption application shall be used for this purpose, and shall be filed with the district director. In the case of an enmployees' trust described in section 401(a), the information described in § 1.404(a)–2 shall be submitted with a letter claiming exemption. All employees' trust described in section 401(a) shall submit this information to the district director with whom a request for a determination as to its qualification under section 401 and exemption under section 501 may be submitted under paragraph (s) of § 601.201 of this chapter (Statement of Procedural Rules). A claim for exemption must contain or have attached to it, in addition to the information generally required of such an organization claiming exemption as an organization described in section 501(c) (17), or (18), or section 401(a) (or section 501(c)(3) prior to January 1, 1970), a written declaration made under the penalities of perjury by principal officer of such organization authorized to make such declaration that the organization will not knowingly again engage in a prohibited transaction, (as defined in section 503(b) (or 4975(c) if such section applies to such organization)). In the case of section 501(c)(3) organizations which have lost their exemption after December 31, 1969, pursuant to section 503, a

claim for exemption must contain or have attached to it a written agreement made under penalities of perjury by a principal officer of such organization authorized to make such agreement that the organization will not violate the provisions of chapter 42. In addition, such organization must comply with the rules for governing instruments as prescribed in § 1.508–3. See § 1.501(a)–1 for proof of exemption requirements in general.

(b) If the Commissioner is satisfied that such organization will not knowingly again engage in a prohibited transaction (as defined under section 503(b) or 4975(c), as applicable to such organization) or in the case of a section 501(c)(3) organization, will not violate the provisions of chapter 42, and the organization also satisfied all the other requirements under section 501(c) (3), (17), or (18), or section 401(a), the organization will be so notified in writing. In such case the organization will be exempt (subject to the provisions of section 501(c)(3), or sections 501(c) (17), (18) or 401(a), and 503, and 504 when applicable) with respect to the taxable years subsequent to the taxable year in which the claim described in section 503(c) is filed. Section 503 contemplates that an organization denied exemption because of the terms of such section will be subject to taxation for at least one full taxable year. For the purpose of this section, the term *taxable year* means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the *taxable year* of the organization means the calendar year.

(c) For taxable years beginning after December 31, 1969, the denial of an exemption pursuant to this section, for a taxable year prior to January 1, 1970, of an organization described in section 501(c)(3) shall not cause such organization to cease to be described in section 501(c)(3) for purposes of part II of subchapter F, chapter 1 and for purposes of the application of chapter 42 taxes.

(d) In the case of an organization described in section 501(c)(3), which has lost its exemption pursuant to section 503, and which has not notified the Commissioner that it is applying for recognition of its exempt status under section 508(a) and this section, no gift or contribution made after December 31, 1969, which would otherwise be deductible under section 170, 642(c), or 545(b)(2) shall be allowed as a deduction. For rules relating to the denial of deductions with respect to gifts or contributions made before January 1, 1970, see, § 1.503(e)–4.

[T.D. 7428, 41 FR 34622, Aug. 16, 1976, as amended by T.D. 7896, 48 FR 23817, May 27, 1983]

§ 1.503(d)–1 Cross references.

For provisions relating to loans described in section 503(b)(1) by a trust described in section 401(a), see § 1.503(b)–1 and section 503 (e) and (f) and the regulations thereunder.

[T.D. 7428, 41 FR 34623, Aug. 16, 1976]

§ 1.503(e)–1 Special rules.

(a) *In general.* (1) Section 503(e) provides that for purposes of section 503(b)(1) (relating to loans made without the receipt of adequate security and a reasonable rate of interest) the acquisition of a bond, debenture, note, or certificate or other evidence of indebtedness shall not be treated as a loan made without the receipt of adequate security if certain requirements are met. Those requirements are described in § 1.503(e)–2.

(2) Section 503(e) does not affect the requirement in section 503(b)(1) of a reasonable rate of interest. Thus, although the acquistion of a certificate of indebtedness which meets all of the requirements of section 503(e) and of § 1.503(e)–2 will not be considered as a loan made without the receipt of adequate security, the acquisition of such an indebtedness does consitute a prohibited transaction if the indebtedness does not bear a reasonable rate of interest.

(3) The provisions of section 503(e) do not limit the effect of section 401(a) and § 1.401–2, section 501(c)(17)(A)(i), or section 501(c)(18)(A), all relating to the use of diversion of corpus or incopme of the respective employee trusts. Furthermore, the provisions of section 503(e) do not limit the effect of any of the provisions of section 503 other than section 503(b)(1). Thus, for example, although a loan made by employees'

trust described in section 503(a)(1)(B) meets all the requirements of section 503(e) and therefore is not treated as a loan made without the receipt of adequate security, such an employees' trust making such a loan will lose its exempt status if the loan is not considered as made for the exclusive benefit of the employees or their beneficiaries. Similarly, a loan which meets the requirements of section 503(e) will constitute a prohibited transaction within the meaning of section 503(b)(6) if it results in a substantial diversion of the trust's income or corpus to a person described in section 503(b).

(b) *Definitions*. For purposes of section 503(e):

(1) The term *obligation* means bond, debenture, note, or certificate or other evidence of indebtedness.

(2) The term *issuer* includes any person described in section 503(b) who issues an obligation.

(3)(i) The term *person independent of the issuer* means a person who is not related to the issuer by blood, by marriage, or by reason of any substantial business interests. Persons who will be considered not to be independent of the issuer include but are not limited to:

(*a*) The spouse, ancestor, lineal descendant, or brother or sister (whether by whole or half blood) of an individual who is the issuer of an obligation;

(*b*) A corporation controlled directly or indirectly by an individual who is the issuer, or directly or indirectly by the spouse, ancestor, lineal descendant, or brother or sister (whether by whole or half blood) of an individual who is the issuer;

(*c*) A corporation which directly or indirectly controls, or is controlled by, a corporate issuer;

(*d*) A controlling shareholder of a corporation which is the issuer, or which controls the issuer;

(*e*) An officer, director, or other employee of the issuer, of a corporation controlled by the issuer, or of a corporation which controls the issuer;

(*f*) A fiduciary of any trust created by the issuer, by a corporation which controls the issuer, or by a corporation which is controlled by the issuer; or

(*g*) A corporation controlled by a person who controls a corporate issuer.

(ii) For purposes of paragraph (b)(3)(i) of this section, the term *control* means, with respect to a corporation, direct or indirect ownership of 50 percent or more of the total combined voting power of all voting stock or 50 percent or more of the total value of shares of all classes of stock. If the aggregate amount of stock in a corporation owned by an individual and by the spouse, ancestors, lineal descendants, brothers and sisters (whether by whole of half blood) of the individual is 50 percent or more of the total combined voting power of all voting stock or is 50 percent or more of the total value of all classes of stock, then each of these persons shall be considered as the controlling shareholder of the corporation.

(iii) In determining family relationships for purposes of paragraph (b)(3)(i) of this section, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(4) The term *issue* means all the obligations of an issuer which are offered for sale on substantially the same terms. Obligations shall be considered offered for sale on substantially the same terms if such obligation would, at the same time and under the same circumstances, be traded on the market at the same price. On the other hand, if the terms on which obligations are offered for sale differ in such manner as would cause such obligations to be traded on the market at different prices, then such obligations are not part of the same issue. The following are examples of terms which, if different, would cause obligations to be traded on the market at different prices: (i) Interest rate; (ii) Maturity date; (iii) Collateral; and (iv) Conversion provisions

The fact that obligations are offered for sale on different dates will not preclude such obligations from being part of the same issue if they all mature on the same date and if the terms on which they are offered for sale are otherwise the same, since such obligations would, at the same time and under the same conditions, be traded on the market at the same price. Obligations shall not be considered part of the same issue merely because they are part of the same authorization or because they are registered as part of the same issue

with the Securities and Exchange Commission.

[T.D. 7428, 41 FR 34623, Aug. 16, 1976]

§ 1.503(e)–2 Requirements.

(a) *In general.* The requirements which must be met under section 503(e) for an obligation not to be treated as a loan made without the receipt of adequate security for purposes of section 503(b)(1) are described in paragraphs (b), (c), and (d) of this section. For purposes of this section, the term *employee trust* shall mean any of the three kinds of organizations described in section 503(a)(1).

(b) *Methods of acquisition*—(1) *In general.* The employee trust must acquire the obligation of the market, by purchase from an underwriter, or by purchase from the issuer, in the manner described in subparagraph (2), (3), or (4) of this paragraph.

(2) *On the market.* (i) An obligation is acquired on the market when it is purchased through a national securities exchange which is registered with the Securities and Exchange Commission, or when it is purchased in an over-the-counter transaction. For purposes of the preceding sentence, securities purchased through an exchange which is not a national securities exchange registered with the Securities and Exchange Commission shall be treated as securities purchased in an over-the-counter transaction.

(ii)(*a*) If the obligation is listed on a national securities exchange registered with the Securities and Exchange Commission, it must be purchased through such an exchange or in an over-the-counter transaction at a price not greater than the price of the obligation prevailing on such an exchange at the time of the purchase by the employee trust.

(*b*) For purposes of section 503(e), the price of the obligation prevailing at the time of the purchase means the price which accurately reflects the market value of the obligation. In the case of an obligation purchased through a national securities exchange which is registered with the Securities and Exchange Commission, the price paid for the obligation will be considered the prevailing price of the obligation. In the case of an obligation purchased in an over-the-counter transaction, the prevailing price may be the price at which the last sale of the obligation was affected on such national securities exchange immediately before the employee trust's purchase of such obligation on the same day or may be the mean between the highest and lowest prices at which sales were effected on such exchange on the same day or on the immediately preceding day or on the last day during which there were sales of such obligation or may be a price determined by any other method which accurately reflects the market value of the obligation.

(iii)(*a*) If the obligation is not listed on a national securities exchange which is registered with the Securities and Exchange Commission, it must be purchased in an over-the-counter transaction at a price not greater than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer.

(*b*) For purposes of section 503(e) the offering price for the obligation at the time of the purchase means the price which accurately reflects the market value of the obligation. The offering price may be the price at which the last sale of the obligation to a person independent of the issuer was effected immediately before the employee trust's purchase of such obligation on the same day or may be the mean between the highest and lowest prices at which sales to persons independent of the issuer were effected on the same day or on the last day during which they were sales of such obligation or may be a price determinated by any other method which accurately reflects the market value of the obligation. The offering price for an obligation must be a valid price for the amount of the obligations which the trust is purchasing. For example, if an employees' trust described in section 503(a)(1)(B) purchases 1,000 bonds of the employer corporation at the offering price established by current prices for a lot of 10 such bonds, such offering price may not be a valid price for 1,000 bonds and the purchase may therefore not meet the requirements of this subdivision. For a purchase of an obligation to qualify under

this subdivision, there must be sufficient current prices quoted by persons independent of the issuer to establish accurately the current value of the obligation. Thus, if there are no current prices quoted by persons independent of the issuer, an over-the-counter transaction will not qualify under this subparagraph even though the obligation was purchased in an arms's length transaction from a person independent of the issuer.

(iv) For purposes of this section, an over-the-counter transaction is one not executed on a national securities exchange which is registered with the Securities and Exchange Commission. An over-the-counter transaction may be made through a dealer or an exchange which is not such a national securities exchange or may be made directly from the seller to the purchaser.

(3) *From an underwriter.* An obligation may be purchased from an underwriter if it is purchased at a price not greater than:

(i) The public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission, or

(ii) The price at which a substantial portion of the issue including such obligation is acquired by persons independent of the issuer

whichever is the lesser price. For purposes of this subparagraph, a portion of the issue will be considered substantial if the purchasers of such portion by persons independent of the issuer are sufficient to establish that fair market value of the obligations included in such issue. In determining whether the purchases are sufficient to establish the fair market value, all the surrounding facts and circumstances will be considered, including the number of independent purchasers, the aggregate amount purchased by each such independent purchaser, and the number of transactions. In the case of a large issue, purchases of a small percentage of the outstanding obligations may be considered purchases of a substantial portion of the issue; whereas, in the case of a small issue, purchases of a larger percentage of the outstanding obligations will ordinarily be required. The requirement in paragraph (b)(3)(ii) of this section contemplates purchase of the obligations by persons independent of the issuer contemporaneously with the purchase by the employee trust. If a substantial portion has been purchased at different prices, the price of the portion may be based on the average of such prices, and if several substantial portions have been sold to persons independent of the issuer, the price of any of the substantial portions may be used for pusposes of this subparagraph.

(4) *From the issuer.* An obligation may be purchased directly from the issuer at a price not greater than the price paid currently for a substantial portion of the same issue by persons independent of the issuer. This requirement contemplates purchase of a substantial portion of the same issue by persons independent of the issuer contemporaneously with the purchase by the employee trust. For purposes of this subparagraph, a portion of the issue will be considered substantial if the purchases of such portion by persons independent of the issuer are sufficient to establish the fair market value of the obligations included in such issue. In determining whether the purchases are sufficient to establish the fair market value, all the surrounding facts and circumstances will be considered, including the number of independent purchasers, the aggregage amount purchased by each such independent purchaser, and the number of transactions. In the case of a large issue, purchases of a small percentage of the outstanding obligations may be considered purchases of a substantial portion of the issue; whereas, in the case of a small issue, purchases of a larger percentage of the outstanding obligations will ordinarily be required. The price paid for a substantial portion of the issue may be determined in the manner privided in paragraph (b)(3) of this section.

(c) *Limitations on holdings of obligations.* (1) Immediately following acquisition of the obligation by the employee trust:

(i) Not more than 25 percent of the aggregate amount of the obligations issued in such issue and outstanding immediately after acquisition by the trust may be held by the trust, and

(ii) At least 50 percent of such aggregate amount must be held by persons independent of the issuer.

(2)(i) For purposes of paragraph (c)(1) of this section, an obligation is not considered as outstanding if it is held by the issuer. For example, if an obligation which has been issued and outstanding is repurchased and held by the issuer, without cancellation or retirement, such an obligation is not considered outstanding.

(ii) For purposes of paragraph (c)(1) of this section, the amounts of the obligations held by the trust and by persons independent of the issuer shall be computed on the basis of the face amount of the obligations.

(d) *Limitation on amount invested in obligations.* (1)(i) Immediately following acquisition of the obligation, not more 25 percent of the assets of the employee trust may be invested in all obligations of all persons described in section 503(b). For purposes of determining the amount of the trust's assets which are invested in obligations of persons described in section 503(b) immediately following acquisition of the obligation, those obligations shall be valued as follows:

(*a*) Those obligations included in the acquisition in respect of which the percentage test in the first sentence of this subdivision is being applied shall be valued at their adjusted basis, as provided in section 1011, relating to adjusted basis for determining gain or loss; and

(*b*) All other obligations of persons described in section 503(b) which were part of the trust's assets immediately before the acquisition of the obligations described in (d)(1)(i)(*a*) of this section shall be valued at their fair market value on the day that the obligations described in (d)(1)(i)(*a*) of this section were acquired. For purposes of determining the total amount of the assets of the trust (including obligations of persons described in section 503(b)), there shall be used the fair market value of those assets on the day the obligation is acquired.

(ii) The application of the rules in paragraph (d)(1)(i) of this section may be illustrated by the following example:

Example. On February 1, 1960, an exempt employees' trust described in section 401(a) purchases unsecured debentures issued by the employer corporation for $1,000. At the time of this purchase, such debentures have a fair market value of $1,200. Immediately after the purchase of such unsecured debentures, the assets of the trust consist of the following:

	Cost	Fair market value on Feb. 1, 1960
(a) Assets other than obligations of persons described in sec. 503(b)	$5,000	$7,800
(b) Obligations of persons described in sec. 503(b) acquired before Feb. 1, 1960	500	1,000
(c) Unsecured debentures of employer purchased on Feb. 1, 1960	1,000	1,200

Immediately following acquisition of the unsecured debentures by the trust, the percent of the assets of the trust that are invested in all obligations of all persons described in section 503(b) is computed as follows:

(1) Obligations of persons described in section 503(b) acquired before Feb. 1, 1960 (valued at fair market value)	$1,000
(2) Unsecured debentures of employer purchased on Feb. 1, 1960 (valued at cost)	1,000
(3) Total amount of trust's assets invested in obligations of persons described in section 503(b) ((1) plus (2))	2,000
(4) Assets of the trust other than obligations of persons described in section 503(b) (valued at fair market value on Feb. 1, 1960)	7,800
(5) Obligations of persons described in section 503(b) acquired before Feb. 1, 1960 (valued at fair market value on Feb. 1, 1960)	1,000
(6) Unsecured debentures of employer purchased on Feb. 1, 1960 (valued at fair market value on Feb. 1, 1960)	$1,200
(7) Total assets of the trust valued at fair market value on Feb. 1, 1960 (sum of (4), (5), and (6))	10,000
(8) Percent of assets of the trust invested in all obligations of all persons described in section 503(b) immediately following purchase of unsecured debentures on Feb. 1, 1960 ((3) ÷ (7), that is, $2,000 ÷ $10,000)	20%

(2) In determining for purposes of subparagraph (1) of this paragraph the amount invested in obligations of persons described in section 503(b), there shall be included amounts invested in any obligations issued by any such person, irrespective of whether the obligation is secured, and irrespective of whether the obligation meets the conditions of section 503(e) or section 503(f). Obligations of persons described

in section 503(b) other than the issuer of the obligation to which section 503(e) applies are also included within the 25 percent limitation. For example, if on February 19, 1959, an exempt employees' trust described in section 401(a) purchases unsecured debentures issued by the employer corporation in a transaction effected on the New York Stock Exchange, and if immediately after the purchase 10 percent of the trust's assets is invested in such debentures and 20 percent of its assets is invested in a loan made with adequate security on January 12, 1959, to the wholly-owned subsidiary of the employer corporation, then the purchase of the employer's debentures will not qualify under section 503(e), since 30 percent of the trust's assets are then invested in obligations of persons described in section 503(b).

(e) *Change of terms of an obligation.* A change in terms of an obligation is considered as the acquisition of a new obligation. If such new obligation is not adequately secured, the requirements of section 503(e) must be met at the time the terms of the obligation are changed for such section to be applicable to such new loan.

[T.D. 7428, 41 FR 34624, Aug. 16, 1976]

§ 1.503(e)–3 Effective dates.

(a) Section 503(e) and §§ 1.503(e)–1 and 1.503(e)–3 are effective in the case of an employees' trust described in section 401(a) for taxable years ending after March 15, 1956. Thus, if during a taxable year ending before March 16, 1956, an employees' trust made a loan which meets the requirements of section 503(e), such loan will not be treated as made without the receipt of adequate security and will not cause the loss of exemption for taxable years ending after March 15, 1956, although such loan was not considered adequately secured when made. (However, section 503 does not apply to organizations described in section 401(a) not referred to in section 4975(g) (2) or (3) for transactions occurring after December 31, 1974.)

(b)(1) In the case of obligations acquired by an employees' trust described in section 401(a) before September 2, 1958, which were held on that date, the requirements described in paragraphs (c) and (d) of § 1.503(e)–2 which were not satisfied immediately following the acquisition shall be treated as satisfied at that time if those requirements would have been satisfied had the obligations been acquired on September 2, 1958. For example, on January 3, 1955, an employees' trust described in section 401(a) purchased through the New York Stock Exchange unsecured debentures issued by the employer corporation. Under section 503(e) the acquisition of such debentures by the trust will not be treated for taxable years ending after March 15, 1956, as a loan made without the receipt of adequate security if the debentures were held by the employees' trust on September 2, 1958, and if the requirements of paragraphs (c) and (d) of § 1.503(e)–2 which were not met on January 3, 1955, were met on September 2, 1958, as if that date were the date of acquisition.

(2) In the case of obligations acquired before September 2, 1958, which were not held by the employees' trust described in section 401(a) on that date, only the requirements described in paragraph (b) of § 1.503(e)–2 must be satisfied for section 503(e) to be applicable to such acquisition. For example, if on December 5, 1956, an employees' trust lent money to the employer corporation by purchasing a debenture issued by the employer and if the trust sold the debenture on August 1, 1958, such loan would not be treated as made without the receipt of adequate security if the requirement described in paragraph (b) of § 1.503(e)–2 was met on December 5, 1956.

(c) Section 503(e) and §§ 1.503(e)–1 and 1.503(e)–2 are effective in the case of trusts described in section 501(c)(17) with respect to loans made, renewed, or, in the case of demand loans, continued after December 31, 1959, and in the case of trusts described in section 501(c)(18) with respect to loans made, renewed or, in the case of demand loans, continued after December 31, 1969.

(d) See paragraph (b)(2) of § 1.503(b)–1 for the effective dates for the application of the definition of adequate security.

[T.D. 7428, 41 FR 34626, Aug. 16, 1976]

§ 1.503(e)–4 Disallowance of charitable deductions for certain gifts made before January 1, 1970.

Paragraphs (a), (b), and (c) of this section shall apply only to gifts or contributions made before January 1, 1970, to an organization described in section 501(c)(3). For rules relating to the denial of deductions with respect to gifts or contributions made after December 31, 1969, see § 1.503(c)–1(d).

(a) No gift or contribution which would otherwise be allowable as a charitable or other deductions under section 170, 642(c), or 545(b)(2) shall be allowed as a deduction if made to an organization described in section 501(c)(3) which at the time the gift or contribution is made is not exempt under section 501(a) by reason of the provisions of section 503.

(b) If an organization which is described in section 501(c)(3) is not exempt because it engaged in a prohibited transaction involving a substantial part of its income of corpus with the purpose of diverting its income or corpus from its exempt purposes, and if the organization receives a gift or contribution during, or prior to, its taxable year in which such prohibited transaction occurred, then a deduction by the donor with respect to the gift or contribution shall not be disallowed under section 503(b) unless the donor (or any member of his family if the donor is an individual) is a party to such prohibited transaction. For the purpose of the preceding sentence *family* is defined in section 267(c)(4) and includes brothers and sisters, whether by whole or half blood, spouse, ancestors, and lineal descendants. See the regulations under section 267(c).

(c) The application of § 1.503(e)–4 may be illustrated by the following example:

Example. In 1954, Corporation M, which files its income tax returns on the calendar year basis, creates a foundation purportedly for charitable purposes and deducts from its gross income for that year the amount of the gift to the foundation. Corporation M makes additional gifts to this foundation in 1955, 1956, and 1957, and takes charitable deductions for such years. B, an individual, also contributes to the foundation in 1955, 1956, and 1957, and takes charitable deductions for such years. In 1955, the foundation commences purposely to divert its corpus to the benefit of Corporation M, and a substantial amount of such corpus is so diverted by the close of the taxable year 1956. For 1955 and subsequent taxable years, the exemption allowed the foundation as an organization described in section 501(c)(3) is denied by reason of the provisions of section 503(a). Both Corporation M and individual B would be disallowed any deduction for the contributions made during 1957 to the foundation. Moreover, the charitable deductions taken by Corporation M for contributions to the foundation in the years 1955 and 1956 would also be disallowed since Corporation M was a party to the prohibited transactions. If the facts and surrounding cuircumstances indicate that the contribution in 1954 by Corporation M was for the purpose of the prohibited transaction, then the charitable deduction for the year 1954 shall also be disallowed with respect to Corporation M, since the prohibited transaction would then have commenced with the making of such contribution and the exemption allowed the foundation would then be denied for 1954 by reason of the provisions of § 1.503(e)–4. B's deductions for his contributions for the years 1955 and 1956 will not be disallowed since he was not a party to the prohibited transaction.

[T.D. 7428, 41 FR 34626, Aug. 16, 1976]

§ 1.503(f)–1 Loans by employers who are prohibited from pledging assets.

(a) *In general*. (1) Section 503(f) provides that section 503(b)(1) shall not apply to a loan made to the employer by an employees' trust described in section 401(a) if the loan bears a reasonable rate of interest and certain conditions are met. Section 503(f) also applies to the renewal of loans to the employer and, in the case of demand loans, to the continuation of such loans.

(2) The provisions of section 503(f) do not limit the effect of section 401(a) and § 1.401–2, relating to use or diversion of corpus or income of an employees' trust, or the effect of any of the provisions of section 503 other than section 503(b)(1). Consequently, although a loan made by an employees' trust described in section 503(a)(1)(B) meets all the requirements of section 503(f) and therefore is not treated as a loan made without the receipt of adequate security, an employees' trust making such a loan will lose its exempt status if the loan is not considered as made for the exclusive benefit of the

employees or their beneficiaries. Similarly, a loan which meets the requirements of section 503(f) will constitute a prohibited transaction within the meaning of section 503(b)(6) if it results in a substantial diversion of the trust's income or corpus to a person described in section 503(b).

(b) *Conditions.* (1) Section 503(f) applies to a loan only if, with respect to the making or renewal of the loan, the conditions described in paragraphs (b)(2), (3), and (4) of this section are met. For purpose of this paragraph, the mere continuance of a demand loan is not considered as the making or renewal of such a loan.

(2) The employer must be prohibited (at the time of the making or renewal of the loan) by any law of the United States or regulations thereunder from directly or indirectly pledging, as security for such a loan, a particular class or classes of his assets the value of which (at such time) represents more than one-half of the value of all his assets. If a loan is made or renewed when the employer is prohibited by a law of the United States (or the regulations thereunder) from pledging a class of his assets, the qualification of such a loan under section 503(f) will not be affected by a subsequent change in such law or regulations permitting the employer to pledge such assets, unless such loan is renewed after such change. See section 8(a) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78h(a)), which prohibits certain persons from pledging a class of assets as security for loans, and 12 CFR 220.5(a) (credit by brokers, dealers, and members of national securities exchanges).

(3) The making or renewal, as the case may be, must be approved in writing as an investment which is consistent with the exempt purposes of the trust by a trustee who is independent of the employer, and such written approval must not have been previously refused by any other such trustee. A trustee is independent of the employer, for purposes of this subparagraph, if he is entirely free of influence or controlled by the employer. For example, if the employer is a partnership, then a partner in such partnership, or a member of a partner's family would not be considered independent of the employer. Similarly, an employee of the employer would not be considered independent of the employer. For purposes of this subparagraph, the term *trustee* means, with respect to any trust for which there are two trustees who are independent of the employer, both of such trustees and, with respect to any trust for which there are more than two such independent trustees, a majority of the trustees independent of the employer.

(4)(i) Immediately following the making or renewal, as the case may be, the aggregate amount lent by the trust to the employer, without the receipt of adequate security must not exceed 25 percent of the value of all the assets of the trust.

(ii) For purposes of paragraph (b)(4)(i) of this section, the determination as to whether any amount lent by the trust to the employer is a loan made without the receipt of adequate security shall be made without regard to section 503(e). Thus, if an employees' trust makes a loan on January 2, 1959, to the employer without adequate security (but which loan is not considered as made without adequate security under section 503(e)), and if immediately after making such loan 10 percent of the value of all its assets is invested in such loan, then the trust may on that day invest not more than an additional 15 percent of its assets in a loan which would be considered made without adequate security if it were not for the provisions of section 503(f).

(iii) For purposes of paragraph (b)(4)(i) of this section, in determining the value of all the assets of the trust, there shall be used the fair market value of those assets on the day of the making or renewal.

(c) *Reasonable rate of interest.* Section 503(f) only applies if, in addition to meeting the conditions described in paragraph (b) of this section, the loan bears a reasonable rate of interest when it is made, renewed, or, in the case of demand loans, during the period of its existence.

(d) *Change of terms of loan.* A change in the terms of a loan (including a reduction in the security for a loan) is considered as the making of a new loan. If such a new loan is not adequately secured, the requirements of

section 503(f) must be met at the time the terms of the loan are changed for such section to be applicable to such new loan.

(e) *Effective date.* (1) This section and section 503(f) are effective for taxable years ending after September 2, 1958, but only with respect to periods after such date. Thus, if a loan was made on or before September 2, 1958, without the receipt of adequate security and if, when such loan was made, it met all of the requirements of section 503(f) and this section, then the loan is not subject to section 503(b)(1) after September 2, 1958, and would not consitite a prohibited transaction after that date because of a lack of adequate security.

(2) See paragraph (b)(2) of § 1.503(b)–1 for the effective dates for application of the definition of adequate security.

[T.D. 7428, 41 FR 34626, Aug. 16, 1976]

§ 1.504–1 Attempts to influence legislation; certain organizations formerly described in section 501(c)(3) denied exemption.

Section 504(a) and this section apply to an organization that is exempt from taxation at any time after October 4, 1976, as an organization described in section 501(c)(3), and that ceases to be described in that section because it—

(a) Is an *action* organization within the meaning of § 1.501(c)(3)–1(c)(3)(ii) or (iv), on account of activities occurring after October 4, 1976, or

(b) Is denied exemption under the provisions of section 501(h) (see § 1.501(h)–3 or § 56.4911–9).

This section does not apply, however, to an organization that was described in section 501(h)(5) and § 1.501(h)–2(b)(3) (relating generally to churches) for its taxable year immediately preceding the first taxable year for which it is no longer an organization described in section 501(c)(3). An organization to which section 504(a) and this section apply shall not be treated as described in section 501(c)(4) at any time after the organization ceases to be described in section 501(c)(3). Further, an organization denied treatment as an organization described in section 501(c)(4) under this section may not be treated as an organization described in section 501(c) other than as an organization described in section 501(c)(3). For rules relating to recognition of exemption after exemption is denied under section 501(h), § 1.501(h)–3(d).

[T.D. 8308, 55 FR 35592, Aug. 31, 1990]

§ 1.504–2 Certain transfers made to avoid section 504(a).

(a) *Scope.* Under section 504(b), a transfer described in paragraph (b) or (c) of this section to an organization exempt from tax under section 501(a) may result in loss of exemption by the transferee unless the Commissioner determines, under paragraph (e) of this section, that the original transfer did not effect an avoidance of section 504(a). For purposes of this section, the term *transfer* includes any use by, or for the benefit of, the recipient of the transfer, but does not include any transfer made for adequate and full consideration.

(b) *Transferor and transferee commonly controlled*—(1) *Loss of exemption.* A transfer is described in this paragraph (b) if it is described in paragraphs (b)(2) through (b)(6). The transferee of a transfer described in this paragraph will cease to be exempt from tax under section 501(a), unless the provisions of paragraph (e) of this section apply.

(2) *Transferor organization.* A transfer is described in this paragraph (b)(2) only if it is from an organization that—

(i) Is or was described in section 501(c)(3), but not in section 501(h)(5), and

(ii) Is determined to be an ''action'' organization (as defined in § 1.501(c)(3)–1(c)(3)(ii) or (iv)), or is denied exemption from tax by reason of section 501(h) and either § 1.501(h)–3 or § 56.4911–9.

(3) *Transferor and transferee commonly controlled.* A transfer is described in this paragraph (b)(3) only if, at the time of the transfer or at any time during the transferee's ten taxable years following the year in which the transfer was made, the transferee is controlled (directly or indirectly), as defined in paragraph (f) of this section, by the same person or persons who control the transferor.

(4) *Time of transfer.* A transfer is described in this paragraph (b)(4) only if the transfer is made—

(i) After the date that is 24 months before the earliest of the effective date of the determination under section 501(h) that the transferor is not exempt, the effective date of the Commissioner's determination that the transferor is an ''action'' organization (as defined in §1.501(c)(3)(ii) or (iv)), or the date on which the Commissioner proposes to treat it as no longer described in section 501(c)(3), and

(ii) Before the transferor again is recognized as an organization described in section 501(c)(3).

(5) *Transferee.* A transfer is described in this paragraph (b)(5) only if the transferee is exempt from tax under section 501(a) but the transferee is neither—

(i) An organization described in section 501(c)(3), nor

(ii) An organization described in section 401(a) to which the transferor contributes as an employer.

(6) *Amount of transfer.* A transfer is described in this paragraph (b)(6) only if the amount of the transfer exceeds the lesser of 30 percent of the net fair market value of the transferor's assets or 50 percent of the net fair market value of the transferee's assets, computed immediately before the transfer. For purposes of this paragraph (b)(6)—

(i) The amount of a transfer by a transferor is the sum of the amounts transferred to any number of transferees in any number of transfers, all of which are described in paragraphs (b)(2) through (b)(5) of this section, and the time of the transfer is the time of the first transfer so taken into account; and

(ii) The amount of a transfer to a transferee is the sum of the amounts transferred by a transferor to the transferee in any number of transfers, all of which are described in paragraphs (b)(2) through (b)(5) of this section, and the time of the transfer is the time of the first transfer so taken into account.

(c) *Other transfers*—(1) *Transfers included.* A transfer is described in this paragraph (c) if it would be described in paragraph (b) of this section except that either—

(i) The amount of the transfer is less than the amount determined in paragraph (b)(6) of this section, or

(ii) The transferor and transferee are not commonly controlled as described in paragraph (b)(3) of this section, or

(iii) The transferee is an organization described in sections 501(c)(3) and 501(h)(4).

(2) *Loss of exemption.* The transferee of a transfer described in this paragraph (c) will cease to be exempt under section 501(a) if the Commissioner determines on all the facts and circumstances that the transfer effected an avoidance of section 504(a). In determining whether a transfer effected an avoidance of section 504(a), the Commissioner may consider whether the transferee engages, or has engaged, in attempts to influence legislation and may also consider any factors enumerated in paragraph (e) of this section.

(d) *Date of loss of exempt status.* A transferee of a transfer described in paragraph (b), (c)(1)(ii), or (c)(1)(iii) of this section will cease to be exempt from tax under section 501(a) on the date that all requirements of paragraph (b), (c)(1)(ii), or (c)(1)(iii) (other than the determination by the Commissioner) are satisfied. A transferee of a transfer described in paragraph (c)(1)(i) of this section will cease to be exempt from tax under section 501(a) on the date of the last transfer preceding notification of the transferee that the Commissioner proposes to treat the transferee as other than an exempt organization.

(e) *Transfers not in avoidance of section 504(a).* Notwithstanding paragraph (b) of this section, if, based on all the facts and circumstances, the Commissioner determines that a transfer described in paragraph (b) did not effect an avoidance of section 504(a), the transferee will not be denied exemption from tax by reason of section 504(b) and this section. In making the determination called for in the preceding sentence, the Commissioner may consider all relevant factors including:

(1) Whether enforceable and effective conditions on the transfer preclude use of any of the transferred assets for any purpose that, if it were a substantial part of an organization's activities, would be inconsistent with exemption as an organization described in section 501(c)(3);

(2) In the absence of conditions described in paragraph (e)(1) of this section, whether the transferred assets are used exclusively for purposes that are consistent with the transferor's exemption as an organization described in section 501(c)(3);

(3) Whether the assets transferred would be describe in § 53.4942(a)(–2(c)(3) before, as well as after, the transfer if both the transferor and transferee were private foundations;

(4) Whether and to what extent the transfer would satisfy the provisions of § 1.507–2(a) (7) and (8) if the transferor were a private foundation;

(5) Whether all of the transferred assets have been expended during a period when the transferee was not controlled (directly or indirectly) by the same person or persons who controlled the transferor; and

(6) Whether the entire amount of the transferred assets were in turn transferred, before the close of the transferee's taxable year following the taxable year in which the transferred assets were received, to one or more organizations described in section 507(b)(1)(A) none of which are controlled (directly or indirectly) by the same persons who control either the original transferor or transferee.

(f) *Control.* For purposes of section 504 and the regulations thereunder—

(1) The transferor will be presumed to control any organization with which it is affiliated within the meaning of § 56.4911–7(a), or would be if both organizations were described in section 501(c)(3), and

(2) The transferee will be treated as controlled (directly of indirectly) by the same person or persons who control the transferor if the transferee would be treated as controlled under § 53.4942(a)–3(a)(3), for which purpose the transferor shall be treated as a private foundation.

[T.D. 8308, 55 FR 35592, Aug. 31, 1990]

§ 1.505(c)–1T Questions and answers relating to the notification requirement for recognition of exemption under paragraphs (9), (17) and (20) of Section 501(c) (temporary).

Q–1: What does section 505(c) of the Internal Revenue Code provide?

A–1: Section 505(c) provides that an organization will not be recognized as exempt under section 501(c)(9) as a voluntary employees' beneficiary association, under section 501(c)(17) as a trust forming part of a plan providing for the payment of supplemental unemployment compensation benefits, or under section 501(c)(20) as a trust forming part of a qualified group legal services plan unless notification is given to the Internal Revenue Service. The notification required of a trust created pursuant to section 501(c)(20) and forming part of a qualified group legal services plan is set forth in Q&A–2. The notification required of an organization organized after July 18, 1984, and applying for exempt status as an organization described in section 501(c) (9) or (17) is set forth in Q&A–3 through Q&A–8. The notification required of an organization organized on or before July 18, 1984, and claiming exemption as an organization described in section 501(c) (9) or (17) is set forth in Q&A–9 through Q&A–11. However, an organization that has previously notified the Internal Revenue Service of its claim to exemption under section 501(c) (9), (17), or (20) or its claim to exemption under those sections pursuant to another provision of the Code, is not required, under section 505(c), to submit a renotification (See Q&A–2 and Q&A–12).

SECTION 501(c)(20) TRUSTS

Q–2: What is the notice required of a trust created pursuant to section 501(c)(20) and forming part of a qualified group legal services plan under section 120?

A–2: (a) A trust claiming exemption as an organization described in section 501(c)(20) will be recognized as exempt if the exclusive function of the trust is to form part of a qualified group legal services plan or plans. Exemption of the trust under section 501(c)(20) will generally be dependent upon and coextensive with recognition of the plan as a qualified group legal services plan. Therefore, a trust organized pursuant to section 501(c)(20) after July 18, 1984, need not file a separate notice with the Internal Revenue Service of its claim to exemption because the notice required by section 120(c)(4) will suffice for purposes of section 505(c), provided a copy of the trust instrument is filed with the Form 1024 submitted by the group legal services plan. If the trust instrument has not been filed with the Form 1024 submitted by the group legal services plan, the trust must comply with (and exemption will be dependent upon) the filing applicable to a trust organized on or before July 18, 1984. For the notice required and effective dates of exemption of a qualified group legal services plan under section 120, see § 1.120–3.

(b) A trust organized on or before July 18, 1984, that claims exempt status as a trust described in section 501(c)(20) and that forms

part of a qualified group legal services plan which has been recognized as exempt under section 120, must file a copy of its trust instrument with the Internal Revenue Service before February 4, 1987. If a copy of the trust instrument is filed within the time provided, the trust's exemption will be recognized retroactively to the date the qualified group legal services plan was recognized as exempt under section 120. However, if a copy of the trust instrument is filed after the time provided, exemption will be recognized only for the period after the copy of the trust instrument is filed with the Internal Revenue Service. See Q&A–7 for a further discussion of *date of filing*. A trust that has previously filed a copy of its trust instrument with the Service need not refile that document.

SECTION 501(c)(9) AND (17) ORGANIZATIONS ORGANIZED AFTER JULY 18, 1984

Q–3: What is the notice required of an organization or trust, organized after July 18, 1984, that is applying for recognition of tax exempt status under section 501(c) (9) or (17)?

A–3: An organization or trust that is organized after July 18, 1984, will not be treated as described in paragraphs (9) or (17) of section 501(c), unless the organization notifies the Internal Revenue Service that it is applying for recognition of exemption. In addition, unless the required notice is given in the manner and within the time prescribed by these regulations, an organization will not be treated as exempt for any period before the giving of the required notice. The notice is filed by submitting a properly completed and executed Form 1024, ''Application for Recognition of Exemption Under Section 501(a) or for Determination Under Section 120'' together with the additional information required under Q&A–4 and Q&A–5. The notice is filed with the district director for the key district in which the organization's principal place of business or principal office is located.

The notice may be filed by either the plan administrator (as defined in section 414(g)) or the trustee. The Internal Revenue Service will not accept a Form 1024 for any organization or trust before such entity has been organized.

Q–4: What information, in addition to the information required by Form 1024, must be submitted by an organization or trust seeking recognition of exemption under section 501(c) (9) or (17)?

A–4: A notice will not be considered complete unless, in addition to a properly completed and executed Form 1024, the organization or trust submits a full description of the benefits available to participants under section 501(c) (9) or (17). Moreover, both the terms and conditions of eligibility for membership and the terms and conditions of eligibility for benefits must be set forth. This information may be contained in a separate document, such as a *plan document*, or it may be contained in the creating document of the entity (e.g., the articles of incorporation or association, or a trust indenture). For benefits provided through a policy or policies of insurance, all such policies must be included with the notice. Where individual policies of insurance are provided to the participants, single exemplar copies, typical of policies generally issued to participants, are acceptable, provided they adequately describe all forms of insurance available to participants. In providing a full description of the benefits available, the benefits provided must be sufficiently described so that each benefit is definitely determinable. A benefit is definitely determinable if the amount of the benefit, its duration, and the persons eligible to receive it are ascertainable from the plan document or other instrument. Thus, a benefit is not definitely determinable if the rules governing either its amount, its duration, or its recipients are not ascertainable from the plan document or other instrument but are instead subject to the discretion of a person or committee. Likewise, a benefit is not definitely determinable if the amount for any individual is based upon a percentage share of any item that is within the discretion of the employer. However, a disability benefit will not fail to be considered definitely determinable merely because the determination of whether an individual is disabled is made under established guidelines by an authorized person or committee.

Q–5: What is the notice required of collectively bargained plans?

A–5: If an organization or trust claiming exemption under section 501(c) (9) or (17) is organized and maintained pursuant to a collective bargaining agreement between employee representatives and one or more employer, only one Form 1024 is required to be filed for the organization or trust, regardless of the number of employers originally participating in the agreement. Moreover, once a Form 1024 is filed pursuant to a collective bargaining areement, an additional Form 1024 is not required to be filed by an employer who thereafter participates in that agreement. When benefits are provided pursuant to a collective bargaining agreement, the notice will not be considered complete unless, in addition to a properly completed and executed Form 1024, a copy of the collective bargaining agreement is also submitted together with the additional information delineated in Q&A–4.

Q–6: When must the required notice be filed by an organization or trust, organized after July 18, 1984, that seeks recognition of exemption under section 501(c) (9) or (17)?

A–6: An organization or trust applying for exemption must file the required notice by the later of February 4, 1987 or 15 months

from the end of the month in which the organization or trust was organized. An extension of time for filing the required notice may be granted by the district director if the request is submitted before the end of the applicable period and it is demonstrated that additional time is needed.

Q–7: What is the effective date of exemption for a new organization or trust, organized after July 18, 1984, that has submitted the required notice?

A–7: If the required notice is filed within the time provided by these regulations, the organization's exemption will be recognized retroactively to the date the organization was organized, provided its purpose, organization and operation (including compliance with the applicable nondiscrimination requirements) during the period prior to the date of the determination letter are in accordance with the applicable law. However, if the required notice is filed after the time provided by these regulations, exemption will be recognized only for the period after the application is filed with the Internal Revenue Service. The date of filing is the date of the United States postmark on the cover in which an exemption application is mailed or, if no postmark appears on the cover, the date the application is stamped as received by the Service. If an extension for filing the required notice has been granted to the organization, a notice filed on or before the last day specified in the extension will be considered timely and not the otherwise applicable date under Q&A–6.

Q–8: What is the effect on exemption of the filing of an incomplete notice?

A–8: Although a properly completed and executed Form 1024 together with the required additional information (See Q&A–4 and Q&A–5) must be submitted to satisfy the notice required by section 505(c), the failure to file, within the time specified, all of the information necessary to complete such notice will not alone be sufficient to deny recognition of exemption from the date of organization to the date the completed information is submitted to the Service. If the notice which is filed with the Service within the required time is substantially complete, and the organization supplies the necessary additional information requested by the Service within the additional time allowed, the original notice will be considered timely. However, if the notice is not substantially complete or the additional information is not provided within the additional time allowed, exemption will be recognized only from the date of filing of the additional information.

SECTION 501(c)(9) AND (17) ORGANIZATIONS ORGANIZED ON OR BEFORE JULY 18, 1984

Q–9: What is the notice required of an organization or trust organized on or before July 18, 1984, that claims exempt status as an organization described in section 501(c) (9) or (17)?

A–9: Section 505(c) provides a special rule for existing organizations and trusts organized on or before July 18, 1984. Such an organization or trust will not be treated as described in paragraphs (9) or (17) of section 501(c) unless the organization or trust notifies the Internal Revenue Service in the manner and within the time prescribed in these regulations that it is claiming exemption under the particular section. The type of notice, the manner for filing that notice, and the additional information required is the same as that set forth in Q&A–3 through Q&A–5 for new organizations.

Q–10: When must the required notice be filed by an organization or trust organized on or before July 18, 1984?

A–10: An organization or trust organized on or before July 18, 1984, that claims exempt status as an organization described in section 501(c) (9) or (17), must file the required notice before February 4, 1987. An extension of time for filing the required notice may be granted by the district director if the request is submitted before the due date of the notice and it is demonstrated that additional time is needed.

Q–11: What is the effective date of exemption for an organization or trust organized on or before July 18, 1984, that has submitted the required notice?

A–11: If the required notice is filed within the time provided by these regulations, the organization's exemption will be recognized retroactively to the date the organization was organized, provided its purpose, organization and operation (including compliance with the applicable nondiscrimination requirements) during the period prior to the date of the determination letter are in accordance with the applicable law. If, on the other hand, the required notice is filed after the time provided by these regulations, exemption will be recognized only for the period after the notice is received by the Internal Revenue Service. See Q&A–7 for a further discussion of *date of filing*. See also Q&A–8 for the effect on exemption of a notice that has been timely filed but is incomplete.

EXCEPTIONS TO NOTICE REQUIREMENT

Q–12: Are any organizations or trusts claiming recognition of exemption as an organization described in section 501(c) (9) or (17) excepted from the notice requirement of section 505(c)?

A–12: An organization or trust that has previously notified the Internal Revenue Service of its claim to exemption by filing Form 1024 is not required, under section 505(c), to renotify the Service. Thus, an organization that has filed a Form 1024 that is pending with the Service need not refile that form. Also, an organization that has received a ruling or determination letter from the

Service recognizing its exemption from taxation need not submit the notification required by section 505(c).

[T.D. 8073, 51 FR 4330, Feb. 4, 1986]

PRIVATE FOUNDATIONS

§ 1.507–1 General rule.

(a) *In general.* Except as provided in § 1.507–2, the status of any organization as a private foundation shall be terminated only if:

(1) Such organization notifies the district director of its intent to accomplish such termination, or

(2)(i) With respect to such organization, there have been either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to liability for tax under chapter 42, and

(ii) The Commissioner notifies such organization that, by reason of subdivision (i) of this subparagraph, such organization is liable for the tax imposed by section 507(c)

and either such organization pays the tax imposed by section 507(c) (or any portion not abated under section 507(g)) or the entire amount of such tax is abated under section 507(g).

(b) *Termination under section 507(a)(1).* (1) In order to terminate its private foundation status under paragraph (a)(1) of this section, an organization must submit a statement to the district director of its intent to terminate its private foundation status under section 507(a)(1). Such statement must set forth in detail the computation and amount of tax imposed under section 507(c). Unless the organization requests abatement of such tax pursuant to section 507(g), full payment of such tax must be made at the time the statement is filed under section 507(a)(1). An organization may request the abatement of all of the tax imposed under section 507(c), or may pay any part thereof and request abatement of the unpaid portion of the amount of tax assessed. If the organization requests abatement of the tax imposed under section 507(c) and such request is denied, the organization must pay such tax in full upon notification by the Internal Revenue Service that such tax will not be abated. For purposes of subtitle F of the Code, the statement described in this subparagraph, once filed, shall be treated as a return.

(2) Termination of private foundation status under section 507(a)(1) does not relieve a private foundation, or any disqualified person with respect thereto, of liability for tax under chapter 42 with respect to acts or failures to act prior to termination or for any additional taxes imposed for failure to correct such acts or failures to act. See subparagraph (8) of this paragraph as to the possible imposition of transferee liability in cases not involving termination of private foundation status.

(3) In the case of an organization which has terminated its private foundation status under section 507(a) and continues in operation thereafter, if such organization wishes to be treated as described in section 501(c)(3), then pursuant to section 509(c) and § 1.509(c)–1 such organization must apply for recognition of exemption as an organization described in section 501(c)(3) in accordance with the provisions of section 508(a).

(4) See § 53.4947–1(c)(7) of this chapter as to the application of section 507(a) to certain split-interest trusts.

(5) For purposes of section 508(d)(1), the Internal Revenue Service shall make notice to the public (such as by publication in the Internal Revenue Bulletin) of any notice received from a private foundation pursuant to section 507(a)(1) or of any notice given to a private foundation pursuant to section 507(a)(2).

(6) If a private foundation transfers all or part of its assets to one or more other private foundations (or one or more private foundations and one or more section 509(a) (1), (2), (3), or (4) organizations) pursuant to a transfer described in section 507(b)(2) and § 1.507–3(c), such transferor foundation will not have terminated its private foundation status under section 507(a)(1). See § 1.507–3, however, for the special rules applicable to private foundations participating in section 507(b)(2) transfers.

(7) Neither a transfer of all of the assets of a private foundation nor a significant disposition of assets (as defined in § 1.507–3(c)(2)) by a private foundation (whether or not any portion of such significant disposition of assets is made to another private foundation)

shall be deemed to result in a termination of the transferor private foundation under section 507(a) unless the transferor private foundation elects to terminate pursuant to section 507(a)(1) or section 507(a)(2) is applicable. Thus, if a private foundation transfers all of its assets to one or more persons, but less than all of its net assets to one or more organizations described in section 509(a)(1) which have been in existence and so described for a continuous period of 60 calendar months, for purposes of this paragraph such transferor foundation will not be deemed by reason of such transfer to have terminated its private foundation status under section 507 (a) or (b) unless section 507(a)(2) is applicable. Such foundation will continue to be treated as a private foundation for all purposes. For example, if a private foundation transfers all of its net assets to a section 509(a)(2) organization in 1971 and receives a bequest in 1973, the bequest will be regarded as having been made to a private foundation and the foundation will be subject to the provisions of chapter 42 with respect to such funds. If a private foundation makes a transfer of all of its net assets to a section 509(a) (2) or (3) organization, for example, it must retain sufficient income or assets to pay the tax imposed under section 4940 for that portion of its taxable year prior to such transfer. For additional rules applicable to a transfer by a private foundation of all of its net assets to a section 509(a)(1) organization which has not been in existence and so described for a continuous period of 60 calendar months, see § 1.507–3(e).

(8) If a private foundation makes a transfer described in subparagraph (7) of this paragraph and prior to, or in connection with, such transfer, liability for any tax under chapter 42 is incurred by the transferor foundation, transferee liability may be applied against the transferee organization for payment of such taxes. For purposes of this subparagraph, liability for any tax imposed under chapter 42 for failure to correct any act or failure to act shall be deemed incurred on the date on which the act or failure to act giving rise to the initial tax liability occurred.

(9) A private foundation which transfers all of its net assets is required to file the annual information return required by section 6033, and the foundation managers are required to file the annual report of a private foundation required by section 6056, for the taxable year in which such transfer occurs. However, neither such foundation nor its foundation managers will be required to file such returns for any taxable year following the taxable year in which the last of any such transfers occurred, if at no time during the subsequent taxable years in question the foundation has either legal or equitable title to any assets or engages in any activity.

(c) *Involuntary termination under section 507(a)(2).* (1) For purposes of section 507(a)(2)(A), the term *willful repeated acts (or failures to act)* means at least two acts or failures to act both of which are voluntary, conscious, and intentional.

(2) For purposes of section 507(a)(2)(A), a *willful and flagrant act (or failure to act)* is one which is voluntarily, consciously, and knowingly committed in violation of any provision of chapter 42 (other than section 4940 or 4948(a)) and which appears to a reasonable man to be a gross violation of any such provision.

(3) An act (or failure to act) may be treated as an act (or failure to act) by the private foundation for purposes of section 507(a)(2) even though tax is imposed upon one or more foundation managers rather than upon the foundation itself.

(4) For purposes of section 507(a)(2), the failure to correct the act or acts (or failure or failures to act) which gave rise to liability for tax under any section of chapter 42 by the close of the correction period for such section may be a willful and flagrant act (or failure to act).

(5) No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make an act (or failure to act) willful. However, a foundation's act (or failure to act) is not willful if the foundation (or a foundation manager, if applicable) does not know that it is an act of self-dealing, a taxable expenditure, or other act (or

failure to act) to which chapter 42 applies. Rules similar to the regulations under chapter 42 (see, for example, § 53.4945–1(a)(2)(iii) of this chapter) shall apply in determining whether a foundation or a foundation manager *knows* that an act (or failure to act) is an act of self-dealing a taxable expenditure or other such act (or failure to act).

[T.D. 7233, 37 FR 28157, Dec. 21, 1972, as amended by T.D. 7290, 38 FR 31833, Nov. 19, 1973]

§ 1.507–2 Special rules; transfer to, or operation as, public charity.

(a) *Transfer to public charities*—(1) *General rule*. Under section 507(b)(1)(A) a private foundation, with respect to which there have not been either willful repeated acts (or failures to act) or a willful and flagrant act (or failure to act) giving rise to liability for tax under Chapter 42, may terminate its private foundation status by distributing all of its net assets to one or more organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)) each of which has been in existence and so described for a continuous period of at least 60 calendar months immediately preceding such distribution. Because section 507(a) does not apply to such a termination, a private foundation which makes such a termination is not required to give the notification described in section 507(a)(1). A private foundation that terminates its private foundation status under section 507(b)(1)(A) does not incur tax under section 507(c) and, therefore, no abatement of such tax under section 507(g) is required.

(2) *Effect of current ruling*. A private foundation seeking to terminate its private foundation status pursuant to section 507(b)(1)(A) may rely on a ruling or determination letter issued to a potential distributee organization that such distributee organization is an organization described in section 170(b)(1)(A)(i), 170(b)(1)(A)(ii), 170(b)(1)(A)(iii), 170(b)(1)(A)(iv), 170(b)(1)(A)(v), or 170(b)(1)(A)(vi) in accordance with the provisions of § 1.509(a)–7.

(3) *Organizations described in more than one clause of section 170(b)(1)(A)*. For purposes of this paragraph and section 507(b)(1)(A), the parenthetical term ''other than in clauses (vii) and (viii)'' shall refer only to an organization that is described only in section 170(b)(1)(A)(vii) or section 170(b)(1)(A)(viii). Thus, an organization described in section 170(b)(1)(A)(i), 170(b)(1)(A)(ii), 170(b)(1)(A)(iii), 170(b)(1)(A)(iv), 170(b)(1)(A)(v), or 170(b)(1)(A)(vi) will not be precluded from being a distributee described in section 507(b)(1)(A) merely because it also appears to meet the description of an organization described in section 170(b)(1)(A)(vii) or section 170(b)(1)(A)(viii).

(4) *Applicability of Chapter 42 to foundations terminating under section 507(b)(1)(A)*. An organization that terminates its private foundation status pursuant to section 507(b)(1)(A) will remain subject to the provisions of Chapter 42 until the distribution of all of its net assets to distributee organizations described in section 507(b)(1)(A) has been completed.

(5) *Return required from organizations terminating private foundation status under section 507(b)(1)(A)*—(i) An organization that terminates its private foundation status under section 507(b)(1)(A) is required to file a return under the provisions of section 6043(b).

(ii) An organization that terminates its private foundation status under section 507(b)(1)(A) is not required to comply with section 6104(d) for the taxable year in which such termination occurs.

(6) *Distribution of net assets*. A private foundation will meet the requirement to ''distribute all of its net assets'' within the meaning of section 507(b)(1)(A) only if it transfers all of its right, title, and interest in and to all of its net assets to one or more organizations referred to in section 507(b)(1)(A).

(7) *Effect of restrictions and conditions upon distributions of net assets*—(i) *In general*. In order to effectuate a transfer of ''all of its right, title, and interest in and to all of its net assets'' within the meaning of paragraph (a)(6) of this section, a transferor private foundation may not impose any material restriction or condition that prevents the transferee organization referred to

in section 507(b)(1)(A) (herein sometimes referred to as the ''public charity'') from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes. Whether or not a particular condition or restriction imposed upon a transfer of assets is material (within the meaning of this paragraph (a)(7)) must be determined from all of the facts and circumstances of the transfer. Some of the more significant facts and circumstances to be considered in making such a determination are—

(A) Whether the public charity (including a participating trustee, custodian, or agent in the case of a community trust) is the owner in fee of the assets it receives from the private foundation;

(B) Whether such assets are to be held and administered by the public charity in a manner consistent with one or more of its exempt purposes;

(C) Whether the governing body of the public charity has the ultimate authority and control over such assets, and the income derived therefrom; and

(D) Whether, and to what extent, the governing body of the public charity is organized and operated so as to be independent from the transferor.

(ii) *Independent governing body*. As provided in paragraph (a)(7)(i)(D) of this section, one of the more significant facts and circumstances to be considered in making the determination whether a particular condition or restriction imposed upon a transfer of assets is material within the meaning of this paragraph (a)(7) is whether, and the extent to which, the governing body is organized and operated so as to be independent from the transferor. In turn, the determination as to such factor must be determined from all of the facts and circumstances. Some of the more significant facts and circumstances to be considered in making such a determination are—

(A) Whether, and to what extent, members of the governing body are comprised of persons selected by the transferor private foundation or disqualified persons with respect thereto or are themselves such disqualified persons;

(B) Whether, and to what extent, members of the governing body are selected by public officials acting in their capacities as such; and

(C) How long a period of time each member of the governing body may serve in such capacity. In the case of a transfer that is to a community trust, the community trust shall meet this paragraph (a)(7)(ii)(C) if—

(*1*) Its governing body is comprised of members who may serve a period of not more than ten consecutive years; and

(*2*) Upon completion of a period of service (beginning before or after the date of transfer), no member may serve again within a period consisting of the lesser of five years or the number of consecutive years the member has immediately completed serving.

(iii) *Factors not adversely affecting determination*. The presence of some or all of the following factors will not be considered as preventing the transferee ''from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes'' (within the meaning of paragraph (a)(7)(i) of this section):

(A) *Name*. The fund is given a name or other designation which is the same as or similar to that of the transferor private foundation or otherwise memorializes the creator of the foundation or his family.

(B) *Purpose*. The income and assets of the fund are to be used for a designated purpose or for one or more particular section 509(a)(1), section 509(a)(2), or section 509(a)(3) organization, and such use is consistent with the charitable, educational, or other basis for the exempt status of the public charity under section 501(c)(3).

(C) *Administration*. The transferred assets are administered in an identifiable or separate fund, some or all of the principal of which is not to be distributed for a specified period, if the public charity (including a participating trustee, custodian, or agent in the case of a community trust) is the legal and equitable owner of the fund and the governing body exercises ultimate and direct authority and control over such fund, as, for example, a fund to endow a chair at a university or a medical research fund at a hospital. In the case of a community trust, the

transferred assets must be administered in or as a component part of the community trust within the meaning of § 1.170A–9(f)(11).

(D) *Restrictions on disposition.* The transferor private foundation transfers property the continued retention of which by the transferee is required by the transferor if such retention is important to the achievement of charitable or other similar purposes in the community because of the peculiar features of such property, as, for example, where a private foundation transfers a woodland preserve which is to be maintained by the public charity as an arboretum for the benefit of the community. Such a restriction does not include a restriction on the disposition of an investment asset or the distribution of income.

(iv) *Adverse factors.* The presence of any of the following factors will be considered as preventing the transferee ''from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes'' (within the meaning of paragraph (a)(7)(i) of this section):

(A) *Distributions.* (*1*) With respect to distributions made after April 19, 1977, the transferor private foundation, a disqualified person with respect thereto, or any person or committee designated by, or pursuant to the terms of an agreement with, such a person (hereinafter referred to as donor), reserves the right, directly or indirectly, to name (other than by designation in the instrument of transfer of particular section 509(a)(1), section 509(a)(2), or section 509(a)(3) organizations) the persons to which the transferee public charity must distribute, or to direct the timing of such distributions (other than by direction in the instrument of transfer that some or all of the principal, as opposed to specific assets, not be distributed for a specified period) as, for example, by a power of appointment. The IRS will examine carefully whether the seeking of advice by the transferee from, or the giving of advice by, any donor after the assets have been transferred to the transferee constitutes an indirect reservation of a right to direct such distributions. In any such case, the reservation of such a right will be considered to exist where the only criterion considered by the public charity in making a distribution of income or principal from a donor's fund is advice offered by the donor. Whether there is a reservation of such a right will be determined from all of the facts and circumstances, including, but not limited to, the factors contained in paragraphs (a)(7)(iv)(A)(*2*) and (a)(7)(iv)(A)(*3*) of this section.

(*2*) The presence of some or all of the following factors will indicate that the reservation of a right to direct distributions does not exist:

(*i*) There has been an independent investigation by the staff of the public charity evaluating whether the donor's advice is consistent with specific charitable needs most deserving of support by the public charity (as determined by the public charity).

(*ii*) The public charity has promulgated guidelines enumerating specific charitable needs consistent with the charitable purposes of the public charity and the donor's advice is consistent with such guidelines.

(*iii*) The public charity has instituted an educational program publicizing to donors and other persons the guidelines enumerating specific charitable needs consistent with the charitable purposes of the public charity.

(*iv*) The public charity distributes funds in excess of amounts distributed from the donor's fund to the same or similar types of organizations or charitable needs as those recommended by the donor.

(*v*) The public charity's solicitations (written or oral) for funds specifically state that such public charity will not be bound by advice offered by the donor.

(*3*) The presence of some or all of the following factors will indicate the reservation of a right to direct distributions does exist:

(*i*) The solicitations (written or oral) of funds by the public charity state or imply, or a pattern of conduct on the part of the public charity creates an expectation, that the donor's advice will be followed.

(*ii*) The advice of a donor (whether or not restricted to a distribution of income or principal from the donor's trust or fund) is limited to distributions of amounts from the donor's

fund, and the factors described in paragraph (a)(7)(iv)(A)(*2*)(*i*) or paragraph (a)(7)(iv)(A)(*2*)(*ii*) of this section are not present.

(*iii*) Only the advice of the donor as to distributions of such donor's fund is solicited by the public charity and no procedure is provided for considering advice from persons other than the donor with respect to such fund.

(*iv*) For the taxable year and all prior taxable years the public charity follows the advice of all donors with respect to their funds substantially all of the time.

(B) *Other action or withholding of action*. The terms of the transfer agreement, or any expressed or implied understanding, required the public charity to take or withhold action with respect to the transferred assets which is not designed to further one or more of the exempt purposes of the public charity, and such action or withholding of action would, if performed by the transferor private foundation with respect to such assets, have subjected the transferor to tax under Chapter 42 (other than with respect to the minimum investment return requirement of section 4942(e)).

(C) *Assumption of leases, contractual obligations, or liabilities*. The public charity assumes leases, contractual obligations, or liabilities of the transferor private foundation, or takes the assets thereof subject to such liabilities (including obligations under commitments or pledges to donees of the transferor private foundation), for purposes inconsistent with the purposes or best interests of the public charity, other than the payment of the transferor's Chapter 42 taxes incurred prior to the transfer to the public charity to the extent of the value of the assets transferred.

(D) *Retention of investment assets*. The transferee public charity is required by any restriction or agreement (other than a restriction or agreement imposed or required by law or regulatory authority), express or implied, to retain any securities or other investment assets transferred to it by the private foundation. In a case where such transferred assets consistently produce a low annual return of income, the IRS will examine carefully whether the transferee is required by any such restriction or agreement to retain such assets.

(E) *Right of first refusal*. An agreement is entered into in connection with the transfer of securities or other property which grants directly or indirectly to the transferor private foundation or any disqualified person with respect thereto a right of first refusal with respect to the transferred securities or other property when and if disposed of by the public charity, unless such securities or other property was acquired by the transferor private foundation subject to such right of first refusal prior to October 9, 1969.

(F) *Relationships*. An agreement is entered into between the transferor private foundation and the transferee public charity which establishes irrevocable relationships with respect to the maintenance or management of assets transferred to the public charity, such as continuing relationships with banks, brokerage firms, investment counselors, or other advisors with regard to the investments or other property transferred to the public charity (other than a relationship with a trustee, custodian, or agent for a community trust acting as such). The transfer of property to a public charity subject to contractual obligations which were established prior to November 11, 1976, between the transferor private foundation and persons other than disqualified persons with respect to such foundation will not be treated as prohibited under the preceding sentence, but only if such contractual obligations were not entered into pursuant to a plan to terminate the private foundation status of the transferor under section 507(b)(1)(A) and if the continuation of such contractual obligations is in the best interests of the public charity.

(G) *Other conditions*. Any other condition is imposed on action by the public charity which prevents it from exercising ultimate control over the assets received from the transferor private foundation for purposes consistent with its exempt purposes.

(v) *Examples*. The provisions of this paragraph (a)(7) may be illustrated by the following examples:

Example 1. The M Private Foundation transferred all of its net assets to the V Cancer Institute, a public charity described in section 170(b)(1)(A)(iii). Prior to the transfer, M's activities consisted of making grants to hospitals and universities to further research into the causes of cancer. Under the terms of the transfer, V is required to keep M's assets in a separate fund and use the income and principal to further cancer research. Although the assets may be used only for a limited purpose, this purpose is consistent with and in furtherance of V's exempt purposes, and does not prevent the transfer from being a distribution for purposes of section 507(b)(1)(A).

Example 2. The N Private Foundation transferred all of its net assets to W University, a public charity described in section 170(b)(1)(A)(ii). Under the terms of the transfer, W is required to use the income and principal to endow a chair at the university to be known as the ''John J. Doe Memorial Professorship,'' named after N's creator. Although the transferred assets are to be used for a specified purpose by W, this purpose is in furtherance of W's exempt educational purposes, and there are no conditions on investment or reinvestment of the principal or income. The use of the name of the foundation's creator for the chair is not a restriction which would prevent the transfer from being a distribution for purposes of section 507(b)(1)(A).

Example 3. The O Private Foundation transferred all of its net assets to X Bank as trustee for the Q Community Trust, a community trust that is a public charity described in section 170(b)(1)(A)(vi). Under the terms of the transfer, X is to hold the assets in trust for Q and is directed to distribute the income annually to the Y Church, a public charity described in section 170(b)(1)(A)(i). The distribution of income to Y Church is consistent with Q's exempt purposes. If the trust created by this transfer otherwise meets the requirements of § 1.170A–9(f)(11) as a component part of the Q Community Trust, the assets transferred by O to X will be treated as distributed to one or more public charities within the meaning of section 507(b)(1)(A). The direction to distribute the income to Y Church meets the conditions of paragraph (a)(7)(iii)(B) of this section and will therefore not disqualify the transfer under section 507(b)(1)(A).

Example 4. (i) The P Private Foundation transferred all of its net assets to Z Bank as trustee for the R Community Trust, a community trust that is a public charity described in section 170(b)(1)(A)(vi). Under the terms of the transfer, Z is to hold the assets in trust for R and distribute the income to those public charities described in section 170(b)(1)(A)(i) through (b)(1)(A)(vi) that are designated by B, the creator of P. R's governing body has no authority during B's lifetime to vary B's direction. Under the terms of the transfer, it is intended that Z retain the transferred assets in their present form for a period of 20 years, or until the date of B's death if it occurs before the expiration of such period. Upon the death of B, R will have the power to distribute the income to such public charities as it selects and may dispose of the corpus as it sees fit.

(ii) Under paragraph (a)(7)(iv)(A) or paragraph (a)(7)(iv)(D) of this section, as a result of the restrictions imposed with respect to the transferred assets, there has been no distribution of all P's net assets within the meaning of section 507(b)(1)(A) at the time of the transfer. In addition, P has not transferred its net assets to a component part of R Community Trust, but rather to a separate trust described in § 1.170A–9(f)(12).

(b) *Operation as a public charity*—(1) *In general.* Under section 507(b)(1)(B), an organization can terminate its private foundation status if the organization—

(i) Meets the requirements of section 509(a)(1), section 509(a)(2) or section 509(a)(3) for a continuous period of 60 calendar months beginning with the first day of any taxable year that begins after December 31, 1969;

(ii) In compliance with section 507(b)(1)(B)(ii) and paragraph (b)(3) of this section, properly notifies the IRS, in such manner as may be provided by published guidance, publication, form or instructions, before the commencement of such 60-month period, that it is terminating its private foundation status; and

(iii) Properly establishes immediately after the expiration of such 60-month period that such organization has complied with the requirements of section 509(a)(1), section 509(a)(2) or section 509(a)(3) during the 60-month period, in the manner described in paragraph (b)(4) of this section.

(2) *Relationship of section 507(b)(1)(B) to sections 507(a), 507(c), and 507(g).* Because section 507(a) does not apply to a termination described in section 507(b)(1)(B), a private foundation's notification that it is commencing a termination pursuant to section 507(b)(1)(B) will not be treated as a notification described in section 507(a) even if the private foundation does not successfully terminate its private foundation status pursuant to section 507(b)(1)(B). A private foundation that terminates its private foundation status under section

507(b)(1)(B) does not incur tax under section 507(c) and, therefore, no abatement of such tax under section 507(g) is required.

(3) *Notification of termination.* In order to comply with the requirements under section 507(b)(1)(B)(ii), an organization shall before the commencement of the 60-month period under section 507(b)(1)(B)(i) notify the IRS, in such manner as may be provided by published guidance, publication, form or instructions, of its intention to terminate its private foundation status. Such notification shall contain the following information—

(i) The name and address of the private foundation;

(ii) Its intention to terminate its private foundation status;

(iii) The Code section under which it seeks classification (section 509(a)(1), section 509(a)(2) or section 509(a)(3));

(iv) If section 509(a)(1) is applicable, the clause of section 170(b)(1)(A) involved;

(v) The date its regular taxable year begins; and

(vi) The date of commencement of the 60-month period.

(4) *Establishment of termination.* In order to comply with the requirements under section 507(b)(1)(B)(iii), an organization shall within 90 days after the expiration of the 60-month period file such information with the IRS, in such manner as may be provided by published guidance, publication, form or instructions, as is necessary to make a determination as to the organization's status as an organization described under section 509(a)(1), section 509(a)(2) or section 509(a)(3) and the related regulations. See paragraph (c) of this section as to the information required to be submitted under this paragraph (b)(4).

(5) *Incomplete information.* The failure to supply, within the required time, all of the information required by paragraph (b)(3) or paragraph (b)(4) of this section is not alone sufficient to constitute a failure to satisfy the requirements of section 507(b)(1)(B). If the information that is submitted within the required time is incomplete and the organization supplies the necessary additional information at the request of the Commissioner within the additional time period allowed by him, the original submission will be considered timely.

(6) *Application of special rules and filing requirements.* An organization that has terminated its private foundation status under section 507(b)(1)(B) is not required to comply with the special rules set forth in sections 508(a) and 508(b). Such organization is also not required to file a return under the provisions of section 6043(b) by reason of termination of its private foundation status under the provisions of section 507(b)(1)(B).

(7) *Extension of time to assess deficiencies.* If a private foundation files a notification (described in paragraph (b)(3) of this section) that it intends to begin a 60-month termination pursuant to section 507(b)(1)(B) and does not file a request for an advance ruling pursuant to paragraph (d) of this section, such private foundation may file with the notification described in paragraph (b)(3) of this section a consent under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for any taxable year within the 60-month termination period shall not expire prior to one year after the date of expiration of the time prescribed by law for the assessment of a deficiency for the last taxable year within the 60-month period. Such consents, if filed, will ordinarily be accepted by the Commissioner. See paragraph (e)(3) of this section for an illustration of the procedure required to obtain a refund of the tax imposed by section 4940 in a case where such a consent is not in effect.

(c) *Sixty-month terminations*—(1) *Method of determining normal sources of support.* (i) In order to meet the requirements of section 507(b)(1)(B) for the 60-month termination period as a section 509(a)(1) or section 509(a)(2) organization, an organization must meet the requirements of section 509(a)(1) or section 509(a)(2), as the case may be, for a continuous period of at least 60 calendar months. In determining whether an organization seeking status under section 509(a)(1) as an organization described in section 170(b)(1)(A)(iv) or section 170(b)(1)(A)(vi) or under section 509(a)(2) normally meets the requirements set forth under such sections,

support received in taxable years prior to the commencement of the 60-month period shall not be taken into consideration, except as otherwise provided in this section.

(ii) For purposes of section 507(b)(1)(B), an organization will be considered to be a section 509(a)(1) organization described in section 170(b)(1)(A)(vi) for a continuous period of 60 calendar months only if the organization satisfies the provisions of §1.170A–9(f), other than §1.170A–9(f)(4)(v), based upon aggregate data for such entire period. The calculation of public support shall be made over the period beginning with the date of the commencement of the 60-month period, and ending with the last day of the 60-month period.

(iii) For purposes of section 507(b)(1)(B), an organization will be considered to be a section 509(a)(2) organization only if such organization meets the support requirements set forth in sections 509(a)(2)(A) and 509(a)(2)(B) and the related regulations, other than §1.509(a)–3(d), for the continuous period of 60 calendar months prescribed under section 507(b)(1)(B). The calculation of public support shall be made over the period beginning with the date of the commencement of the 60-month period, and ending with the last day of the 60-month period.

(2) *Organizational and operational tests*. In order to meet the requirements of section 507(b)(1)(B) for the 60-month termination period as an organization described in section 170(b)(1)(A)(i), 170(b)(1)(A)(ii), 170(b)(1)(A)(iii), 170(b)(1)(A)(iv), or 170(b)(1)(A)(v) or section 509(a)(3), as the case may be, an organization must meet the requirements of the applicable provisions for a continuous period of at least 60 calendar months. For purposes of section 507(b)(1)(B), an organization will be considered to be such an organization only if it satisfies the requirements of the applicable provision (including with respect to section 509(a)(3), the organizational and operational test set forth in section 509(a)(3)(A)) at the commencement of such 60-month period and continuously thereafter during such period.

(d) *Advance rulings for 60-month terminations*—(1) *In general*. An organization that files the notification required by section 507(b)(1)(B)(ii) that it is commencing a 60-month termination may obtain an advance ruling from the Commissioner that it can be expected to satisfy the requirements of section 507(b)(1)(B)(i) during the 60-month period. Such an advance ruling may be issued if the organization can reasonably be expected to meet the requirements of section 507(b)(1)(B)(i) during the 60-month period. The issuance of a ruling will be discretionary with the Commissioner.

(2) *Basic consideration*. In determining whether an organization can reasonably be expected (within the meaning of paragraph (d)(1) of this section) to meet the requirements of section 507(b)(1)(B)(i) for the 60-month period, the basic consideration is whether its organizational structure (taking into account any revisions made prior to the beginning of the 60-month period), current or proposed programs or activities, actual or intended method of operation, and current or projected sources of support are such as to indicate that the organization is likely to satisfy the requirements of section 509(a)(1), section 509(a)(2), or section 509(a)(3) and paragraph (c) of this section during the 60-month period. In making such a determination, all pertinent facts and circumstances shall be considered.

(3) *Reliance by grantors and contributors*. For purposes of sections 170, 545(b)(2), 642(c), 4942, 4945, 4966, 2055, 2106(a)(2), and 2522, grants or contributions to an organization which has obtained a ruling referred to in this paragraph will be treated as made to an organization described in section 509(a)(1), section 509(a)(2), or section 509(a)(3), as the case may be, until the IRS publishes notice that such advance ruling is being revoked (such as by publication in the Internal Revenue Bulletin). However, a grantor or contributor may not rely on such an advance ruling if the grantor or contributor was responsible for, or aware of, the act or failure to act that resulted in the organization's failure to meet the requirements of section 509(a)(1), section 509(a)(2), or section 509(a)(3), or acquired knowledge that the IRS had given notice to such organization that its advance ruling would be revoked.

Prior to the making of any grant or contribution which allegedly will not result in the grantee's failure to meet the requirements of section 509(a)(1), section 509(a)(2), or section 509(a)(3), a potential grantee organization may request a ruling whether such grant or contribution may be made without such failure. A request for such ruling may be filed by the grantee organization with the IRS. The issuance of such ruling will be at the sole discretion of the Commissioner. The organization must submit all information necessary to make a determination on the factors referred to in paragraph (d)(2) of this section. If a favorable ruling is issued, such ruling may be relied upon by the grantor or contributor of the particular contribution in question for purposes of sections 170, 507, 545(b)(2), 642(c), 4942, 4945, 4966, 2055, 2106(a)(2), and 2522.

(4) *Reliance by organization.* An organization obtaining an advance ruling pursuant to this paragraph cannot rely on such a ruling. Consequently, if the organization does not pay the tax imposed by section 4940 for any taxable year or years during the 60-month period, and it is subsequently determined that such tax is due for such year or years (because the organization did not in fact complete a successful termination pursuant to section 507(b)(1)(B) and was not treated as an organization described in section 509(a)(1), section 509(a)(2), or section 509(a)(3) for such year or years), the organization is liable for interest in accordance with section 6601 if any amount of tax under section 4940 has not been paid on or before the last date prescribed for payment. However, because any failure to pay such tax during the 60-month period (or prior to the revocation of such ruling) is due to reasonable cause, the penalty under section 6651 with respect to the tax imposed by section 4940 shall not apply.

(5) *Extension of time to assess deficiencies.* The advance ruling described in paragraph (d)(1) of this section shall be issued only if such organization's request for an advance ruling is filed with a consent under section 6501(c)(4) to the effect that the period of limitations upon assessment under section 4940 for any taxable year within the advance ruling period shall not expire prior to one year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for the last taxable year within the 60-month period.

(e) *Effect on grantors or contributors and on the organization itself*—(1) *Effect of satisfaction of requirements for termination; treatment during the termination period.* In the event that an organization satisfies the requirements of section 507(b)(1)(B) for termination of its private foundation status during the continuous 60-month period, such organization shall be treated for such entire 60-month period in the same manner as an organization described in section 509(a)(1), section 509(a)(2), or section 509(a)(3), as the case may be.

(2) *Failure to meet termination requirements*—(i) *In general.* Except as otherwise provided in paragraphs (d) and (e)(2)(ii) of this section, any organization that fails to satisfy the requirements of section 507(b)(1)(B) for termination of its private foundation status during the continuous 60-month period shall be treated as a private foundation for the entire 60-month period, for purposes of sections 507 through 509 and Chapter 42, and grants or contributions to such an organization shall be treated as made to a private foundation for purposes of sections 170, 507(b)(1)(A), 4942, and 4945.

(ii) *Certain 60-month terminations.* Notwithstanding paragraph (e)(2)(i) of this section, if an organization fails to satisfy the requirements of section 509(a)(1), section 509(a)(2), or section 509(a)(3) for the continuous 60-month period but does satisfy the requirements of section 509(a)(1), section 509(a)(2), or section 509(a)(3), as the case may be, for any taxable year or years during such 60-month period, the organization shall be treated as a section 509(a)(1), section 509(a)(2), or section 509(a)(3) organization for such taxable year or years, and grants or contributions made during such taxable year or years shall be treated as made to an organization described in section 509(a)(1), section 509(a)(2), or section 509(a)(3). In addition, sections 507 through 509 and Chapter 42 shall not apply to such organization for any taxable year within such 60-month period

for which it does meet such requirements. For purposes of determining whether an organization satisfies the requirements of section 509(a)(1), section 509(a)(2), or section 509(a)(3) for any taxable year in the 60-month period, the calculation of public support shall be made over the period beginning with the date of the commencement of the 60-month period, and ending with the last day of the taxable year being tested. The organization shall not be treated as a section 509(a)(1) or section 509(a)(2) organization for any taxable year during the 60-month period solely by reason of having met a public support test for the preceding year. In addition, the transition rules in §§1.170–9(f)(14)(iii) and 1.509(a)–3(n)(iii) shall not apply.

(iii) *Aggregate tax benefit.* For purposes of section 507(d), the organization's aggregate tax benefit resulting from the organization's section 501(c)(3) status shall continue to be computed from the date from which such computation would have been made, but for the notice filed under section 507(b)(1)(B)(ii), except that any taxable year within such 60-month period for which such organization meets the requirements of section 509(a)(1), section 509(a)(2), or section 509(a)(3) shall be excluded from such computations.

(iv) *Excess business holdings.* See section 4943 and the related regulations for rules relating to decreases in a private foundation's holdings in a business enterprise which are caused by the foundation's failure to terminate its private foundation status after giving the notification for termination under section 507(b)(1)(B)(ii).

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

Example 1. Y, a calendar year private foundation, notifies the IRS that it intends to terminate its private foundation status by converting into a publicly supported organization described in section 170(b)(1)(A)(vi) and that its 60-month termination period will commence on January 1, 2010. Y does not obtain a ruling described in paragraph (d) of this section. Based upon its support for 2010, Y does not qualify as a publicly supported organization within the meaning of §1.170A–9(f) and this paragraph for 2010. Consequently, in order to avoid the risks of penalties and interest if Y fails to terminate within the 60-month period, Y files its 2010 return as a private foundation and pays the tax imposed by section 4940. Because a consent (described in paragraph (b)(7) of this section), which would prevent the period of limitations for all years in the 60-month period from expiring, is not in effect, in order to be able to file a claim for refund, Y and the IRS must agree to extend the period of limitation for all taxes imposed under Chapter 42 for 2010. Based on the aggregate data for the entire 60-month period (2010 through 2014), Y does qualify as a publicly-supported organization for the entire 60-month period. Consequently, Y is treated as a publicly-supported organization for the entire 60-month period. Y files a claim for refund for the taxes paid under section 4940 for 2010, and such taxes are refunded.

(f) *Effective/applicability date*—(1) *Effective date.* These regulations are effective on September 8, 2011.

(2) *Applicability date.* The regulations in this section shall apply to tax years beginning on or after January 1, 2008. For taxable years beginning after December 31, 1969, and beginning before January 1, 2008, see §1.507–2 (as contained in 26 CFR part 1 revised April 1, 2008).

[T.D. 9549, 76 FR 55760, Sept. 8, 2011]

§1.507–3 Special rules; transferee foundations.

(a) *General rule.* (1) For purposes of part II, subchapter F, chapter 1 of the Code, in the case of a transfer of assets of any private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization, the transferee organization shall not be treated as a newly created organization. Thus, in the case of a significant disposition of assets to one or more private foundations within the meaning of paragraph (c) of this section, the transferee organization shall not be treated as a newly created organization. A transferee organization to which this paragraph applies shall be treated as possessing those attributes and characteristics of the transferor organization which are described in subparagraphs (2), (3), and (4) of this paragraph.

(2)(i) A transferee organization to which this paragraph applies shall succeed to the aggregate tax benefit of the transferor organization in an amount

determined as follows: Such amount shall be an amount equal to the amount of such aggregate tax benefit multiplied by a fraction the numerator of which is the fair market value of the assets (less encumbrances) transferred to such transferee and the denominator of which is the fair market value of the assets of the transferor (less encumbrances) immediately before the transfer. Fair market value shall be determined as of the time of the transfer.

(ii) Notwithstanding subdivision (i) of this subparagraph, a transferee organization which is not effectively controlled (within the meaning of § 1.482–1(a)(3)), directly or indirectly, by the same person or persons who effectively control the transferor organization shall not succeed to an aggregate tax benefit in excess of the fair market value of the assets transferred at the time of the transfer.

(iii) This subparagraph may be illustrated by the following examples:

Example 1. Pursuant to a transfer described in section 507(b)(2), F, a private foundation, transfers to G, a private foundation, all of its assets, which have a fair market value of $400,000. Immediately before the transfer F's aggregate tax benefit was $200,000, and G's aggregate tax benefit was $300,000. After the transfer G's aggregate tax benefit is $500,000 ($200,000 + $300,000).

Example 2. Pursuant to a transfer described in section 507(b)(2), M, a private foundation, transfers all of its assets, which immediately prior to the transfer have a fair market value of $100,000. The assets were transferred to the following organizations at the following fair market values (determined at the time of transfer) $40,000 to N, a private foundation, $30,000 to O, a private foundation, and $30,000 to P, an organization described in section 170(b)(1)(A)(vi). Immediately before the transfer M's aggregate tax benefit was $50,000. Therefore, N succeeds to M's aggregate tax benefit to the extent of $20,000 ($50,000 × $40,000/$100,000) and O succeeds to M's aggregate tax benefit to the extent of $15,000 ($50,000 × $30,000/$100,000). The remaining $15,000 of M's aggregate tax benefit is retained by M as M has not terminated under section 507.

Example 3. Assume the same facts as in Example 2 except that the transfers were made as follows: M transferred $30,000 to N on January 1, 1972, $40,000 to P on July 1, 1972, and $30,000 to O on December 31, 1972. Further, assume that the fair market value of the assets and the aggregate tax benefit do not change during 1972 and that O is not effectively controlled (directly or indirectly) by the same person or persons who effectively control M. N succeeds to M's aggregate tax benefit to the extent of $15,000 ($50,000 × $30,000/$100,000). However, since $40,000 of the remaining $70,000 ($100,000 − $30,000) of assets of M was transferred to P on July 1, 1972, immediately before the transfer to O, the fair market value of the assets held by M is $30,000 ($70,000 − $40,000). On the other hand, because P is not a private foundation, M's aggregate tax benefit immediately before the transfer to O remains $35,000 ($50,000 − $15,000). Therefore, before applying subdivision (ii) of this subparagraph, O would succeed to $35,000 ($35,000 × $30,000/$30,000) of M's aggregate tax benefit. However, applying subdivision (ii) of this subparagraph since M transferred only $30,000 to O, O shall succeed to only $30,000 of M's aggregate tax benefit. The remaining $5,000 ($35,000 − $30,000) of M's aggregate tax benefit is retained by M as M has not terminated under section 507.

(3) For purposes of section 507(d)(2), in the event of a transfer of assets described in section 507(b)(2), any person who is a *substantial contributor* (within the meaning of section 507(d)(2)) with respect to the transferor foundation shall be treated as a *substantial contributor* with respect to the transferee foundation, regardless of whether such person meets the $5,000-two percent test with respect to the transferee organization at any time. If a private foundation makes a transfer described in section 507(b)(2) to two or more transferee private foundations, any person who is a *substantial contributor* with respect to the transferor foundation prior to such transfer shall be considered a *substantial contributor* with respect to each transferee private foundation.

(4) If a private foundation incurs liability for one or more of the taxes imposed under chapter 42 (or any penalty resulting therefrom) prior to, or as a result of, making a transfer of assets described in section 507(b)(2) to one or more private foundations, in any case where transferee liability applies each transferee foundation shall be treated as receiving the transferred assets subject to such liability to the extent that the transferor foundation does not satisfy such liability.

(5) Except as provided in subparagraph (9) of this paragraph, a private foundation is required to meet the distribution requirements of section 4942 for any taxable year in which it makes

a section 507(b)(2) transfer of all or part of its net assets to another private foundation. Such transfer shall itself be counted toward satisfaction of such requirements to the extent the amount transferred meets the requirements of section 4942(g). However, where the transferor has disposed of all of its assets, the recordkeeping requirements of section 4942(g)(3)(B) shall not apply during any period in which it has no assets. Such requirements are applicable for any taxable year other than a taxable year during which the transferor has no assets.

(6) For purposes of section 4943(c) (4), (5), and (6), whenever a private foundation makes a section 507(b)(2) transfer of all or part of its net assets to another private foundation, the applicable period of time described in section 4943(c) (4), (5), or (6) shall include both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets.

(7) Except as provided in subparagraph (9) of this paragraph, where the transferor has disposed of all of its assets, during any period in which the transferor has no assets, section 4945 (d)(4) and (h) shall not apply to the transferee or the transferor with respect to any *expenditure responsibility* grants made by the transferor. However, the exception contained in this subparagraph shall not apply with respect to any information reporting requirements imposed by section 4945 and the regulations thereunder for any year in which any such transfer is made.

(8)(i) Except as provided in subdivision (ii) of this subparagraph or subparagraph (6) or (9) of this paragraph or whenever a private foundation makes a transfer of assets described in section 507(b)(2) to one or more private foundations, the transferee foundation:

(*a*) Will not be treated as being in existence prior to January 1, 1970, with respect to any transferred assets;

(*b*) Will not be treated as holding the transferred assets prior to January 1, 1970; and

(*c*) Will not be treated as having engaged in, or become subject to, any transaction, lease, contract, or other obligation with respect to the transferred assets prior to January 1, 1970.

(ii) Notwithstanding subdivision (i) of this subparagraph, the provisions enumerated in (*a*) through (*g*) of this subdivision shall apply to the transferee foundation with respect to the assets transferred to the same extent and in the same manner that they would have applied to the transferor foundation had the transfer described in section 507(b)(2) not been effected:

(*a*) Section 4940(c)(4)(B) and the regulations thereunder with respect to basis of property,

(*b*) Section 4942(f)(4) and the regulations thereunder with respect to distributions of income,

(*c*) Section 101(l)(2) of the Tax Reform Act of 1969 (83 Stat. 533), as amended by sections 1301 and 1309 of the Tax Reform Act of 1976 (90 Stat. 1713, 1729), with respect to the provisions of section 4941,

(*d*) Section 101(*l*)(3)(A) of the Tax Reform Act of 1969 (83 Stat. 534) with respect to the provisions of section 4942, but only if the transferor qualified for the application of such section immediately before the transfer, and at least 85 percent of the fair market value of the net assets of the transferee immediately after the transfer was received pursuant to the transfer,

(*e*) Section 101(*l*)(3) (B) through (E) of the Tax Reform Act of 1969 (83 Stat. 534) with respect to the provisions of section 4942,

(*f*) Section 101(l)(5) of the Tax Reform Act of 1969 (83 Stat. 535) with respect to the provisions of section 4945, and

(*g*) Section 101(*l*)(6) of the Tax Reform Act of 1969 (83 Stat. 535) with respect to the provisions of section 508(e).

(9) (i) If a private foundation transfers all of its net assets to one or more private foundations which are effectively controlled (within the meaning of § 1.482–1(a)(3)), directly or indirectly, by the same person or persons which effectively controlled the transferor private foundation, for purposes of chapter 42 (section 4940 *et seq.*) and part II of subchapter F of chapter 1 of the Code (sections 507 through 509) such a transferee private foundation shall be treated as if it were the transferor. However, where proportionality is appropriate, such a transferee private

foundation shall be treated as if it were the transferor in the proportion which the fair market value of the assets (less encumbrances) transferred to such transferee bears to the fair market value of the assets (less encumbrances) of the transferor immediately before the transfer.

(ii) Subdivision (i) of this subparagraph shall not apply to the requirements under sections 6033, 6056, and 6104 which must be complied with by the transferor private foundation, nor to the requirement under section 6043 that the transferor file a return with respect to its liquidation, dissolution, or termination.

(iii) This subparagraph may be illustrated by the following examples:

Example 1. The trustees of X charitable trust, a private foundation, form the Y charitable corporation, also a private foundation, in order to facilitate the conduct of their activities. The trustees of X are also the directors of Y. Y has the same charitable purposes as X. All of the assets of X are transferred to Y, and Y continues to carry on X's charitable activities. Under such circumstances, Y shall be treated as if it were X for the purposes of subdivision (i) of this subparagraph. Thus, for example, Y will be permitted to take advantage of any special rules or savings provisions with respect to chapter 42 to the same extent as X could have if X had continued in existence.

Example 2. A and B are the trustees of the P charitable trust, a private foundation, and are the only substantial contributors to P. On July 1, 1973, in order to facilitate accomplishment of diverse charitable purposes, A and B create and control the R Foundation, the S Foundation and the T Foundation and transfer the net assets of P to R, S, and T. As of the end of 1973, P has an outstanding grant to Foundation W and has been required to exercise expenditure responsibility with respect to this grant under sections 4945 (d)(4) and (h). Under these circumstances, R, S, and T shall each be treated as if they are P in the proportion the fair market value of the assets transferred to each bears to the fair market value of the assets of P immediately before the transfer. Since R, S, and T are treated as P, absent a specific provision for exercising expenditure responsibility with respect to the grant to W, each of them is required to exercise expenditure responsibility with respect to such grant. If, as a part of the transfer to R, P assigned, and R assumed, P's duties with respect to the expenditure responsibility grant to W, only R would be required to exercise expenditure responsibility with respect to the grant to W. Since R, S, and T are treated as P rather than as recipients of *expenditure responsibility* grants, there are no expenditure responsibility requirements which must be exercised under sections 4945 (d)(4) and (h) with respect to the transfers of assets to R, S, and T.

(10) For certain rules relating to filing requirements where a private foundation has transferred all its net assets, see § 1.507–1(b)(9).

(b) *Status of transferee organization under section 507(b)(2).* Since a transfer of assets pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization or reorganization to an organization not described in section 501(c)(3) (other than an organization described in section 509(a)(4)) or 4947 is a taxable expenditure under section 4945(d)(5), in order for such a transfer of assets not to be a taxable expenditure, it must be to an organization described in section 501(c)(3) (other than an organization described in section 509(a)(4)) or treated as described in section 501(c)(3) under section 4947. See § 53.4945–6(c)(3) of this chapter. Consequently, unless such a transferee is an organization described in section 509(a) (1), (2), or (3), the transferee is a private foundation and the rules of section 507(b)(2) and paragraph (a) of this section apply. On the other hand, if such a transfer of assets is made to a transferee organization which is not described in either section 501(c)(3) (other than an organization described in section 509(a)(4)) or 4947, and in order to correct the making of a taxable expenditure, such assets are transferred to a private foundation, section 507(b)(2) and paragraph (a) of this section shall apply as if the transfer of assets had been made directly to such private foundation.

(c) *Section 507(b)(2) transfers.* (1) A transfer of assets is described in section 507(b)(2) if it is made by a private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization. This shall include any organization or reorganization described in subchapter C of chapter 1. For purposes of section 507(b)(2), the terms

other adjustment, organization, or reorganization shall include any partial liquidation or any other significant disposition of assets to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income. For purposes of this paragraph, a distribution out of current income shall include any distribution described in section 4942(h)(1) (A) and (B).

(2) The term *significant disposition of assets to one or more private foundations* shall include any disposition for a taxable year where the aggregate of:

(i) The dispositions to one or more private foundations for the taxable year, and

(ii) Where any disposition to one or more private foundations for the taxable year is part of a series of related dispositions made during prior taxable years, the total of the related dispositions made during such prior taxable years, is 25 percent or more of the fair market value of the net assets of the foundation at the beginning of the taxable year (in the case of subdivision (i) of this subparagraph) or at the beginning of the first taxable year in which any of the series of related dispositions was made (in the case of subdivision (ii) of this subparagraph). A *significant disposition of assets* may occur in a single taxable year (as in subdivision (i) of this subparagraph) or over the course of two or more taxable years (as in subdivision (ii) of this subparagraph). The determination whether a significant disposition has occurred through a series of related distributions (within the meaning of subdivision (ii) of this subparagraph) will be made on the basis of all the facts and circumstances of the particular case. However, if one or more persons who are disqualified persons (within the meaning of section 4946) with respect to the transferor private foundation are also disqualified persons with respect to any of the transferee private foundations, such fact shall be evidence that the transfer is part of a series of related dispositions (within the meaning of subdivision (ii) of this subparagraph). In the case of a series of related dispositions described in subdivision (ii) of this subparagraph, each transferee private foundation shall (on any date) be subject to the provisions of section 507(b)(2) (with respect to all such dispositions made to it on or before such date) to the extent described in paragraphs (a) and (b) of this section.

(3) A private foundation which fails to meet the requirements of section 507(b)(1)(A) for a taxable year may be required to file a return under section 6043(b) by reason of a transfer of assets to one or more sections 509(a) (1), (2), or (3) organizations. Hence, such filing does not necessarily mean that a section 507(b)(2) transfer has occurred. See § 1.6043–3(f)(1).

(4) This paragraph applies to any section 507(b)(2) transfer made by a private foundation referred to in section 170(b)(1)(E) (i), (ii), or (iii).

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

Example 1. M is a private foundation on the calendar year basis. It has net assets worth $100,000 as of January 1, 1971. In 1971, in addition to distributions out of current income, M transfers $10,000 to N, $10,000 to O, and $10,000 to P. N, O, and P are all private foundations. Under subparagraph (2)(i) of this paragraph, M has made a significant disposition of its assets in 1971 since M has disposed of more than 25 percent of its net assets (with respect to the fair market value of such assets as of January 1, 1971). M has therefore made section 507(b)(2) transfers within the meaning of this paragraph, and section 507(b)(2) applies to the transfers made to N, O, and P.

Example 2. U, a tax-exempt private foundation on the calendar year basis, has net assets worth $100,000 as of January 1, 1971. As part of a series of related dispositions in 1971 and 1972, U transfers in 1971, in addition to distributions out of current income, $10,000 to private foundation X and $10,000 to private foundation Y, and in 1972, in addition to distributions out of current income, U transfers $10,000 to private foundation Z. Under subparagraph (2)(ii) of this paragraph, U is treated as having made a series of related dispositions in 1971 and 1972. The aggregate of the 1972 disposition (under subparagraph (2)(i) of this paragraph) and the series of related dispositions (under subparagraph (2)(ii) of this paragraph) is $30,000, which is more than 25 percent of the fair market value of U's net assets as of the beginning of 1971 ($100,000), the first year in which any such disposition was made. Thus, U has made a significant disposition of its assets and has made transfers described in section 507(b)(2). The provisions of paragraphs (a) and (b) of this section apply to each of the transferees

as of the date on which it received assets from U.

(d) *Inapplicability of section 507(a) to section 507(b)(2) transfers.* Unless a private foundation voluntarily gives notice pursuant to section 507(a)(1), a transfer of assets described in section 507(b)(2) will not constitute a termination of the transferor's private foundation status under section 507(a)(1). Such transfer must, nevertheless, satisfy the requirements of any pertinent provisions of chapter 42. See subparagraphs (5) through (7) of paragraph (a) of this section. However, if such transfer constitutes an act or failure to act which is described in section 507(a)(2)(A), then such transfer will be subject to the provisions of section 507(a)(2) rather than section 507(b)(2). For example, X, a private nonoperating foundation, transfers all of its net assets to Y, a private operating foundation, in 1971. X does not file the notice referred to in section 507(a)(1) and the transfer does not constitute either a willful and flagrant act (or failure to act), or one of a series of willful repeated acts (or failures to act), giving rise to liability for tax under chapter 42. Under these circumstances, the transfer is described in section 507(b)(2) and the provisions of paragraph (a) of this section apply with respect to Y. The private foundation status of X has not been terminated under section 507(a).

(e) *Transfers to certain section 509(a)(1), (2), or (3) organizations.* If a private foundation transfers all or part of its assets to one or more organizations described in section 509(a) (1), (2), or (3) and, within a period of 3 years from the date of such transfers, one or more of the transferee organizations lose their section 509(a) (1), (2), or (3) status and become private foundations, then for purposes of this section, a transfer of assets within the meaning of paragraph (c) of this section to such an organization which becomes a private foundation will be treated as a transfer described in section 507(b)(2), and the provisions of paragraph (a) of this section shall be treated as applying to such a transferee organization from the date on which any such transfer was made to it.

(f) *Certain transfers made during section 507(b)(1)(B) terminations.* If:

(1) During the course of the 12-month or 60-month period described in section 507(b)(1)(B), a private foundation makes one or more transfers to one or more private foundations;

(2) Such transfers are described in § 1.507–3(c)(1); and

(3) Even though the transferor foundation thereafter meets the requirements of section 507(b)(1)(B)

then for purposes of this section, the provisions of § 1.507–2(e) shall not apply with respect to such transfers, and such transfers will be treated as transfers described in section 507(b)(2) and § 1.507–3 rather than as transfers from an organization described in section 509(a) (1), (2), or (3).

[T.D. 7233, 37 FR 28158, Dec. 21, 1972; 38 FR 3189, Feb. 2, 1973, as amended by T.D. 7678, 45 FR 12415, Feb. 26, 1980]

§ 1.507–4 Imposition of tax.

(a) *General rule.* Section 507(c) imposes on each organization the private foundation status of which is terminated under section 507(a) a tax equal to the lower of:

(1) The amount which such organization substantiates by adequate records (or other corroborating evidence which may be required by the Commissioner) as the aggregate tax benefit (as defined in section 507(d)) resulting from the section 501(c)(3) status of such organization, or

(2) The value of the net assets of such organization.

(b) *Transfers not subject to section 507(c).* Private foundations which make transfers described in section 507(b)(1)(A) or (2) are not subject to the tax imposed under section 507(c) with respect to such transfers unless the provisions of section 507(a) become applicable. See §§ 1.507–1(b), 1.507–2(a)(6) and 1.507–3(d).

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.507–5 Aggregate tax benefit; in general.

(a) *General rule.* For purposes of section 507(c)(1), the aggregate tax benefit resulting from the section 501(c)(3) status of any private foundation is the sum of:

(1) The aggregate increases in tax under chapters 1, 11, and 12 (or the corresponding provisions of prior law) which would have been imposed with respect to all substantial contributors to the foundation if deductions for all contributions made by such contributors to the foundation after February 28, 1913, had been disallowed,

(2) The aggregate increases in tax under chapter 1 (or the corresponding provisions of prior law) which would have been imposed with respect to the income of the private foundation for taxable years beginning after December 31, 1912, if (i) it had not been exempt from tax under section 501(a) (or the corresponding provisions of prior law), and (ii) in the case of a trust, deductions under section 642(c) (or the corresponding provisions of prior law) had been limited to 20 percent of the taxable income of the trust (computed without the benefit of section 642(c) but with the benefit of section 170(b)(1)(A)),

(3) The amount succeeded to from transferors under §1.507–3(a) and section 507(b)(2), and

(4) Interest on the increases in tax determined under subparagraphs (1), (2), and (3) of this paragraph from the first date on which each such increase would have been due and payable to the date on which the organization ceases to be a private foundation.

(b) *Contributions*. In computing the amount of the aggregate increases in tax under subparagraph (1) of this paragraph, all deductions attributable to a particular contribution shall be included. For example, if a substantial contributor has taken deductions under sections 170 and 2522 (or the corresponding provisions of prior law) with respect to the same contribution, the amount of each deduction shall be included in the computations under section 507(d)(1)(A). Accordingly, the aggregate tax benefit may exceed the fair market value of the property transferred.

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§1.507–6 Substantial contributor defined.

(a) *Definition*—(1) *In general*. Except as provided in subparagraph (2) of this paragraph, the term *substantial contributor* means, with respect to a private foundation, any person (within the meaning of section 7701(a)(1)), whether or not exempt from taxation under section 501(a), who contributed or bequeathed an aggregate amount of more than $5,000 to the private foundation, if such amount is more than 2 percent of the total contributions and bequests received by the private foundation before the close of the taxable year of the private foundation in which a contribution or bequest is received by the foundation from such person. In the case of a trust, the term *substantial contributor* also means the creator of the trust. Such term does not include a governmental unit described in section 170(c)(1).

(2) *Special rules*. For purposes of sections 170(b)(1)(E)(iii), 507(d)(1), 508(d), 509(a) (1) and (3), and chapter 42, the term *substantial contributor* shall not include an organization which is described in section 509(a) (1), (2), or (3) or any other organization which is wholly owned by such section 509(a) (1), (2), or (3) organization. Furthermore, taking section 4941 (relating to taxes on self-dealing) in context, it would unduly restrict the activities of private foundations if the term *substantial contributor* were to include any section 501(c)(3) organizations. It was not intended, for example, that a large grant for charitable purposes from one private foundation to another world forever preclude the latter from making any grants to, or otherwise dealing with, the former. Accordingly, for purposes of section 4941 only, the term *substantial contributor* shall not only include any organization which is described in section 501(c)(3) (other than an organization described in section 509(a)(4)).

(b) *Determination of substantial contributor*—(1) *In general*. In determining under paragraph (a) of this section whether the aggregate of contributions and bequests from a person exceeds 2 percent of the total contributions and bequests received by a private foundation, both the total of such amounts received by the private foundation, and the aggregate of such amounts contributed and bequeathed by such person, shall be determined as of the last day of each taxable year commencing with

the first taxable year ending after October 9, 1969. Generally, under section 507(d)(2) and this section, except for purposes of valuation under section 507(d)(2)(B)(i), all contributions and bequests made before October 9, 1969, are deemed to have been made on October 9, 1969. For purposes of section 509(a)(2) and the support test described in §1.509(a)–3(c), contributions and bequests before October 9, 1969, will be taken into account in the year when actually made. For example, in the case of a contribution or bequest of $6,000 in 1967, such contribution or bequest shall be treated as made by a substantial contributor in 1967 for purposes of section 509(a)(2) and §1.509(a)–3(c) if such person met the $5,000—2 percent test as of December 31, 1967, and December 31, 1969 (in the case of a calendar year accounting period). Although the determination of the percentage of total contributions and bequests represented by a given donor's contributions and bequests is not made until the end of the foundation's taxable year, a donor is a substantial contributor as of the first date when the foundation received from him an amount sufficient to make him a substantial contributor. Except as otherwise provided in this subparagraph, such amount is treated for all purposes as made by a substantial contributor. Thus, the total contributions and bequests received by the private foundation from all persons, and the aggregate contributions and bequests made by a particular person, are to be determined as of December 31, 1969 (in the case of a calendar year organization which was in existence on that date), and the amounts included in each respective total would be all contributions and bequests received by the organization on or before that date, and all contributions and bequests made by the person on or before that date. Thereafter, a similar determination is to be made with respect to such private foundation as of the end of each of its succeeding taxable years. Status as a substantial contributor, however, will date from the time when the donor first met the $5,000 and 2 percent test. Once a person is a substantial contributor with respect to a private foundation, he remains a substantial contributor even though he might not be so classified if a determination were first made at some later date. For instance, even though the aggregate contributions and bequests of a person become less than 2 percent of the total received by a private foundation (for example, because of subsequent contributions and bequests by other persons), such person remains a substantial contributor with respect to the foundation.

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

Example 1. On January 1, 1968, A, an individual, gave $4,500 to M, a private foundation on a calendar year basis. On June 1, 1969, A gave M the further sum of $1,500. Throughout its existence, through December 31, 1969, M has received $250,000 in contributions and bequests from all sources. As of June 1, 1969, A is a substantial contributor to M for purposes of section 509(a)(2).

Example 2. On September 9, 1966, B, an individual, gave $3,500 to N, a private foundation on a calendar year basis. On March 15, 1970, B gave N the further sum of $3,500. Throughout its existence, through December 31, 1970, N has received $200,000 in contributions and bequests from all sources. B is a substantial contributor to N as of March 15, 1970, since that is the first date on which his contributions met the 2 percent-$5,000 test.

Example 3. On July 21, 1964, X, a corporation, gave $2,000 to O, a private foundation on a calendar year basis. As of December 31, 1969, O had received $150,000 from all sources. On September 17, 1970, X gave O the further sum of $3,100. Through September 17, 1970, O had received $245,000 from all sources as total contributions and bequests. Between September 17, 1970, and December 31, 1970, however, O received $50,000 in contributions and bequests from others. X is not a substantial contributor to O, since X's contributions to O were not more than 2 percent of the total contributions and bequests received by O by December 31, 1970, the end of O's taxable year, even though X's contributions met that test at one point during the year.

Example 4. On September 16, 1970, C, an individual, gave $10,000 to P, a private foundation on a calendar year basis. Throughout its existence, and through December 31, 1970, the close of its taxable year, P had received a total of $100,000 in contributions and bequests. On January 3, 1971, P received a bequest of $1 million. C is a substantial contributor to P since he was a substantial contributor as of September 16, 1970, and therefore remains one even though he no longer meets the 2-percent test on a later date after the end of the taxable year of the foundation

in which he first became a substantial contributor.

(c) *Special rules*—(1) *Contributions defined*. The term *contribution* shall, for purposes of section 507(d)(2), have the same meaning as such term has under section 170(c) and also include bequests, legacies, devises, and transfers within the meaning of section 2055 or 2106(a)(2). Thus, for purposes of section 507(d)(2), any payment of money or transfer of property without adequate consideration shall be considered a *contribution*. Where payment is made or property transferred as consideration for admissions, sales of merchandise, performance of services, or furnishing of facilities to the donor, the qualification of all or any part of such payment or transfer as a contribution under section 170(c) shall determine whether and to what extent such payment or transfer constitutes a *contribution* under section 507(d)(2).

(2) *Valuation of contributions and bequests*. Each contribution or bequest to a private foundation shall be valued at fair market value when actually received by the private foundation.

(3) *Contributions and bequests by a spouse*. An individual shall be considered, for purposes of this section, to have made all contributions and bequests made by his spouse during the period of their marriage. Thus, for example, where W contributed $500,000 to P, a private foundation, in 1941 and that amount exceeded 2 percent of the total contributions received by P as of the end of P's first taxable year ending after October 9, 1969, H (W's spouse at the time of the 1941 gift) is considered to have made such contribution (even if W died prior to October 9, 1969, or their marriage was otherwise terminated prior to such date). Similarly, any bequest or devise shall be treated as having been made by the decedent's surviving spouse.

[T.D. 7241, 37 FR 28743, Dec. 29, 1972; 38 FR 24206, Sept. 6, 1973]

§ 1.507–7 Value of assets.

(a) *In general*. For purposes of section 507(c), the value of the net assets shall be determined at whichever time such value is higher:

(1) The first day on which action is taken by the organization which culminates in its ceasing to be a private foundation, or

(2) The date on which it ceases to be a private foundation.

(b) *Valuation dates*. (1) In the case of a termination under section 507(a)(1), the date referred to in paragraph (a)(1) of this section shall be the date on which the terminating foundation gives the notification described in section 507(a)(1).

(2) In the case of a termination under section 507(a)(2), the date referred to in paragraph (a)(1) of this section shall be the date of occurrence of the willful and flagrant act (or failure to act) or the first of the series of willful repeated acts (or failures to act) giving rise to liability for tax under chapter 42 and the imposition of tax under section 507(a)(2).

(c) *Fair market value*. For purposes of this section, fair market value shall be determined pursuant to the provisions of § 53.4942(a)–2(c)(4) of this chapter.

(d) *Net assets*. For purposes of section 507 and the regulations thereunder, the term *net assets* shall mean the gross assets of a private foundation reduced by all liabilities of the foundation, including appropriate estimated and contingent liabilities. Thus, a determination of net assets may reflect reductions for any liability or contingent liability for tax imposed upon the private foundation under chapter 42 with respect to acts or failures to act prior to termination, for any liability or contingent liability for failures to correct such acts or failures to act, or for any liability or estimated or contingent liability with respect to expenses associated with winding up the organization. If a private foundation's determination of net assets reflects any reduction for any estimated or contingent liability, such private foundation must establish, to the satisfaction of the Commissioner, the reasonableness of such reduction. If the amount of net assets reflects a reduction for any estimated or contingent liability, at the earlier of the final determination of the contingency or the termination of a reasonable time, any excess of the amount by which the gross assets was reduced over the amount of the liability shall be treated in the same manner as if

such excess had been considered part of the net assets.

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.507–8 Liability in case of transfers.

For purposes of determining liability for the tax imposed under section 507(c) in the case of assets transferred by the private foundation, such tax shall be deemed to have been imposed on the first day on which action is taken by the organization which culminates in its ceasing to be a private foundation. If an organization's private foundation status is terminated under section 507(a)(2), the first day on which action is taken which culminates in its ceasing to be a private foundation (within the meaning of section 507(f)) shall be the date described in § 1.507–7(b)(2). If an organization terminates its private foundation status under section 507(a)(1), the first day on which action is taken which culminates in its ceasing to be a private foundation (within the meaning of section 507(f)) shall be the date described in § 1.507–7(b)(1).

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.507–9 Abatement of taxes.

(a) *General rule*. The Commissioner may at his discretion abate the unpaid portion of the assessment of any tax imposed by section 507(c), or any liability in respect thereof, if:

(1) The private foundation distributes all of its net assets to one or more organizations described in section 170(b)(1)(A) (other than in clauses (vii) or (viii)) each of which has been in existence and so described for a continuous period of at least 60 calendar months, or

(2) Effective assurance is given to the Commissioner in accordance with paragraphs (b) and (c) of this section that the assets of the organization which are dedicated to charitable purposes will, in fact, be used for charitable purposes

The provisions of § 1.507–2(a) (2), (3), and (7) shall apply to distributions under subparagraph (1) of this paragraph. Since section 507(g) provides only for the abatement of tax imposed under section 507(c), no tax imposed under any provision of chapter 42 shall be abated under section 507(g). Where the taxpayer files a petition with the Tax Court with respect to a notice of deficiency regarding any tax under section 507(c), such tax shall be treated as having been assessed for the purposes of abatement of such tax under section 507(g) and the regulations thereunder.

(b) *State proceedings*. (1) The Commissioner may at his discretion abate the unpaid portion of the assessment of any tax imposed by section 507(c), or any liability in respect thereof, under the procedures outlined in subparagraphs (2) and (3) of this paragraph. Such tax may not be abated by the Commissioner unless he determines that corrective action as defined in paragraph (c) of this section has been taken. The Commissioner may not abate by reason of section 507(g) any amount of such tax which has already been collected since only the unpaid portion thereof can be abated.

(2) The appropriate State officer shall have 1 year from the date of notification prescribed in section 6104(c) that a notice of deficiency of tax imposed under section 507(c) has been issued with respect to a foundation, to advise the Commissioner that corrective action has been initiated pursuant to State law as may be ordered or approved by a court of competent jurisdiction. Corrective action may be initiated either by the appropriate State officer or by an organization described in section 509(a) (1), (2), or (3) which is a beneficiary of the private foundation and has enforceable rights against such foundation under State law. Copies of all pleadings and other documents filed with the court at the initial stages of the proceedings shall be attached to the notification made by the State officer to the Commissioner. Prior to notification by the appropriate State officer that corrective action has been initiated, the Commissioner shall follow those procedures which would apply with respect to the assessment and collection of the tax imposed under section 507(c) without regard to section 507(g)(2). Subsequent to notification by the appropriate State officer that corrective action has been initiated, the Commissioner shall suspend action with respect to the assessment or collection of tax imposed under section

507(c) until notified of the final determination of such corrective action, as long as any such resulting delay does not jeopardize the collection of such tax and does not cause collection to be barred by operation of law or any rule of law. In any case where collection of such tax is about to be barred by operation of section 6502 and the Commissioner has not been advised of the final determination of corrective action, the Commissioner should make every effort to obtain appropriate agreements with the foundation subject to such tax to extend the period of limitations under section 6502(a)(2). Where such agreements are obtained, action with respect to the assessment and collection of such tax may be suspended to the extent not inconsistent with this subparagraph.

(3) Upon receipt of certification from the appropriate State officer that action has been ordered or approved by a court of competent jurisdiction, the Commissioner may abate the unpaid portion of the assessment of tax imposed by section 507(c), or any liability in respect thereof, if in his judgment such action is corrective action within the meaning of paragraph (c) of this section. In the event that such action is not corrective action, the Commissioner may in his discretion again suspend action on the assessment and collection of such tax until corrective action is obtained, or if in his judgment corrective action cannot be obtained, he may resume the assessment and collection of such tax.

(c) *Corrective action*. The term *corrective action* referred to in paragraph (b) of this section means vigorous enforcement of State laws sufficient to assure implementation of the provisions of chapter 42 and insure that the assets of such private foundation are preserved for such charitable or other purposes specified in section 501(c)(3). Except where assets of the terminated private foundation are transferred to an organization described in section 509(a) (1) through (4) the State is required to take such action to assure that the provisions of section 508(e)(1) (A) and (B) are applicable to the terminated foundation (or any transferee) with respect to such assets as if such organization were a private foundation. Thus, the governing instrument of such organization must include provisions with respect to such assets:

(1) Requiring its income therefrom for each taxable year to be distributed at such time and in such manner as not to subject such organization to tax under section 4942 (as if the organization were a private foundation),

(2) Prohibiting such organization from engaging in any act of self-dealing (as defined in section 4941(d) as if the organization were a private foundation),

(3) Prohibiting such organization from retaining any excess business holdings (as defined in section 4943(c) as if the organization were a private foundation),

(4) Prohibiting such organization from making any investments in such manner as to subject such organization to tax under section 4944 (as if the organization were a private foundation), and

(5) Prohibiting such organization from making any taxable expenditures (as defined in section 4945(d) as if the organization were a private foundation). Consequently, in cases where the preceding sentence applies, although the private foundation status of an organization is terminated for tax purposes, it is contemplated that its status under State law would remain unchanged, because the tax under section 507(c) has been abated solely because the Commissioner has been given effective assurance that there is vigorous enforcement of State laws sufficient to assure implementation of the provisions of chapter 42. Therefore, in such a case while chapter 42 will not apply to acts occurring subsequent to termination which previously would have resulted in the imposition of tax under chapter 42, it is contemplated that there will be vigorous enforcement of State laws (including laws made applicable by the provisions in the governing instrument) with respect to such acts. Notwithstanding the preceding three sentences, no amendment to the organization's governing instrument is necessary where there are provisions of State law which have the effect of requiring a terminated private

foundation to which the rules of subparagraphs (1) through (5) of this paragraph apply to be subject to such rules whether or not there are such provisions in such terminated private foundation's governing instrument.

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.508–1 Notices.

(a) *New organizations must notify the Commissioner that they are applying for recognition of section 501(c)(3) status*—(1) *In general.* Except as provided in subparagraph (3) of this paragraph, an organization that is organized after October 9, 1969, will not be treated as described in section 501(c)(3):

(i) Unless such organization has given the Commissioner notice in the manner prescribed in subparagraph (2) of this paragraph; or

(ii) For any period before the giving of such notice, unless such notice is given in the manner and within the time prescribed in subparagraph (2) of this paragraph

No organization shall be exempt from taxation under section 501(a) by reason of being described in section 501(c)(3) whenever such organization is not treated as described in section 501(c)(3) by reason of section 508(a) and this paragraph. See section 508(d)(2)(B) and § 1.508–2(b) regarding the deductibility of charitable contributions to an organization during the period such organization is not exempt under section 501(a) as an organization described in section 501(c)(3) by reason of failing to file a notice under section 508(a) and this subparagraph. See also § 1.508–2(b)(1)(viii) regarding the deductibility of charitable contributions to trusts described in section 4947(a)(1).

(2) *Filing of notice.* (i) [Reserved] For further guidance, see § 1.508–1T(a)(2)(i).

(ii) [Reserved] For further guidance, see § 1.508–1T(a)(2)(ii).

(iii) For purposes of subdivision (i) of this subparagraph and paragraph (b)(2)(i) of this section, an organization shall be considered *organized* on the date it becomes an organization described in section 501(c)(3) (determined without regard to section 508(a)).

(iv) Since a trust described in section 4947(a)(2) is not an organization described in section 501(c)(3), it is not required to file a notice described in section 508(a).

(v) For the treatment of community trusts, and the trusts or funds comprising them, under section 508, see the special rules under § 1.170A–9(e).

(vi) A foreign organization shall, for purposes of section 508, be treated in the same manner as a domestic organization, except that section 508 shall not apply to a foreign organization which is described in section 4948(b).

(3) *Exceptions from notice.* (i) Paragraphs (a) (1) and (2) of this section are inapplicable to the following organizations:

(*a*) Churches, interchurch organizations of local units of a church, conventions or associations of churches, or integrated auxiliaries of a church. See § 1.6033–2(h) regarding the definition of integrated auxiliary of a church;

(*b*) Any organization which is not a private foundation (as defined in section 509(a)) and the gross receipts of which in each taxable year are normally not more than $5,000 (as described in subdivision (ii) of this subparagraph);

(*c*) Subordinate organizations (other than private foundations) covered by a group exemption letter;

(*d*) Solely for purposes of sections 507, 508(d)(1), 508(d)(2)(A) and 508(d)(3), 508(e), 509 and chapter 42, a trust described in section 4947(a)(1). (However, a trust described in section 501(c)(3) which was organized after October 9, 1969, shall be exempt under section 501(a) by reason of being described in section 501(c)(3) only if it files such notice); and

(*e*) Any other class of organization that the Commissioner from time to time excludes from the requirement of filing notice under section 508(a).

(ii) For purposes of subdivision (i) (*b*) of this subparagraph and paragraph (b)(7)(ii) of this section, the gross receipts (as defined in subdivision (iii) of this subparagraph) of an organization are normally not more than $5,000 if:

(*a*) During the first taxable year of the organization the organization has received gross receipts of $7,500 or less;

(*b*) During its first 2 taxable years the aggregate gross receipts received by the organization are $12,000 or less; and

(*c*) In the case of an organization which has been in existence for at least 3 taxable years, the aggregate gross receipts received by the organization during the immediately preceding 2 taxable years, plus the current year are $15,000 or less

If an organization fails to meet the requirements of (*a*), (*b*), or (*c*) of this subdivision, then with respect to the organization, such organization shall be required to file the notices described in section 508 (a) and (b) within 90 days after the end of the period described in (*a*), (*b*), or (*c*) of this subdivision or before March 22, 1973, whichever is later, in lieu of the period prescribed in subparagraph (2)(i) of this paragraph. Thus, for example, if an organization meets the $7,500 requirement of (*a*) of this subdivision for its first taxable year, but fails to meet the $12,000 requirement of (*b*) of this subdivision for the period ending with its second taxable year, then such organization shall meet the notification requirements of section 508(a)(1) and 508(b) and subparagraph (2)(i) of this paragraph if it files such notification within 90 days after the close of its second taxable year. If an organization which has been in existence at least 3 taxable years meets the requirements of (*a*), (*b*), and (*c*) with respect to all prior taxable years, but fails to meet the requirements of (*c*) of this subdivision with respect to the current taxable year, then even if the organization fails to make such notification within 90 days after the close of the current taxable year, section 508(a)(1) and 508(b) shall not apply with respect to its prior years. In such a case, the organization shall not be treated as described in section 501(c)(3) for a period beginning with such current taxable year and ending when such notice is given under section 508(a)(2).

(iii) For a definition of *gross receipts* for purposes of subdivision (i)(*b*) of this subparagraph and paragraph (b)(7)(ii) of this section, see §1.6033–2(g)(4).

(4) *Voluntary filings by new organizations excepted from filing notice.* Any organization excepted from the requirement of filing notice under section 508(a) will be exempt from taxation under section 501(c)(3) if it meets the requirements of that section, whether or not it files such notice. However, in order to establish its exemption with the Internal Revenue Service and receive a ruling or determination letter recognizing its exempt status, an organization excepted from the notice requirement by reason of subparagraph (3) of this paragraph should file proof of its exemption in the manner prescribed in §1.501(a)–1.

(b) *Presumption that old and new organizations are private foundations*—(1) *In general.* Except as provided in subparagraph (7) of this paragraph, any organization (including an organization in existence on October 9, 1969) which is described in section 501(c)(3), and which does not notify the Commissioner within the time and in the manner prescribed in subparagraph (2) that it is not a private foundation, will be presumed to be a private foundation.

(2) *Filing of notice.* (i) Except as provided in subparagraph (7) of this paragraph, an organization must file the notice described in section 508(b) and subparagraph (1) of this paragraph within 15 months from the end of the month in which such organization was organized, or before March 22, 1973, whichever comes later. See paragraph (a)(2)(iii) of this section, for rules pertaining to when an organization is *organized*.

(ii) Any organization filing notice under this paragraph that has received a ruling or determination letter from the Internal Revenue Service dated on or before July 13, 1970, recognizing its exemption from taxation under section 501(c)(3) (or the corresponding provisions of prior law), shall file the notice described in section 508(b) by submitting a properly completed and executed Form 4653, Notification Concerning Foundation Status.

(iii) The financial schedule on Form 4653 need be completed only if the organization is, or thinks it might be, described in section 170(b)(1)(A) (iv) or (vi) or section 509(a)(2).

(iv) [Reserved] For further guidance, see §1.508–1T(b)(2)(iv).

(v) [Reserved] For further guidance, see §1.508–1T(b)(2)(v).

(3) *Effect of notice upon the filing organization.* (i) The notice filed under this paragraph may not be relied upon by the organization so filing unless and

until the Internal Revenue Service notifies the organization that it is an organization described in paragraph (1), (2), (3), or (4), of section 509(a). For purposes of the preceding sentence, an organization that has filed notice under section 508(b), and has previously received a ruling that it is an organization described in section 170(b)(1)(A) (other than clauses (vii) and (viii) thereof), will be considered to have been notified by the Internal Revenue Service that it is an organization described in paragraph (1) of section 509(a) if (*a*) the facts and circumstances forming the basis for the issuance of such ruling have not substantially changed, and (*b*) the ruling issued under that section has not been revoked expressly or by a subsequent change of the law or regulations under which the ruling was issued.

(ii) If an organization has filed a notice under section 508(b) stating that it is not a private foundation and designating only one paragraph of section 509(a) under which it claims recognition of its classification (such as an organization described in section 509(a)(2)), and if it has received a ruling or determination letter which recognizes that it is not a private foundation but which fails to designate the paragraph under section 509(a) in which it is described, then such organization will be treated as described under the paragraph designated by it, until such ruling or determination letter is modified or revoked. The rule in the preceding sentence shall not apply to an organization which indicated that it does not know its status under section 509(a) or which claimed recognition of its status under more than one paragraph of section 509(a).

(4) *Effect of notice upon grantors or contributors to the filing organization.* In the case of grants, contributions, or distributions made prior to:

(i) In the case of community trusts, 6 months after the date on which corrective and clarifying regulations designated as §1.170A–9(e)(10) become final;

(ii) In the case of medical research organizations, 6 months after the date on which corrective and clarifying regulations designated as §1.170A–9(b)(2), become final, and

(iii) In all other cases, January 1, 1976, any organization which has properly filed the notice described in section 508(b) prior to March 22, 1973 will not be treated as a private foundation for purposes of making any determination under the internal revenue laws with respect to a grantor, contributor or distributor (as for example, a private foundation distributing all of its net assets pursuant to a section 507(b)(1)(A) termination) thereto, unless the organization is controlled directly or indirectly by such grantor, contributor or distributor, if by the 30th day after the day on which such notice is filed, the organization has not been notified by the Commissioner that the notice filed by such organization has failed to establish that such organization is not a private foundation. See subparagraph (6) of this paragraph for the effect of an adverse notice by the Internal Revenue Service. For purposes of this subparagraph, an organization which has properly filed notice described in section 508(b) prior to March 22, 1973, and which has claimed recognition of its status under only one paragraph of section 509(a) in such notice, will be treated only for purposes of grantors, contributors or distributors as having the classification claimed in the notice if the provisions of this subparagraph are otherwise satisfied.

(5) *Statement that old and new organizations are operating foundations.* (i) Any organization (including an organization in existence on October 9, 1969) which is described in section 501(c)(3) may submit a statement, in the form and manner provided for notice in subparagraph (2) of this paragraph, that it is an operating foundation (as defined in section 4942(j)(3)) and include in such statement:

(*a*) Necessary supporting information as required by the regulations under section 4942(j)(3) to confirm such determination (including a statement identifying the clause of section 4942(j)(3)(B) that is applicable); and

(*b*) A written declaration by the principal officer, manager, or authorized trustee that there is a reasonable basis in law and in fact that the organization so filing is an operating foundation, and that to the best of the knowledge

and belief of such officer, manager or trustee, the information submitted is complete and correct.

(ii) The statement filed under this subparagraph may not be relied upon by the organization so filing unless and until the Internal Revenue Service notifies the organization that it is an operating foundation described in section 4942(j)(3).

(iii) In the case of grants, contributions, or distributions made prior to March 22, 1973, any organization which has properly filed the statement described in this subparagraph prior to such date will be treated as an operating foundation for purposes of making any determination under the internal revenue laws with respect to a grantor, contributor, or distributor thereto, unless the organization is controlled directly or indirectly by such grantor, contributor, or distributor, if by the 30th day after the day on which such statement is filed, the organization has not been notified by the Commissioner or his delegate that its statement has failed to establish that such organization is an operating foundation. See subparagraph (6) of this paragraph for the effect of an adverse notice by the Internal Revenue Service.

(6) *Effect of notice by Internal Revenue Service concerning organization's notice or statement.* Subparagraph (4) and subdivision (iii) of subparagrph (5) of this paragraph shall have no effect:

(i) With respect to a grantor, contributor, or distributor to any organization for any period after the date on which the Internal Revenue Service makes notice to the public (such as by publication in the Internal Revenue Bulletin) that a grantor, contributor, or distributor to such organization can no longer rely upon the notice or statement submitted by such organization; and

(ii) Upon any grant, contribution, or distribution made to an organization on or after the date on which a grantor, contributor, or distributor acquired knowledge that the Internal Revenue Service has given notice to such organization that its notice or statement has failed to establish that such organization either is not a private foundation, or is an operating foundation, as the case may be.

(7) *Exceptions from notice.* Subparagraphs (1) and (2) of this paragraph are inapplicable to the following organizations:

(i) Churches, interchurch organizations of local units of a church, conventions or associations of churches, or integrated auxiliaries of a church, such as a men's or women's organization, religious school, mission society, or youth group;

(ii) Any organization which is not a private foundation (as defined in section 509(a)) and the gross receipts of which in each taxable year are normally not more than $5,000 (as determined under paragraph (a)(3)(ii) of this section);

(iii) Subordinate organizations (other than private foundations) covered by a group exemption letter but only if the parent or supervisory organization submits a notice covering the subordinates;

(iv) Trusts described in section 4947(a)(1); and

(v) Any other class of organization that the Commissioner from time to time excludes from the notification requirements of section 508(b).

(8) *Voluntary filings by organizations excepted from filing notice.* Any organization excepted from the requirement of filing notice under section 508(b) by reason of subdivisions (i), (ii), and (v) of subparagraph (7) of this paragraph may receive the benefits of subparagraph (4) of this paragraph by filing such notice.

(c) [Reserved] For further guidance, see § 1.508–1T(c).

(Secs. 508 and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7232, 37 FR 28289, Dec. 22, 1972, as amended by T.D. 7342, 40 FR 1237, Jan. 7, 1975; T.D. 7395, 41 FR 1063, Jan. 6, 1976; T.D. 8640, 60 FR 65552, Dec. 20, 1995; T.D. 9674, 79 FR 37632, July 2, 2014]

§ 1.508–1T Notices (temporary).

(a)(1) [Reserved] For further guidance, see § 1.508–1(a)(1).

(2) *Filing of notice.* (i) For purposes of paragraph (a)(1) of this section, except as provided in paragraph (a)(3) of this section, an organization seeking exemption under section 501(c)(3) must file the notice described in section 508(a) within 15 months from the end of

the month in which the organization was organized, or before March 22, 1973, whichever comes later. Such notice is filed by submitting a properly completed and executed Form 1023 (or if applicable, Form 1023–EZ), exemption application. Notice should be filed with the appropriate office as designated by the Commissioner in guidance published in the Internal Revenue Bulletin, forms or instructions to the applicable forms. A request for extension of time for the filing of such notice should be submitted to such appropriate office. Such request may be granted if it demonstrates that additional time is required.

(ii) Although the information required by either Form 1023 or Form 1023–EZ must be submitted to satisfy the notice required by this section, the failure to supply, within the required time, all of the information required to complete such form is not alone sufficient to deny exemption from the date of organization to the date such complete information for such form is submitted by the organization. If the information that is submitted within the required time is incomplete, and the organization supplies the necessary additional information at the request of the Commissioner within the additional time period allowed by him, the original notice will be considered timely.

(iii) through (b)(2)(iii) [Reserved] For further guidance, see §1.508–1(a)(2)(iii) through (b)(2)(iii).

(iv) Any organization filing notice under this paragraph (b)(2)(iv) that has not received a ruling or determination letter from the Internal Revenue Service dated on or before July 13, 1970, recognizing its exemption from taxation under section 501(c)(3) (or the corresponding provisions of prior law), shall file its notice by submitting a properly completed and executed Form 1023 (or if applicable, Form 1023–EZ) and providing information that it is not a private foundation. The organization shall also submit all information required by the regulations under section 170 or 509 (whichever is applicable) necessary to establish recognition of its classification as an organization described in section 509(a)(1), (2), (3), or (4). A Form 1023 submitted prior to July 14, 1970, will satisfy this requirement if the organization submits an additional statement that it is not a private foundation together with all pertinent additional information required. Any statement filed under this paragraph (b)(2)(iv) shall be accompanied by a written declaration by the principal officer, manager or authorized trustee that there is a reasonable basis in law and in fact for the statement that the organization so filing is not a private foundation, and that to the best of the knowledge and belief of such officer, manager or trustee, the information submitted is complete and correct.

(v) The notice filed under paragraph (b)(2)(ii) of this section should be filed in accordance with the instructions applicable to Form 4653. The notice required by paragraph (b)(2)(iv) of this section should be filed with the appropriate office as designated by the Commissioner in guidance published in the Internal Revenue Bulletin, forms, or instructions to the applicable forms. An extension of time for the filing of such notice may be granted by such office upon timely request by the organization, if the organization demonstrates that additional time is required.

(b)(3) through (8) [Reserved] For further guidance, see §1.508–1(b)(3) through (8).

(c) *Effective/applicability date.* (1) Paragraphs (a)(2)(i), (a)(2)(ii), (b)(2)(iv), and (b)(2)(v) of this section apply on and after July 1, 2014.

(2) *Expiration date.* Paragraphs (a)(2)(i), (a)(2)(ii), (b)(2)(iv), and (b)(2)(v) of this section expire on or before June 30, 2017.

[T.D. 9674, 79 FR 37632, July 2, 2014; 79 FR 41886, July 18, 2014]

§1.508–2 Disallowance of certain charitable, etc., deductions.

(a) *Gift or bequest to organizations subject to section 507(c) tax*—(1) *General rule.* No gift or bequest made to an organization upon which the tax provided by section 507(c) has been imposed shall be allowed as a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such gift or bequest is made:

(i) By any person after notification has been made by the organization under section 507(a)(1) or after notification has been made by the Commissioner under section 507(a)(2)(B), or

(ii) By a substantial contributor (as defined in section 507(d)(2)) in his taxable year which includes the first day on which action is taken by such organization which culminates in the imposition of tax under section 507(c) and any subsequent taxable year

For purposes of subdivision (ii) of this subparagraph, the first day on which action is taken by an organization which culminates in the imposition of tax under section 507(c) shall be determined under the rules set forth in §1.507–7(b) (1) and (2).

(2) *Exception*. Subparagraph (1) of this paragraph shall not apply if the entire amount of the unpaid portion of the tax imposed by section 507(c) is abated by the Commissioner under section 507(g).

(b) *Gift or bequest to taxable private foundation, section 4947 trust, etc.*—(1) *General rule*. (i) Except as provided in subparagraph (2) of this paragraph, no gift or bequest made to an organization shall be allowed as a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such gift or bequest is made:

(*a*) To a private foundation or a trust described in section 4947(a)(2) in a taxable year for which it fails to meet the requirements of section 508(e) (determined without regard to section 508(e)(2) (B) and (C), or

(*b*) To any organization in a period for which it is not treated as an organization described in section 501(c)(3) by reason of section 508(a).

(ii) For purposes of subdivision (i)(*a*) of this subparagraph the term *taxable year* refers to the taxable year of the donee or beneficiary organization. In the event a bequest is made to a private foundation or trust described in section 4947(a)(2) which is not in existence at the date of the testator's death (but which is created under the terms of the testator's will), the term *taxable year* shall mean the first taxable year of the private foundation or trust.

(iii) For purposes of subdivision (i)(*a*) of this subparagraph, an organization does not fail to meet the requirements of section 508(e) for a taxable year, unless it fails to meet such requirements for the entire year. Therefore, even if a donee organization fails to meet the requirements of section 508(e) on the date it receives a grant from a donor, the donor's grant will not be disallowed by operation of section 508(d)(2)(A) and subdivision (i)(*a*) of this subparagraph, if the organization meets the requirements of section 508(e) (determined without regard to section 508(e)(2) (B) or (C)) by the end of its taxable year.

(iv) No deduction will be disallowed under section 508(d)(2)(A) with respect to a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 if during the taxable year in question, the private foundation or trust described in section 4947(a)(2) has instituted a judicial proceeding which is necessary to reform its governing instrument or other instrument in order to meet the requirements of section 508(e)(1). This subdivision shall not apply unless within a reasonable time such judicial proceedings succeed in so reforming such instrument.

(v) No deduction will be disallowed under section 508(d)(2)(A) and subdivision (i)(*a*) of this subparagraph for any taxable year beginning before January 1, 1972, with respect to a private foundation or trust described in section 4947 organized before January 1, 1970. See also §1.508–3(g) regarding transitional rules for extending compliance with section 508(e)(1).

(vi)(*a*) In the case of a contribution or bequest to a trust described in section 4947(a)(2) other than to a trust to which subdivision (vii) of this subparagraph applies, no deduction shall be disallowed by reason of section 508(d)(2)(A) on the grounds that such trust's governing instrument contains no provisions with respect to section 4942. Similarly, if for a taxable year such trust is also a trust described in section 4947(b)(3), no deduction for such year shall be so disallowed on the grounds that the governing instrument contains no provision with respect to section 4943 or 4944.

(*b*) This subdivision may be illustrated by the following example:

Example. H executes a will on January 1, 1977, establishing a charitable remainder

trust (as described in section 664) with income payable to W, his wife, for life, remainder to X university, an organization described in section 170(b)(1)(A)(ii). The will provides that the trust is prohibited from engaging in activities which would subject itself, its foundation manager or a disqualified person to taxes under section 4941 or 4945 of the Code. The will is silent as to sections 4942, 4943, and 4944. H dies February 12, 1978. Section 508(d)(2)(A) will not operate to disallow any deduction to H's estate under section 2055 with respect to such trust.

(vii)(*a*) In the case of a trust described in section 4947(a)(2) which by its terms will become a trust described in section 4947(a)(1) and the governing instrument of which is executed after March 22, 1973, the governing instrument shall not meet the requirements of section 508(e)(1) if it does not contain provisions to the effect that the trust must comply with the provisions of section 4942, or sections 4942, 4943, and 4944 (as the case may be) to the extent such section or sections shall become applicable to such trust.

(*b*) This subdivision may be illustrated by the following example:

Example. H executes a will on January 1, 1977, establishing a charitable remainder trust (as described in section 664) with income payable to W, his wife, for life, remainder in trust in perpetuity for the benefit of an organization described in section 170(c). By its terms the trust will become a trust described in section 4947(a)(1), and will become a private foundation. The will provides that the trust is prohibited from engaging in activities which would subject itself, its foundation manager or a disqualified person to taxes under sections 4941 or 4945 of the Code. The will is silent as to sections 4942, 4943, and 4944. H dies February 12, 1978. Unless the trust's governing instrument is amended prior to the end of the trust's first taxable year, or judicial proceedings have been instituted under subdivision (iv) of this subparagraph, section 508(d)(2)(A) will operate to disallow any deduction to H's estate under section 2055 with respect to such trust.

(viii) Since a charitable trust described in section 4947(a)(1) is not required to file a notice under section 508(a), section 508(d)(2)(B) and subdivision (i)(*b*) of this subparagraph are not applicable to such a trust.

(2) *Transitional rules*. Any deduction which would otherwise be allowable under section 642(c)(2), 2106(a)(2), or 2055 shall not be disallowed under section 508(d)(2)(A) if such deduction is attributable to:

(i) Property passing under the terms of a will executed on or before October 9, 1969,

(*a*) If the decedent dies after October 9, 1969, but before October 9, 1972, without having amended any dispositive provision of the will after October 9, 1969, by codicil or otherwise,

(*b*) If the decedent dies after October 9, 1969, and at no time after that date had the right to change the portions of the will which pertains to the passing of property to, or for the use of, an organization described in section 170(c)(2)(B) or 2055(a), or

(*c*) If no dispositive provision of the will is amended by the decedent, by codicil or otherwise, before October 9, 1972, and the decedent is on October 9, 1972, and at all times thereafter under a mental disability (as defined in §1.642(c)–2(b)(3)(ii)) to amend the will by codicil or otherwise, or

(ii) Property transferred in trust on or before October 9, 1969,

(*a*) If the grantor dies after October 9, 1969, but before October 9, 1972, without having amended, after October 9, 1969, any dispositive provision of the instrument governing the disposition of the property,

(*b*) If the property transferred was an irrevocable interest to, or for the use of, an organization described in section 170(c)(2)(B) or 2055(a),

(*c*) In the case of a deduction under section 2106(a)(2) or 2055; if no dispositive provision of the instrument governing the disposition of the property is amended by the grantor before October 9, 1972, and the grantor is on October 9, 1972, and at all times thereafter under a mental disability (as defined in §1.642(c)–2(b)(3)(ii)) to change the disposition of the property, or

(*d*) In the case of a deduction under section 642(c)(2)(A), if the grantor is at all times after October 9, 1969, and up to, and including, the last day of the taxable year for which the deduction under such section is claimed, under a mental disability (as defined in §1.642(c)–2(b)(3)(ii)) to change the terms of the trust

See also §1.508–3(g) regarding the extension of time for compliance with section 508(e), §1.664–1(f)(3) (ii) and (g)

regarding the special transitional rules for charitable remainder annuity and unitrusts described in section 664 which were created prior to December 31, 1972, and § 20.2055–2(e)(4) of this chapter regarding the rules for determining if the dispositive provisions have been amended.

[T.D. 7232, 37 FR 28291, Dec. 22, 1972]

§ 1.508–3 Governing instruments.

(a) *General rule.* A private foundation shall not be exempt from taxation under section 501(a) for a taxable year unless by the end of such taxable year its governing instrument includes provisions the effects of which are:

(1) To require distributions at such times and in such manner as not to subject the foundation to tax under section 4942, and

(2) To prohibit the foundation from engaging in any act of self-dealing (as defined in section 4941(d)), from retaining any excess business holdings (as defined in section 4943(c)), from making any investments in such manner as to subject the foundation to tax under section 4944, and from making any taxable expenditures (as defined in section 4945(d)).

(b) *Effect and nature of governing instrument*—(1) *In general.* Except as provided in paragraph (d) of this section, the provisions of a foundation's governing instrument must require or prohibit, as the case may be, the foundation to act or refrain from acting so that the foundation, and any foundation managers or other disqualified persons with respect thereto, shall not be liable for any of the taxes imposed by sections 4941, 4942, 4943, 4944, and 4945 of the Code or, in the case of a split-interest trust described in section 4947(a)(2), any of the taxes imposed by those sections of chapter 42 made applicable under section 4947. Specific reference to these sections of the Code will generally be required to be included in the governing instrument, unless equivalent language is used which is deemed by the Commissioner to have the same full force and effect. However, a governing instrument which contains only language sufficient to satisfy the requirements of the organizational test under § 1.501(c)(3)–1(b) will not be considered as meeting the requirements of this subparagraph, regardless of the interpretation placed on such language as a matter of law by a State court in a particular jurisdiction, unless the requirements of paragraph (d) of this section are satisfied.

(2) *Corpus.* A governing instrument does not meet the requirements of paragraph (a)(1) of this section if it expressly prohibits the distribution of capital or corpus.

(3) *Savings provisions.* For purposes of sections 508(d)(2) (A) and (e), a governing instrument need not include any provision which is inconsistent with section 101(l) (2), (3), (4), or (5) of the Tax Reform Act of 1969 (83 Stat. 533), as amended by sections 1301 and 1309 of the Tax Reform Act of 1976 (90 Stat. 1713, 1729), with respect to the organization. Accordingly, a governing instrument complying with the requirements of subparagraph (1) of this paragraph may incorporate any savings provision contained in section 101(l) (2), (3), (4), or (5) of the Tax Reform Act of 1969, as amended by sections 1301 and 1309 of the Tax Reform Act of 1976, as a specific exception to the general provisions of paragraph (a) of this section. In addition, in the absence of any express provisions to the contrary, the exceptions contained in such savings provisions will generally be regarded as contained in a governing instrument meeting the requirements of subparagraph (1) of this paragraph.

(4) *Excess holdings.* For purposes of paragraph (a)(2) of this section, the prohibition against *retaining any excess business holdings (as defined in section 4943(c))* shall be deemed only to prohibit the foundation from retaining any excess business holdings when such holdings would subject the foundation to tax under section 4943(a).

(5) *Revoked ruling on status.* In the case of an organization which:

(i) Has been classified as an organization described in section 509(a) (1), (2), (3), or (4), and

(ii) Subsequently receives a ruling or determination letter stating that it is no longer described in section 509(a) (1), (2), (3), or (4), but is a private foundation within the meaning of section 509,

such organization shall have 1 year from the date of receipt of such ruling or determination letter, or the final

ruling or determination letter if a protest is filed to an earlier one, to meet the requirements of section 508(e). Section 508(d)(2)(A) shall not be applicable with respect to gifts and bequests made during this 1-year period if such requirements are met within the 1-year period.

(6) *Judicial proceeding*. For purposes of paragraphs (a), (b)(5), (d)(2), and (e)(3) of this section, an organization shall be deemed to have met the requirements of section 508(e) within a year, if a judicial proceeding which is necessary to reform its governing instrument or other instrument is instituted within the year and within a reasonable time the organization, in fact, meets the requirements of section 508(e). For purposes only of paragraphs (b)(5), (d)(2), and (e)(3) of this section, if an organization organized before January 1, 1970, institutes such a judicial proceeding within such 1-year period, section 508 (e)(2)(C) shall be applied as if such proceeding had been instituted prior to January 1, 1972.

(c) *Meaning of governing instrument*. For purposes of section 508(e), the term *governing instrument* shall have the same meaning as the term *articles of organization* under § 1.501(c)(3)–1(b)(2). The bylaws of an organization shall not constitute its governing instrument for purposes of section 508(e).

(d) *Effect of State law*—(1) *In general*. A private foundation's governing instrument shall be deemed to conform with the requirements of paragraph (a) of this section if valid provisions of State law have been enacted which:

(i) Require it to act or refrain from acting so as not to subject the foundation to the taxes imposed by section 4941 (relating to taxes on self-dealing), 4942 (relating to taxes on failure to distribute income), 4943 (relating to taxes on excess business holdings), 4944 (relating to taxes on investments which jeopardize charitable purpose), and 4945 (relating to taxable expenditures); or

(ii) Treat the required provisions as contained in the foundation's governing instrument.

(2) *Validity*. (i) Any provision of State law described in subparagraph (1) of this paragraph shall be presumed valid as enacted, and in the absence of State provisions to the contrary, to apply with respect to any foundation that does not specifically disclaim coverage under State law (either by notification to the appropriate State official or by commencement of judicial proceedings) except as provided in subdivisions (ii) and (iii) of this subparagraph.

(ii) If such provision is declared invalid or inapplicable with respect to a class of foundations by the highest appellate court of the State or by the Supreme Court of the United States, the foundations covered by the determination must meet the requirements of section 508(e) within 1 year from the date on which the time for perfecting an application for review by the Supreme Court expires. If such application is filed, the requirements of section 508(e) must be met within a year from the date on which the Supreme Court disposes of the case, whether by denial of the application for review or decision on the merits.

(iii) In addition, if such provision of State law is declared invalid or inapplicable with respect to a class of foundations by any court of competent jurisdiction which decision is not reviewed by a court referred to in subdivision (ii) of this subparagraph, and the Commissioner makes notice to the general public (such as by publication in the Internal Revenue Bulletin) that such provision has been so declared invalid or inapplicable, then all foundations in such State must meet the requirements of section 508(e), without reliance upon such statute to the extent declared invalid or inapplicable by such decision, within 1 year from the date such notice is made public.

(iv) This subparagraph shall not apply to any foundation that is subject to a final judgment entered by a court of competent jurisdiction, holding the law invalid or inapplicable with respect to such foundation. See paragraph (b)(6) of this section for the effect of certain judicial proceedings that are brought within 1 year.

(3) *Conflicting instrument*. For taxable years beginning after March 22, 1973 in order for a private foundation or trust described in section 4947(a)(2) to receive the benefit of coverage under any State statute which makes applicable the requirements of section 508(e)(1) (A) and (B), where the statute by its

terms does not apply to a governing instrument which contains a mandatory direction conflicting with any of such requirements, such organization must indicate on its annual return required to be filed under section 6033 (or section 6012 in the case of a trust described in section 4947(a)) that its governing instrument contains no mandatory directions which conflict with the requirements of section 508(e)(1) (A) or (B), as incorporated by the State statute. General language in a governing instrument empowering the trustee to make investments without being limited to those investments authorized by law will not be regarded as a mandatory conflicting direction.

(4) *Exclusion from statute.* (i) For any taxable year beginning after March 22, 1973 in the case of a private foundation or trust described in section 4947(a)(2) subject to a State statute which makes applicable the requirements of section 508(e)(1) (A) and (B) to the governing instruments of such organizations, other than those which take action to be excluded therefrom (such as by filing a notice of exclusion or by instituting appropriate judicial proceedings), an organization will receive the benefit of such State statute only if it indicates on its annual return required to be filed under section 6033 (or section 6012 in the case of a trust described in section 4947(a)) that it has not so taken action to be excluded.

(ii) This paragraph permits certain organizations that are subject to the provisions of such a State law, to avoid changing their governing instruments in order to meet the requirements of section 508(e)(1). Since an organization which avoids the application of a provision or provisions of State law, such as by filing a notice of exclusion, is not entitled to the benefits of this paragraph, such an organization must meet the requirements of section 508(e)(1) without regard to this paragraph and except as provided in section 508(e)(2)(C) or paragraph (g)(1)(iii) of this section must change its governing instrument to the extent inconsistent with section 508(e)(1).

(5) *Treatment of prevailing conflicting clause.* If provisions of State law are inapplicable to a clause in a governing instrument which is contrary to the provisions of section 508(e)(1), the requirements of section 508(e)(2)(C) and paragraph (g)(1)(iii) of this section are not satisfied by a provision of State law which purports to eliminate the need for litigation under such circumstances. Therefore, except as otherwise provided in this section unless the governing instrument is changed or litigation is commenced pursuant to section 508(e)(2)(B) by an organization organized before January 1, 1970, or pursuant to paragraph (g)(1)(ii) of this section, to amend the nonconforming provision to meet the requirements of section 508(e)(1) (A) and (B), then pursuant to section 508(e), such organization will not be exempt from taxation.

(6) *Retroactive application to grants or bequests.* If valid provisions of such a State law apply retroactively to a taxable year within which an organization has received a grant or request, section 508(d)(2)(A) shall not apply so as to disallow such grant or bequest, but only if such valid provisions of State law are enacted within 2 years of such grant or bequest.

(e) *Effect of section 508(e) upon section 4947 trusts*—(1) *Section 4947(a)(1) trusts.* A charitable trust described in section 4947(a)(1) (unless also described in a paragraph of section 509(a)) is subject to all the provisions of paragraph (a) of this section.

(2) *Section 4947(a)(2) trusts.* A split-interest trust described in section 4947(a)(2), as long as it is so described, is subject to the provisions of paragraph (a)(2) of this section, except to the extent that section 4947 makes any such provisions inapplicable to certain trusts and certain amounts in trust. The governing instrument of a trust described in section 4947(a)(2) may except amounts described in section 4947(a)(2) (A), (B), and (C) from the requirements of paragraph (a)(2) of this section. In the case of a trust having amounts transferred to it both before May 27, 1969, and after May 26, 1969, its governing instrument may except from the provisions of paragraph (a)(2) of this section only those segregated amounts excluded from the application of section 4947(a)(2) by reason of section 4947(a)(2)(C) and the regulations thereunder. Also, the governing instrument of such a trust may exclude the

application of sections 4943 and 4944 for any period during which such trust is described in section 4947(b)(3) (A) or (B). See § 53.4947–1(c) of this chapter for rules relating to the applicability of section 4947 to split-interest trusts and § 1.508–2(b)(1) (vi) and (vii) for rules relating to the deductibility of grants or bequests to such trusts.

(3) *A section 4947(a)(2) trust becoming a section 4947(a)(1) trust.* If the governing instrument of a trust described in section 4947(a)(2) meets the applicable requirements of paragraph (a)(2) of this section and such trust ceases to be so described and becomes instead a trust described in section 4947(a)(1), then such governing instrument must meet, prior to the end of 12 months from the date such trust first becomes described in section 4947(a)(1) (except as otherwise provided in this section) all the requirements of paragraph (a) of this section in order to comply with section 508(e).

(f) *Special rules for existing private foundations.* (1) Pursuant to section 508(e)(2), section 508(e)(1) and paragraph (a) of this section shall not apply in the case of any organization whose governing instrument was executed before January 1, 1970:

(i) To any taxable year beginning before January 1, 1972;

(ii) To any period after December 31, 1971, during the pendency of any judicial proceeding begun before January 1, 1972, by the private foundation which is necessary to reform, or to excuse such foundation from compliance with, its governing instrument or any other instrument in order to meet the requirements of section 508(e)(1); and

(iii) To any period after the termination of any judicial proceeding described in subdivision (ii) of this subparagraph during which its governing instrument or any other instrument does not permit it to meet the requirements of section 508(e)(1).

(2) For purposes of subparagraph (1) of this paragraph, and § 1.508–2(b)(1)(vi)(*a*), a governing instrument will not be treated as executed before the applicable date, if, after such date the dispositive provisions of the instrument are amended (determined under rules similar to the rules set forth in § 20.2055–2(e)(4) of this chapter).

(3) For purposes of subparagraph (1) (ii) and (iii) of this paragraph, a private foundation will be treated as meeting the requirements of section 508(e)(2) (B) and (C) if it has commenced a necessary and timely proceeding in an appropriate court of original jurisdiction and such court has ruled that the foundation's governing instrument or any other instrument does not permit it to meet the requirements of section 508(e)(1). Such foundation is not required to commence proceedings in any court of appellate jurisdiction in order to comply with section 508(e)(2)(C). See also § 1.508–2(b)(2).

(g) *Extension of time for compliance with section 508(e).* (1) Except as provided in subparagraph (2) of this paragraph, section 508(e)(1) shall not apply to any private foundation (regardless of when organized) with respect:

(i) To any taxable year beginning before the transitional date,

(ii) To any period on or after the transitional date during the pendency of any judicial proceeding begun before the transitional date by the private foundation which is necessary to reform, or to excuse such foundation from compliance with, its governing instrument or any other instrument in order to meet the requirements of section 508(e)(1), and

(iii) To any period after the termination of any judicial proceeding described in subdivision (ii) of this subparagraph during which its governing instrument or any other instrument does not permit it to meet the requirements of section 508(e)(1).

(2) Subparagraph (1) of this paragraph shall apply only to gifts or bequests referred to in section 508(d)(2)(A) that are made before the transitional date.

(3) For purposes of this paragraph the term *transitional dates* means the earlier of the following dates:

(i) In the case of a medical research organization, May 21, 1976 or in the case of a community trust February 10, 1977, or

(ii) The 91st day after the date an organization receives a final ruling or determination letter that it is a private foundation under section 509(a).

[T.D. 7232, 37 FR 28292, Dec. 22, 1972, as amended by T.D. 7440, 41 FR 50656, Nov. 17, 1976; T.D. 7678, 45 FR 12415, Feb. 26, 1980]

§ 1.508–4 Effective date.

Except as otherwise provided, §§ 1.508–1 through 1.508–3 shall take effect on January 1, 1970.

(Sec. 7805 of the Internal Revenue Code of 1954, 68A Stat. 917; 26 U.S.C. 7805)

[T.D. 7232, 37 FR 28294, Dec. 22, 1972]

§ 1.509(a)–1 Definition of private foundation.

In general. Section 509(a) defines the term *private foundation* to mean any domestic or foreign organization described in section 501(c)(3) other than an organization described in section 509(a) (1), (2), (3), or (4). Organizations which fall into the categories excluded from the definition of *private foundation* are generally those which either have broad public support or actively function in a supporting relationship to such organizations. Organizations which test for public safety are also excluded.

[T.D. 7212, 37 FR 21907, Oct. 17, 1972]

§ 1.509(a)–2 Exclusion for certain organizations described in section 170(b)(1)(A).

(a) *General rule.* Organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)) are excluded from the definition of *private foundation* by section 509(a)(1). For the requirements to be met by organizations described in section 170(b)(1)(A) (i) through (vi), see § 1.170A–9 (a) through (e) and paragraph (b) of this section. For purposes of this section, the parenthetical language *other than in clauses (vii) and (viii)* used in section 509(a)(1) means *other than an organization which is described only in clause (vii) or (viii).* For purposes of this section, an organization may qualify as a section 509(a)(1) organization regardless of the fact that it does not satisfy section 170(c)(2) because:

(1) Its funds are not used within the United States or its possessions, or

(2) It was created or organized other than in, or under the law of, the United States, any State or territory, the District of Columbia, or any possession of the United States.

(b) *Medical research organizations.* In order to qualify under section 509(a)(1) as a medical research organization described in section 170(b)(1)(A)(iii), an organization must meet the requirements of section 170(b)(1)(A)(iii) and § 1.170A–9(c)(2), except that, solely for purposes of classification as a section 509(a)(1) organization, such organization need not be committed to spend every contribution for medical research before January 1 of the fifth calendar year which begins after the date such contribution is made.

[T.D. 7212, 37 FR 21907, Oct. 17, 1972]

§ 1.509(a)–3 Broadly, publicly supported organizations.

(a) *In general*—(1) *General rule.* Section 509(a)(2) excludes certain types of broadly, publicly supported organizations from private foundation status. An organization will be excluded under section 509(a)(2) if it meets the one-third support test under section 509(a)(2)(A) and the not-more-than-one-third support test under section 509(a)(2)(B).

(2) *One-third support test.* An organization will meet the one-third support test if it normally (within the meaning of paragraph (c) or paragraph (d) of this section) receives from permitted sources more than one-third of its support in each taxable year from any combination of—

(i) Gifts, grants, contributions, or membership fees; and

(ii) Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity that is not an unrelated trade or business (within the meaning of section 513), subject to certain limitations described in paragraph (b) of this section. For purposes of this section, governmental units, organizations described in section 509(a)(1), and persons other than disqualified persons with respect to the organization shall be referred to as permitted sources. For purposes of this section, the amount of support received from the sources described in paragraph (a)(2)(i) of this

section and this paragraph (a)(2)(ii) (subject to the limitations referred to in this paragraph (a)(2)) will be referred to as the numerator of the one-third support fraction, and the total amount of support received (as defined in section 509(d)) will be referred to as the denominator of the one-third support fraction. Section 1.509(a)–3(f) distinguishes gifts and contributions from gross receipts; §1.509(a)–3(g) distinguishes grants from gross receipts; §1.509(a)–3(h) defines membership fees; §1.509(a)–3(i) defines ''any bureau or similar agency of a governmental unit''; §1.509(a)–3(j) describes the treatment of certain indirect forms of support; paragraph (k) of this section describes the method of accounting for support; §1.509(a)–3(l) describes the treatment of gross receipts from section 513(a)(1), section 513(a)(2), or section 513(a)(3) activities; §1.509(a)–3(m) distinguishes gross receipts from gross investment income; and §1.509(a)–3(n) describes transition rules for organizations that received advance rulings that expire on or after June 9, 2008.

(3) *Not-more-than-one-third support test*—(i) *In general.* An organization will meet the not-more-than-one-third support test under section 509(a)(2)(B) if it normally (within the meaning of paragraph (c) or (d) of this section) receives not more than one-third of its support in each taxable year from the sum of its gross investment income (as defined in section 509(e)) and the excess (if any) of the amount of its unrelated business taxable income (as defined in section 512) derived from trades or businesses that were acquired by the organization after June 30, 1975, over the amount of tax imposed on such income by section 511. For purposes of this section the amount of support received from items described in section 509(a)(2)(B) will be referred to as the numerator of the not-more-than-one-third support fraction, and the total amount of support (as defined in section 509(d)) will be referred to as the denominator of the not-more-than-one-third support fraction. For purposes of section 509(a)(2), paragraph (m) of this section distinguishes gross receipts from gross investment income. For purposes of section 509(e), gross investment income includes the items of investment income described in §1.512(b)–1(a).

(ii) *Trade or business.* For purposes of section 509(a)(2)(B)(ii), a trade or business acquired after June 30, 1975, by an organization shall include, in addition to other trades or businesses:

(A) A trade or business acquired after such date from, or as a result of the liquidation of, an organization's subsidiary which is described in section 502 whether or not the subsidiary was held on June 30, 1975.

(B) A new trade or business commenced by an organization after such date.

(iii) *Allocation of deductions between businesses acquired before, and businesses acquired after, June 30, 1975.* Deductions which are allowable under section 512 but are not directly connected to a particular trade or business, such as deductions referred to in paragraphs (10) and (12) of section 512(b), shall be allocated in the proportion that the unrelated trade or business taxable income derived from trades or businesses acquired after June 30, 1975, bears to the organization's total unrelated business taxable income, both amounts being determined without regard to such deductions.

(iv) *Allocation of tax.* The tax imposed by section 511 shall be allocated in the same proportion as in paragraph (a)(3)(iii) of this section.

(4) *Purposes.* The one-third support test and the not-more-than-one-third support test are designed to insure that an organization which is excluded from private foundation status under section 509(a)(2) is responsive to the general public, rather than to the private interests of a limited number of donors or other persons.

(b) *Limitation on gross receipts*—(1) *General rule.* In computing the amount of support received from gross receipts under section 509(a)(2)(A)(ii) for purposes of the one-third support test of section 509(a)(2)(A), gross receipts from related activities received from any person, or from any bureau or similar agency of a governmental unit, are includible in any taxable year only to the extent that such receipts do not exceed the greater of $5,000 or 1 percent of the organization's support in such taxable year.

(2) *Examples*. The application of this paragraph may be illustrated by the examples set forth below. For purposes of these examples, the term *general public* is defined as persons other than disqualified persons and other than persons from whom the foundation receives gross receipts in excess of the greater of $5,000 or 1 percent of its support in any taxable year, and the term *gross receipts* is limited to receipts from activities which are not unrelated trade or business (within the meaning of section 513).

Example 1. For the taxable year 1970, X, an organization described in section 501(c)(3), received support of $10,000 from the following sources:

Bureau M (a governmental bureau from which X received gross receipts for services rendered)	$25,000
Bureau N (a governmental bureau from which X received gross receipts for services rendered)	25,000
General public (gross receipts for services rendered)	20,000
Gross investment income	15,000
Contributions from individual substantial contributors (defined as disqualified persons under section 4946(a)(2))	15,000
Total support	100,000

Since the $25,000 received from each bureau amounts to more than the greater of $5,000 or 1 percent of X's support for 1970 (1% of $100,000 = $1,000) under section 509(a)(2)(A)(ii), each amount is includible in the numerator of the one-third support fraction only to the extent of $5,000. Thus, for the taxable year 1970, X received support from sources which are taken into account in meeting the one-third support test of section 509(a)(2)(A) computed as follows:

Bureau M	$5,000
Bureau N	5,000
General public	20,000
Total	30,000

Therefore, in making the computations required under paragraph (c), (d), or (e) of this section, only $30,000 is includible in the aggregate numerator and $100,000 is includible in the aggregate denominator of the support fraction.

Example 2. For the taxable year 1970, Y, an organization described in section 501(c)(3), received support of $600,000 from the following sources:

Bureau O (gross receipts for services rendered)	$10,000
Bureau P (gross receipts for services rendered)	10,000
General public (gross receipts for services rendered)	150,000
General public (contributions)	40,000
Gross investment income	150,000
Contributions from substantial contributors	240,000
Total support	600,000

Since the $10,000 received from each bureau amounts to more than the greater of $5,000 or 1 percent of Y's support for 1970 (1% of $600,000 = $6,000), each amount is includible in the numerator of the one-third support fraction only to the extent of $6,000. Thus, for the taxable year 1970, Y received support from sources required to meet the one-third support test of section 509(a)(2)(A) computed as follows:

Bureau O	$6,000
Bureau P	6,000
General public (gross receipts)	150,000
General public (contributions)	40,000
Total	202,000

Therefore, in making the computations required under paragraph (c), (d), or (e) of this section, $202,000 is includible in the aggregate numerator and $600,000 is includible in the aggregate denominator of the support fraction.

(c) *Normally*—(1) *In general*—(i) *Definition*. The support tests set forth in section 509(a)(2) are to be computed on the basis of the nature of the organization's normal sources of support. An organization will be considered as ''normally'' receiving one third of its support from any combination of gifts, grants, contributions, membership fees, and gross receipts from permitted sources (subject to the limitations described in §1.509(a)–3(b)) and not more than one third of its support from items described in section 509(a)(2)(B) for a taxable year and the taxable year immediately succeeding such year, if, for such taxable year and the four taxable years immediately preceding such taxable year, the aggregate amount of the support received during the applicable period from gifts, grants, contributions, membership fees, and gross receipts from permitted sources (subject to the limitations described in §1.509(a)–3(b)) is more than one third, and the aggregate amount of the support received from items described in section 509(a)(2)(B) is not more than one third, of the total support of the organization for such five-year period. A publicly supported organization described under section 509(a)(2) that has failed to meet either the one-third support test of paragraph (a)(2) of this section or the not-more-than-one-third support test of paragraph (a)(3) of this section for two consecutive years will be treated as a private foundation as of the first day of the second consecutive

taxable year only for purposes of sections 507, 4940, and 6033. Such an organization must file a Form 990–PF, ''Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation,'' and will be liable for the net investment tax imposed by section 4940 and, if applicable, the private foundation termination tax imposed by section 507(c), for that second consecutive failed year. For the succeeding years, the organization will be treated as a private foundation for all purposes.

(ii) *First five years of an organization's existence.* See paragraph (d)(1) of this section for the definition of ''normally'' for organizations in the first five years of their existence.

(2) *Terminations under section 507(b)(1)(B).* For the special rules applicable to the term normally as applied to private foundations that elect to terminate their private foundation status pursuant to the 60-month procedure provided in section 507(b)(1)(B), see the regulations under such section.

(3) *Exclusion of unusual grants.* For purposes of applying the tests for support set forth in paragraphs (a)(2) and (a)(3) of this section, one or more contributions may be excluded from the numerator of the one-third support fraction and from the denominator of both the one-third support and not-more-than-one-third support fractions only if such a contribution meets the requirements of this paragraph (c)(3). The exclusion provided by this paragraph (c)(3) is generally intended to apply to substantial contributions and bequests from disinterested parties, which contributions or bequests—

(i) Are attracted by reason of the publicly supported nature of the organization;

(ii) Are unusual or unexpected with respect to the amount thereof; and

(iii) Would by reason of their size, adversely affect the status of the organization as normally meeting the one-third support test for any of the applicable periods described in this paragraph (c) or paragraph (d) of this section. In the case of a grant (as defined in §1.509(a)–3(g)) that meets the requirements of this paragraph (c)(3), if the terms of the granting instrument require that the funds be paid to the recipient organization over a period of years, the grant amounts may be excluded for such year or years in which they would otherwise be includible in computing support under the method of accounting on the basis of which the organization regularly computes its income in keeping its books under section 446. However, no item described in section 509(a)(2)(B) may be excluded under this paragraph (c)(3). The provisions of this paragraph (c)(3) shall apply to exclude unusual grants made during any of the applicable periods described in this paragraph (c) or paragraph (d) of this section. See paragraph (c)(5) of this section as to reliance by a grantee organization upon an unusual grant ruling under this paragraph (c)(3).

(4) *Determining factors.* In determining whether a particular contribution may be excluded under paragraph (c)(3) of this section, all pertinent facts and circumstances will be taken into consideration. No single factor will necessarily be determinative. Among the factors to be considered are—

(i) Whether the contribution was made by any person (or persons standing in a relationship to such person which is described in section 4946(a)(1)(C) through 4946(a)(1)(G)) who created the organization, previously contributed a substantial part of its support or endowment, or stood in a position of authority, such as a foundation manager (within the meaning of section 4946(b)), with respect to the organization. A contribution made by a person other than those persons described in this paragraph (c)(4)(i) will ordinarily be given more favorable consideration than a contribution made by a person described in this paragraph (c)(4)(i);

(ii) Whether the contribution was a bequest or an inter vivos transfer. A bequest will ordinarily be given more favorable consideration than an inter vivos transfer;

(iii) Whether the contribution was in the form of cash, readily marketable securities, or assets which further the exempt purposes of the organization, such as a gift of a painting to a museum;

(iv) Except in the case of a new organization, whether, prior to the receipt

of the particular contribution, the organization has carried on an actual program of public solicitation and exempt activities and has been able to attract a significant amount of public support;

(v) Whether the organization may reasonably be expected to attract a significant amount of public support subsequent to the particular contribution. In this connection, continued reliance on unusual grants to fund an organization's current operating expenses (as opposed to providing new endowment funds) may be evidence that the organization cannot reasonably be expected to attract future support from the general public;

(vi) Whether, prior to the year in which the particular contribution was received, the organization met the one-third support test described in paragraph (a)(2) of this section without the benefit of any exclusions of unusual grants pursuant to paragraph (c)(3) of this section;

(vii) Whether neither the contributor nor any person standing in a relationship to such contributor which is described in section 4946(a)(1)(C) through 4946(a)(1)(G) continues directly or indirectly to exercise control over the organization;

(viii) Whether the organization has a representative governing body as described in §1.509(a)–3(d)(3)(i); and

(ix) Whether material restrictions or conditions (within the meaning of §1.507–2(a)(7)) have been imposed by the transferor upon the transferee in connection with such transfer.

(5) *Grantors and contributors.* Prior to the making of any grant or contribution expected to meet the requirements for exclusion under paragraph (c)(3) of this section, a potential grantee organization may request a determination whether such grant or contribution may be so excluded. Requests for such determination may be filed by the grantee organization in the time and manner specified by revenue procedure or other guidance published in the Internal Revenue Bulletin. The issuance of such determination will be at the sole discretion of the Commissioner. The organization must submit all information necessary to make a determination of the applicability of paragraph (c)(3) of this section, including all information relating to the factors described in paragraph (c)(4) of this section. If a favorable determination is issued, such determination may be relied upon by the grantor or contributor of the particular contribution in question for purposes of sections 170, 507, 545(b)(2), 642(c), 4942, 4945, 4966, 2055, 2106(a)(2), and 2522 and by the grantee organization for purposes of paragraph (c)(3) of this section.

(6) *Examples.* The application of the principles set forth in this paragraph is illustrated by the examples as follows. For purposes of these examples, the term *general public* is defined as persons other than disqualified persons and other than persons from whom the foundation received gross receipts in excess of the greater of $5,000 or 1 percent of its support in any taxable year, the term *gross investment income* is as defined in section 509(e), and the term *gross receipts* is limited to receipts from activities which are not unrelated trades or businesses (within the meaning of section 513).

Example 1. (i) For the years 2008 through 2012, X, an organization exempt under section 501(c)(3) that makes scholarship grants to needy students of a particular city, received support from the following sources:

2008:	
Gross receipts (general public)	$35,000
Contributions (substantial contributors)	36,000
Gross investment income	29,000
Total support	100,000
2009:	
Gross receipts (general public)	34,000
Contributions (substantial contributors)	35,000
Gross investment income	31,000
Total support	100,000

2010:	
Gross receipts (general public)	35,000
Contributions (substantial contributors)	30,000
Gross investment income	35,000
Total support	100,000
2011:	
Gross receipts (general public)	33,000
Contributions (substantial contributors)	32,000
Gross investment income	35,000
Total support	100,000
2012:	
Gross receipts (general public)	31,000
Contributions (substantial contributors)	39,000
Gross investment income	30,000
Total support	100,000

(ii) In applying section 509(a)(2) to the taxable year 2012, on the basis of paragraph (c)(1)(i) of this section, the total amount of support from gross receipts from the general public ($168,000) for the period 2008 through 2012, was more than one third, and the total amount of support from gross investment income ($160,000) was less than one third, of X's total support for the same period ($500,000). For the taxable years 2012 and 2013, X is therefore considered normally to receive more than one third of its support from the public sources described in section 509(a)(2)(A) and less than one third of its support from items described in section 509(a)(2)(B). The fact that X received less than one third of its support from section 509(a)(2)(A) sources in 2012 and more than one third of its support from items described in section 509(a)(2)(B) in 2011 does not affect its status because it normally met the applicable tests over a five-year period.

Example 2. Assume the same facts as in *Example 1* except that in 2012, X also received an unexpected bequest of $50,000 from A, an elderly widow who was interested in encouraging the work of X, but had no other relationship to it. Solely by reason of the bequest, A became a disqualified person. X used the bequest to create five new scholarships. Its operations otherwise remained the same. Under these circumstances, if A's bequest is included in X's support calculation, X could not meet the five-year support test because the total amount received from gross receipts from the general public ($168,000) would not be more than one-third of its total support for the five-year period ($550,000). Because A is a disqualified person, her bequest cannot be included in the numerator of the one-third support test under section 509(a)(2)(A). However, based on the factors set forth in paragraph (c)(4) of this section, A's bequest may be excluded as an unusual grant under paragraph (c)(3) of this section. Therefore, X will be considered to have met the support test for the taxable years 2012 and 2013.

Example 3. Y, an organization described in section 501(c)(3), was created by A, the holder of all the common stock in M corporation; B, A's wife; and C, A's business associate. The purpose of Y was to sponsor and equip athletic teams for underprivileged children in the community. Each of the three creators makes small cash contributions to Y. A, B, and C have been active participants in the affairs of Y since its creation. Y regularly raises small amounts of contributions through fundraising drives and selling admission to some of the sponsored sporting events. The operations of Y are carried out on a small scale, usually being restricted to the sponsorship of two to four baseball teams of underprivileged children. In 2009, M recapitalizes and creates a first and second class of 6 percent nonvoting preferred stock, most of which is held by A and B. In 2010, A contributes 49 percent of his common stock in M to Y. A's contribution of M's common stock was substantial and constitutes 90 percent of Y's total support for 2010. A combination of the facts and circumstances described in paragraph (c)(4) of this section preclude A's contribution of M's common stock in 2010 from being excluded as an unusual grant under paragraph (c)(3) of this section for purposes of determining whether Y meets the one-third support test under section 509(a)(2).

Example 4. (i) M is organized in 2009 to promote the appreciation of ballet in a particular region of the United States. Its principal activities consist of erecting a theater for the performance of ballet and the organization and operation of a ballet company. M receives a determination letter that it is an organization described in section 501(c)(3) and that it is a public charity described in

section 509(a)(2). The governing body of M consists of nine prominent unrelated citizens residing in the region who have either an expertise in ballet or a strong interest in encouraging appreciation of the art form.

(ii) In 2010, Z, a private foundation, proposes to makes a grant of $500,000 in cash to M to provide sufficient capital for M to commence its activities. Although A, the creator of Z, is one of the nine members of M's governing body, was one of M's original founders, and continues to lend his prestige to M's activities and fund raising efforts, A does not, directly or indirectly, exercise any control over M. M also receives a significant amount of support from a number of smaller contributions and pledges from other members of the general public. M charges admission to the ballet performances to the general public.

(iii) Although the support received in 2010 will not impact M's status as a public charity for its first five taxable years, it will be relevant to the determination of whether M meets the one-third support test under section 509(a)(2) for the 2014 taxable year, using the computation period 2010 through 2014. Within the appropriate timeframe, M may submit a request for a private letter ruling that the $500,000 contribution from Z qualifies as an unusual grant.

(iv) Under the above circumstances, even though A was a founder and member of the governing body of M, M may exclude Z's contribution of $500,000 in 2010 as an unusual grant under paragraph (c)(3) of this section for purposes of determining whether M meets the one-third support test under section 509(a)(2) for 2014.

Example 5. (i) Assume the same facts as *Example 4(i)* except that, in addition, in 2013, B, a widow, passes away and bequeaths $4 million to M. During 2009 through 2013, B made small contributions to M, none exceeding $10,000 in any year. During 2009 through 2013, M received approximately $450,000 from receipts for admissions and contributions from the general public. At the time of B's death, no person standing in a relationship to B described in section 4946(a)(1)(C) through 4946(a)(1)(G) was a member of M's governing body. B's bequest was in the form of cash and readily marketable securities. The only condition placed upon the bequest was that it be used by M to advance the art of ballet.

(ii) Although the support received in 2013 will not impact M's status as a public charity for its first five taxable years, it will be relevant to the determination of whether M meets the one-third support test under section 509(a)(2) for future years. Within the appropriate timeframe, M may submit a request for a private letter ruling that the $4 million bequest from B qualifies as an unusual grant.

(iii) Under the above circumstances, M may exclude B's bequest of $4 million in 2013 as an unusual grant under paragraph (c)(3) of this section for purposes of determining whether M meets the one-third support test under section 509(a)(2) for 2014 and subsequent years.

Example 6. (i) N is a research organization that was created by A in 2009 for the purpose of carrying on economic studies primarily through persons receiving grants from N and engaging in the sale of economic publications. N received a determination letter that it is described in section 501(c)(3) and that it is a public charity described in 509(a)(2). N's five-member governing body consists of A; A's sons, B and C; and two unrelated economists. In 2009, A made a contribution to N of $100,000 to help establish the organization. During 2009 through 2013, A made annual contributions to N averaging $20,000 a year. During the same period, N received annual contributions from members of the general public averaging $15,000 per year and receipts from the sale of its publications averaging $50,000 per year. In 2013, B made an inter vivos contribution to N of $600,000 in cash and readily marketable securities.

(ii) Although the support received in 2013 will not impact N's status as a public charity for its first five taxable years, it will be relevant to the determination of whether N meets the one-third support test under section 509(a)(2) for future years. In determining whether B's contribution of $600,000 in 2013 may be excluded as an unusual grant, the support N received in 2009 through 2013 is relevant in considering the factor described in paragraph (c)(4)(vi) of this section, notwithstanding that N received a determination letter that it is described in section 509(a)(2).

(iii) Under the above circumstances, in particular the facts that B is a disqualified person described in section 4946(a)(1)(D) and N does not have a representative governing body as described in paragraphs (c)(4)(viii) and (d)(3)(i) of this section, N cannot exclude B's contribution of $600,000 in 2013 as an unusual grant under paragraph (c)(3) of this section for purposes of determining whether N meets the one-third support test under section 509(a)(2) for 2014 and future years.

Example 7. (i) O is an educational organization created in 2009. O received a determination letter that it is described in section 501(c)(3) and that it is a public charity described in section 509(a)(2). The governing body of O has 9 members, consisting of A, a prominent civic leader, and 8 other unrelated civic leaders and educators in the community, all of whom participated in the creation of O. During 2009 through 2013, the principal source of income for O has been receipts from the sale of its educational periodicals. These sales have amounted to $200,000 for this period. Small contributions amounting to $50,000 have also been received during the same period from members of the

governing body, including A, as well as other members of the general public.

(ii) In 2013, A contributed $750,000 of the nonvoting stock of S, a closely held corporation, to O. A retained a substantial portion of the voting stock of S. By a majority vote, the governing body of O decided to retain the S stock for a period of at least five years.

(iii) Although the support received in 2013 will not impact O's status as a public charity for its first five taxable years, it will be relevant to the determination of whether O meets the one-third support test under section 509(a)(2) for future years. In determining whether A's contribution of the S stock in 2013 may be excluded as an unusual grant, the support O received in 2009 through 2013 is relevant in considering the factor described in paragraph (c)(4)(vi) of this section, notwithstanding that O received a determination letter that it is described in section 509(a)(2).

(iv) Under the above circumstances, in particular the facts that A is a foundation manager within the meaning of section 4946(b) and A's contribution is in the form of closely held stock, O cannot exclude A's contribution of the S stock in 2013 as an unusual grant under paragraph (c)(3) of this section for purposes of determining whether O meets the one-third support test under section 509(a)(2) for 2014 and future years.

(d) *Definition of normally; first five years of an organization's existence*—(1) *In general.* An organization will ''normally'' meet the one-third support test and the not-more-than-one-third support test during its first five taxable years as a section 501(c)(3) organization if the organization can reasonably be expected to meet the requirements of the one-third support test and the not-more-than-one-third support test during that period. With respect to an organization's sixth taxable year, the general definition of normally in paragraph (c)(1) of this section applies. Alternatively, the organization shall be treated as normally meeting the one-third support test and the not-more-than-one-third support test for its sixth taxable year (but not its seventh taxable year) if it meets the one-third support test and the not-more-than-one-third support test under the definition of normally set forth in paragraph (c)(1)(i) of this section for its fifth taxable year (based on support received in its first through fifth taxable years). If a new publicly supported organization described under section 509(a)(2) cannot meet the requirements of the one-third support test or the not-more-than-one-third support test for its sixth taxable year using either the general definition of normally in paragraph (c)(1) of this section or the alternate rule above (effectively failing to meet a public support test for both its fifth and sixth years), it will be reclassified as a private foundation as of the first day of its sixth taxable year only for purposes of sections 507, 4940, and 6033. Such an organization must file a Form 990–PF, ''Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation,'' and is liable for the net investment tax imposed by section 4940 and, if applicable, the private foundation termination tax imposed by section 507(c), for its sixth taxable year. Beginning the first day of its seventh taxable year, the organization will be treated as a private foundation for all purposes.

(2) *Basic consideration.* In determining whether an organization can reasonably be expected (within the meaning of paragraph (c)(1)(i) of this section) to meet the one-third support test under section 509(a)(2)(A) and the not-more-than-one-third support test under section 509(a)(2)(B) described in paragraph (a) of this section during its first five taxable years, the basic consideration is whether its organizational structure, current or proposed programs or activities, and actual or intended method of operation are such as to attract the type of broadly based support from the general public, public charities, and governmental units that is necessary to meet such tests. The factors that are relevant to this determination, and the weight accorded to each of them, may differ from case to case, depending on the nature and functions of the organization. An organization cannot reasonably be expected to meet the one-third support test and the not-more-than-one-third support test where the facts indicate that an organization is likely during its first five taxable years to receive less than one-third of its support from permitted sources (subject to the limitations of paragraph (b) of this section) or to receive more than one-third of its support from items described in section 509(a)(2)(B).

(3) *Factors taken into account.* All pertinent facts and circumstances shall be taken into account under paragraph (d)(2) of this section in determining whether the organizational structure, programs or activities, and method of operation of an organization are such as to enable it to meet the tests under section 509(a)(2) during its first five taxable years. Some of the pertinent factors are:

(i) Whether the organization has or will have a representative governing body which is comprised of public officials, or individuals chosen by public officials acting in their capacity as such; of persons having special knowledge in the particular field or discipline in which the organization is operating; of community leaders, such as elected officials, clergymen, and educators; or, in the case of a membership organization, of individuals elected pursuant to the organization's governing instrument or bylaws by a broadly based membership. This characteristic does not exist if the membership of the organization's governing body is such as to indicate that it represents the personal or private interests of disqualified persons, rather than the interests of the community or the general public.

(ii) Whether a substantial portion of the organization's initial funding is to be provided by the general public, by public charities, or by government grants, rather than by a limited number of grantors or contributors who are disqualified persons with respect to the organization. The fact that the organization plans to limit its activities to a particular community or region or to a special field which can be expected to appeal to a limited number of persons will be taken into consideration in determining whether those persons providing the initial support for the organization are representative of the general public. On the other hand, the subsequent sources of funding which the organization can reasonably expect to receive after it has become established and fully operational will also be taken into account.

(iii) Whether a substantial proportion of the organization's initial funds are placed, or will remain, in an endowment, and whether the investment of such funds is unlikely to result in more than one third of its total support being received from items described in section 509(a)(2)(B).

(iv) In the case of an organization that carries on fundraising activities, whether the organization has developed a concrete plan for solicitation of funds from the general public on a community or area-wide basis; whether any steps have been taken to implement such plan; whether any firm commitments of financial or other support have been made to the organization by civic, religious, charitable, or similar groups within the community; and whether the organization has made any commitments to, or established any working relationships with, those organizations or classes of persons intended as the future recipients of its funds.

(v) In the case of an organization that carries on community services, such as combating community deterioration in an economically depressed area that has suffered a major loss of population and jobs, whether the organization has a concrete program to carry out its work in the community; whether any steps have been taken to implement that program; whether it will receive any part of its funds from a public charity or governmental agency to which it is in some way held accountable as a condition of the grant or contribution; and whether it has enlisted the sponsorship or support of other civic or community leaders involved in community service programs similar to those of the organization.

(vi) In the case of an organization that carries on educational or other exempt activities for, or on behalf of, members, whether the solicitation for dues-paying members is designed to enroll a substantial number of persons in the community, area, profession, or field of special interest (depending on the size of the area and the nature of the organization's activities); whether membership dues for individual (rather than institutional) members have been fixed at rates designed to make membership available to a broad cross-section of the public rather than to restrict membership to a limited number of persons; and whether the activities of the organization will be likely to appeal to persons having some broad

common interest or purpose, such as educational activities in the case of alumni associations, musical activities in the case of symphony societies, or civic affairs in the case of parent-teacher associations.

(vii) In the case of an organization that provides goods, services, or facilities, whether the organization is or will be required to make its services, facilities, performances, or products available (regardless of whether a fee is charged) to the general public, public charities, or governmental units, rather than to a limited number of persons or organizations; whether the organization will avoid executing contracts to perform services for a limited number of firms or governmental agencies or bureaus; and whether the service to be provided is one which can be expected to meet a special or general need among a substantial portion of the general public.

(4) *Example*. The application of this paragraph (d) may be illustrated by the following example:

Example. (i) Organization X was formed in January 2008 and uses a taxable year ending December 31. After September 9, 2008, and before December 31, 2008, Organization X filed Form 1023 requesting recognition of exemption as an organization described in section 501(c)(3) and in section 509(a)(2). In its application, Organization X established that it can reasonably be expected to operate as a publicly supported organization under paragraph (d) of this section. Subsequently, Organization X received a ruling or determination letter that it is an organization described in sections 501(c)(3) and 509(a)(2) effective as of the date of its formation.

(ii) Organization X is described in section 509(a)(2) for its first five taxable years (for the taxable years ending December 31, 2008, through December 31, 2012).

(iii) Organization X can qualify as a publicly supported organization beginning with the taxable year ending December 31, 2013, if Organization X can meet the requirements of either §1.170A–9(f)(2) or §1.170A–9(f)(3) or paragraphs (a) and (b) of this section for the taxable years ending December 31, 2009, through December 31, 2013, or for the taxable years ending December 31, 2008, through December 31, 2012.

(e) *Determinations on foundation classification and reliance*—(1) A ruling or determination letter that an organization is described in section 509(a)(2) may be issued to an organization. Such determination may be made in conjunction with the recognition of the organization's tax-exempt status or at such other time as the organization believes it is described in section 509(a)(2). The ruling or determination letter that the organization is described in section 509(a)(2) may be revoked if, upon examination, the organization has not met the requirements of this section. The ruling or determination letter that the organization is described in section 509(a)(2) also may be revoked if the organization's application for a ruling or determination contained one or more material misstatements or omissions of fact or such application was part of a scheme or plan to avoid or evade any provision of the Code. The revocation of the determination that an organization is described in section 509(a)(2) does not preclude revocation of the determination that the organization is described in section 501(c)(3).

(2) *Status of grantors or contributors*. (i) For purposes of sections 170, 507, 545(b)(2), 642(c), 4942, 4945, 4966, 2055, 2106(a)(2), and 2522, grantors and contributors may rely upon a determination letter or ruling that an organization is described in section 509(a)(2) until the IRS publishes notice of a change of status (for example, in the Internal Revenue Bulletin or Publication 78, ''Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986,'' which can be searched at *http://www.irs.gov*). For this purpose, grantors or contributors may also rely on an advance ruling that expires on or after June 9, 2008. However, a grantor or contributor may not rely on such an advance ruling or any determination letter or ruling if the grantor or contributor was responsible for, or aware of, the act or failure to act that resulted in the organization's loss of classification under section 509(a)(2) or acquired knowledge that the IRS had given notice to such organization that it would be deleted from such classification.

(ii) A grantor or contributor (other than one of the organization's founders, creators, or foundation managers (within the meaning of section 4946(b))) will not be considered to be responsible for, or aware of, the act or failure to

act that resulted in the loss of the organization's publicly supported classification under section 509(a)(2) if such grantor or contributor has made such grant or contribution in reliance upon a written statement by the grantee organization that such grant or contribution will not result in the loss of such organization's classification as not a private foundation under section 509(a). Such statement must be signed by a responsible officer of the grantee organization and must set forth sufficient information, including a summary of the pertinent financial data for the five taxable years immediately preceding the current taxable year, to assure a reasonably prudent person that his grant or contribution will not result in the loss of the grantee organization's classification as a publicly supported organization under section 509(a). If a reasonable doubt exists as to the effect of such grant or contribution, or if the grantor or contributor is one of the organization's founders, creators, or foundation managers, the procedure for requesting a determination letter set forth in paragraph (c)(5) of this section may be followed by the grantee organization for the protection of the grantor or contributor.

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

Example 1. Y, a calendar year organization described in section 501(c)(3), is created in February 2008 for the purpose of displaying African art. On its exemption application Y shows, under penalties of perjury, that it can reasonably, in accordance with the requirements of paragraph (d) of this section, expect to receive support from the public in 2008 through 2012 that will satisfy the one-third support and not-more-than-one-third support tests described in section 509(a)(2) for its first five taxable years, 2008 through 2012. Y may therefore receive a determination that it meets the requirements of paragraph (a) of this section for its first five taxable years (2008, 2009, 2010, 2011, and 2012), regardless of the public support Y in fact receives during this period.

Example 2. Z, a calendar year organization described in section 501(c)(3), is created in July 2008. On its exemption application Z shows, under penalties of perjury, that it can reasonably, in accordance with the requirements of paragraph (d) of this section, expect to receive support from the public in 2008 through 2012 that will satisfy the one-third support and not-more-than-one-third support tests described in section 509(a)(2) for its first five taxable years, 2008 through 2012. Z receives a determination that it is described in section 509(a)(2). However, the support actually received from the public over Z's first five taxable years (2008 through 2012) does not satisfy the one-third support and not-more-than-one-third support tests described in section 509(a)(2). Moreover, the support Z receives from 2009 through 2013, also does not meet the one-third support and not-more-than-one-third support tests described in section 509(a)(2). Z is described in section 509(a)(2) during its first five years for all purposes. However, because Z has not met the requirements of paragraph (a) of this section for either 2008 through 2012 or 2009 through 2013, Z is not described in section 509(a)(2) for its taxable year 2013. If Z is not described in section 509(a)(1), section 509(a)(3), or section 509(a)(4), then Z will be reclassified as a private foundation as of the first day of 2013. However, for 2013, Z will be treated as a private foundation only for purposes of sections 507, 4940 and 6033. Z must file Form 990–PF and will be liable for the net investment tax imposed by section 4940 and, if applicable, the private foundation termination tax imposed by section 507(c) for 2013. For 2014 and succeeding years, Z will be treated as a private foundation for all purposes (except as provided in paragraph (e)(2) of this section with respect to grantors and contributors).

(f) *Gifts and contributions distinguished from gross receipts*—(1) *In general*. In determining whether an organization normally receives more than one-third of its support from permitted sources, all *gifts* and *contributions* (within the meaning of section 509(a)(2)(A)(i)) received from permitted sources, are includible in the numerator of the support fraction in each taxable year. However, *gross receipts* (within the meaning of section 509(a)(2)(A)(ii)) from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business, are includible in the numerator of the support fraction in any taxable year only to the extent that such gross receipts do not exceed the limitation with respect to the greater of $5,000 or 1 percent of support which is describing paragraph (b) of this section. The terms *gifts* and *contributions* shall, for purposes of section 509(a)(2), have the same meaning as such terms have under section 170(c) and also include bequests, legacies, devises, and transfers within the meaning of section 2055

or 2106(a)(2). Thus, for purposes of section 509(a)(2)(A), any payment of money or transfer of property without adequate consideration shall be considered a *gift* or *contribution*. Where payment is made or property transferred as consideration for admissions, sales of merchandise, performance of services, or furnishing of facilities to the donor, the status of the payment or transfer under section 170(c) shall determine whether and to what extent such payment or transfer constitutes a *gift* or *contribution* under section 509(a)(2)(A)(i) as distinguished from *gross receipts* from related activities under section 509(a)(2)(A)(ii). For purposes of section 509(a)(2), the term *contributions* includes qualified sponsorship payments (as defined in §1.513–4) in the form of money or property (but not services).

(2) *Valuation of property*. For purposes of section 509(a)(2), the amount includible in computing support with respect to gifts, grants or contributions of property or use of such property shall be the fair market or rental value of such property at the date of such gift or contribution.

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

Example 1. P is a local agricultural club described in section 501(c)(3). In order to encourage interest and proficiency by young people in farming and raising livestock, it makes awards at its annual fair for outstanding specimens of produce and livestock. Most of these awards are cash or other property donated by local businessmen. When the awards are made, the donors are given recognition for their donations by being identified as the donor of the award. The recognition given to donors is merely incidental to the making of the award to worthy youngsters. For these reasons, the donations will constitute *contributions* for purposes of section 509(a)(2)(A)(i). The amount includible in computing support with respect to such contributions is equal to the cash contributed or the fair market value of other property on the dates contributed.

Example 2. Q, a performing arts center, enters into a contract with a large company to be the exclusive sponsor of the center's theatrical events. The company makes a payment of cash and products in the amount of $100,000 to Q, and in return, Q agrees to make a broadcast announcement thanking the company before each show and to provide $2,000 of advertising in the show's program (2% of $100,000 is $2,000). The announcement constitutes use or acknowledgment pursuant to section 513(i)(2). Because the value of the advertising does not exceed 2% of the total payment, the entire $100,000 is a qualified sponsorship payment under section 513(i), and $100,000 is treated as a contribution for purposes of section 509(a)(2)(A)(i).

Example 3. R, a charity, enters into a contract with a law firm to be the exclusive sponsor of the charity's outreach program. Instead of making a cash payment, the law firm agrees to perform $100,000 of legal services for the charity. In return, R agrees to acknowledge the law firm in all its informational materials. The total fair market value of the legal services, or $100,000, is a qualified sponsorship payment under section 513(i), but no amount is treated as a contribution under section 509(a)(2)(A)(i) because the contribution is of services.

(g) *Grants distinguished from gross receipts*—(1) *In general*. In determining whether an organization normally receives more than one-third of its support from public sources, all *grants* (within the meaning of section 509(a)(2)(A)(i)) received from permitted sources are includible in full in the numerator of the support fraction in each taxable year. However, *gross receipts* (within the meaning of section 509(a)(2)(A)(ii)) from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business, are includible in the numerator of the support fraction in any taxable year only to the extent that such gross receipts do not exceed the limitation with respect to the greater of $5,000 or 1 percent of support which is described in paragraph (b) of this section. A grant is normally made to encourage the grantee organization to carry on certain programs or activities in furtherance of its exempt purposes. It may contain certain terms and conditions imposed by the grantor to insure that the grantee's programs or activities are conducted in a manner compatible with the grantor's own programs and policies and beneficial to the public. The grantee may also perform a service or produce a work product which incidentally benefits the grantor. Because of the imposition of terms and conditions, the frequent similarlity of public purposes of grantor and grantee, and the possibility of benefit resulting to the grantor,

amounts received as grants *for* the carrying on of exempt activities are sometimes difficult to distinguish from amounts received as gross receipts *from* the carrying on of exempt activities. The fact that the agreement, pursuant to which payment is made, is designated a *contract* or a *grant* is not controlling for purposes of classifying the payment under section 509(a)(2).

(2) *Distinguishing factors.* For purposes of section 509(a)(2)(A)(ii), in distinguishing the term *gross receipts* from the term *grants*, the term *gross receipts* means amounts received from an activity which is not an unrelated trade or business, if a specific service, facility, or product is provided to serve the direct and immediate needs of the payor, rather than primarily to confer a direct benefit upon the general public. In general, payments made primarily to enable the payor to realize or receive some economic or physical benefit as a result of the service, facility, or product obtained will be treated as *gross receipts* with respect to the payee. The fact that a profitmaking organization would, primarily for its own economic or physical betterment, contract with a nonprofit organization for the rendition of a comparable service, facility or product from such organization constitutes evidence that any payments received by the nonprofit payee organization (whether from a governmental unit, a nonprofit or a profitmaking organization) for such services, facilities or products are primarily for the economic or physical benefit of the payor and would therefore be considered *gross receipts*, rather than *grants* with respect to the payee organization. For example, if a nonprofit hospital described in section 170(b)(1)(A)(iii) engages an exempt research and development organization to develop a more economical system of preparing food for its own patients and personnel, and it can be established that a hospital operated for profit might engage the services of such an organization to perform a similar benefit for its economic betterment, such fact would constitute evidence that the payments received by the research and development organization constitute *gross receipts*, rather than *grants*. Research leading to the development of tangible products for the use or benefit of the payor will generally be treated as a service provided to serve the direct and immediate needs of the payor, while basic research or studies carried on in the physical or social sciences will generally be treated as primarily to confer a direct benefit upon the general public.

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

Example 1. M, a nonprofit research organization described in section 501(c)(3), engages in some contract research. It receives funds from the government to develop a specific electronic device needed to perfect articles of space equipment. The initiative for the project came solely from the government. Furthermore, the government could have contracted with profitmaking research organizations which carry on similar activities. The funds received from the government for this project are gross receipts and do not constitute *grants* within the meaning of section 509(a)(2)(A)(i). M provided a specific product at the government's request and thus was serving the direct and immediate needs of the payor within the meaning of subparagraph (2) of this paragraph.

Example 2. N is a nonprofit educational organization described in section 501(c)(3). Its principal activity is to operate institutes to train employees of various industries in the principles of management and administration. The government pays N to set up a special institute for certain government employees and to train them over a 2-year period. Management training is also provided by profitmaking organizations. The funds received are included as *gross receipts*. The particular services rendered were to serve the direct and immediate needs of the government in the training of its employees within the meaning of subparagraph (2) of this paragraph.

Example 3. The Office of Economic Opportunity makes a community action program grant to O, an organization described in section 509(a)(1). O serves as a *delegate agency* of OEO for purposes of financing a local community action program. As part of this program, O signs an agreement with X, an educational and charitable organization described in section 501(c)(3), to carry out a housing program for the benefit of poor families. Pursuant to this agreement, O pays X out of the funds provided by OEO to build or rehabilitate low income housing and to provide advisory services to other nonprofit organizations in order for them to meet similar housing objectives, all on a nonprofit basis. Payments made from O to X constitute *grants* for purposes of section 509(a)(2)(A) because such program is carried

on primarily for the direct benefit of the community.

Example 4. P is an educational institute described in section 501(c)(3). It carries on studies and seminars to assist institutions of higher learning. It receives funds from the government to research and develop a program of black studies for institutions of higher learning. The performance of such a service confers a direct benefit upon the public. Because such program is carried on primarily for the direct benefit of the public, the funds are considered a *grant*.

Example 5. Q is an organization described in section 501(c)(3) which carries on medical research. Its efforts have primarily been directed toward cancer research. Q sought funds from the government for a particular project being contemplated in connection with its work. In order to encourage its activities, the government gives Q the sum of $25,000. The research project sponsored by government funds is primarily to provide direct benefit to the general public, rather than to serve the direct and immediate needs of the government. The funds are therefore considered a *grant*.

Example 6. R is a public service organization described in section 501(c)(3) and composed of State and local officials involved in public works activities. The Bureau of Solid Waste, Management of the Department of Health, Education, and Welfare paid R to study the feasibility of a particular system for disposal of solid waste. Upon completion of the study, R was required to prepare a final report setting forth its findings and conclusions. Although R is providing the Bureau of Solid Waste Management with a final report, such report is the result of basic research and study in the physical sciences and is primarily to provide direct benefit to the general public by serving to further the general functions of government, rather than a direct and immediate governmental needs. The funds paid to R are therefore a *grant* within the meaning of section 509(a)(2).

Example 7. R is the public service organization referred to in example 6. W, a municipality described in section 170(c)(1), decides to construct a sewage disposal plant. W pays R to study a number of possible locations for such plant and to make recommendations to W, based upon a number of factors, as to the best location. W instructed R that in making its recommendation, primary consideration should be given to minimizing the costs of the project to W. Since the study commissioned by W was primarily directed toward producing an economic benefit to W in the form of minimizing the costs of its project, the services rendered are treated as serving W's direct and immediate needs and are includible as *gross receipts* by R.

Example 8. S in an organization described in section 501(c)(3). It was organized and is operated to further African development and strengthen understanding between the United States and Africa. To further these purposes, S receives funds from the Agency for International Development and the Department of State under which S is required to carry out the following programs: Selection, transportation, orientation, counseling, and language training of African students admitted to American institutions of higher learning; payment of tuition, other fees, and maintenance of such students; and operation of schools and vocational training programs in underdeveloped countries for residents of those countries. Since the programs carried on by S are primarily to provide direct benefit to the general public, all of the funds received by S from the Federal agencies are considered *grants* within the meaning of section 509(a)(2).

(h) *Definition of membership fees*—(1) *General rule.* For purposes of section 509(a)(2), the fact that a membership organization provides services, admissions, facilities, or merchandise to its members as part of its overall activities will not, in itself, result in the classification of fees received from members as *gross receipts* rather than *membership fees*. If an organization uses membership fees as a means of selling admissions, merchandise, services, or the use of facilities to members of the general public who have no common goal or interest (other than the desire to purchase such admissions, merchandise, services, or use of facilities), then the income received from such fees shall not constitute *membership fees* under section 509(a)(2)(A)(i), but shall, if from a related activity, constitute *gross receipts* under section 509(a)(2)(A)(ii). On the other hand, to the extent the basic purpose for making the payment is to provide support for the organization rather than to purchase admissions, merchandise, services, or the use of facilities, the income received from such payment shall constitute *membership fees*.

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

Example 1. M is a symphony society described in section 501(c)(3). Its primary purpose is to support the local symphony orchestra. The organization has three classes of membership. Contributing members pay annual dues of $10, sustaining members pay $25, and honorary members pay $100. The dues are placed in a maintenance fund which

is used to provide financial assistance in underwriting the orchestra's annual deficit. Members have the privilege of purchasing subscriptions to the concerts before they go on sale to the general public, but must pay the same price as any other member of the public. They also are entitled to attend a number of rehearsals each season without charge. Under these circumstances, M's receipts from the members constitute *membership fees* for purposes of section 509(a)(2)(A)(i).

Example 2. N is a theater association described in section 501(c)(3). Its purpose is to support a repertory company in the community in order to make live theatrical performances available to the public. The organization sponsors six plays each year. Members of the organization are entitled to a season subscription to the plays. The fee paid as dues approximates the retail price of the six plays, less a 10-percent discount. Tickets to each performance are also sold directly to the general public. The organization also holds a series of lectures on the theater which members may attend. Under these circumstances, the fees paid by members as dues will be considered *gross receipts* from a related activity. Although the fees are designated as membership fees, they are actually admissions to a series of plays.

(i) *Bureau* defined—(1) *In general.* The term *any bureau or similar agency of a governmental unit* (within the meaning of section 509(a)(2)(A)(ii)), refers to a specialized operating unit of the executive, judicial, or legislative branch of government where business is conducted under certain rules and regulations. Since the term *bureau* refers to a unit functioning at the operating, as distinct from the policymaking, level of government, it is normally descriptive of a subdivision of a department of government. The term *bureau,* for purposes of section 509(a)(2)(A)(ii), would therefore not usually include those levels of government which are basically policymaking or administrative, such as the office of the Secretary or Assistant Secretary of a department, but would consist of the highest operational level under such policymaking or administrative levels. Each subdivision of a larger unit within the Federal Government, which is headed by a Presidential appointee holding a position at or above Level V of the Executive Schedule under 5 U.S.C. 5316, will normally be considered an administrative or policymaking, rather than an operating, unit. Amounts received from a unit functioning at the policymaking or administrative level of government will be treated as received from one bureau or similar agency of such unit. Units of a governmental agency above the operating level shall be aggregated and considered a separate bureau for this purpose. Thus, an organization receiving gross receipts from both a policymaking or administrative unit and an operational unit of a department will be treated as receiving gross receipts from two *bureaus* within the meaning of section 509(a)(2)(A)(ii). For purposes of this subparagraph, the Departments of Air Force, Army, and Navy are separate departments and each is considered as having its own policymaking, administrative, and operating units.

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

Example 1. The Bureau of Health Insurance is considered a *bureau* within the meaning of section 509(a)(2)(A)(ii). It is a part of the Department of Health, Education, and Welfare, whose Secretary performs a policymaking function, and is under the Social Security Administration, which is basically an administrative unit. The Bureau of Health Insurance is in the first operating level within the Social Security Administration. Similarly, the National Cancer Institute would be considered a *bureau,* as it is an operating part of the National Institutes of Health within the Department of Health, Education, and Welfare.

Example 2. The Bureau for Africa and the Bureau for Latin America are considered *bureaus* within the meaning of section 509(a)(2)(A)(ii). Both are separate operating units under the administrator of the Agency for International development, a policymaking official. If an organization received gross receipts from both of these bureaus, the amount of gross receipts received from each would be subject to the greater of $5,000 or 1 percent limitation under section 509(a)(2)(A)(ii).

Example 3. The Bureau of International Affairs of the Civil Aeronautics Board is considered a *bureau* within the meaning of section 509(a)(2)(A)(ii). It is an operating unit under the administrative office of the Executive Director. The subdivisions of the Bureau of International Affairs are Geographic Areas and Project Development Staff. If an organization received gross receipts from these subdivisions, the total gross receipts from these subdivisions would be considered gross receipts from the same *bureau,* the Bureau of International Affairs, and would be

subject to the greater of $5,000 or 1 percent limitation under section 509(a)(2)(A)(ii).

Example 4. The Department of Mental Health, a State agency which is an operational part of State X's Department of Public Health, is considered a *bureau*. The Department of Public Health is basically an administrative agency and the Department of Mental Health is at the first operational level within it.

Example 5. The Aeronautical Systems Division of the Air Force Systems Command, and other units on the same level, are considered separate *bureaus* with the meaning of section 509(a)(2)(A)(ii). They are part of the Department of the Air Force which is a separate department for this purpose, as are the Army and Navy. The Secretary and the Under Secretary of the Air Force perform the policymaking function, the Chief of Staff and the Air Force Systems Command are basically administrative, having a comprehensive complement of staff functions to provide administration for the various divisions. The Aeronautical Systems Division and other units on the same level are thus the first operating level, as evidenced by the fact that they are the units that let contracts and perform the various operating functions.

Example 6. The Division of Space Nuclear Systems, the Division of Biology and Medicine, and other units on the same level within the Atomic Energy Commission are each separate *bureaus* within the meaning of section 509(a)(2)(A)(ii). The Commissioners (which make up the Commission) are the policymakers. The general manager and the various assistant general managers perform the administrative function. The various divisions perform the operating function as evidenced by the fact that each has separate programs to pursue and contracts specifically for these various programs.

(j) *Grants from public charities*—(1) *General rule.* For purposes of the one-third support test in section 509(a)(2)(A), grants (as defined in paragraph (g) of this section) received from an organization described in section 509(a)(1) (hereinafter referred to in this subparagraph as a *public charity*) are generally includible in full in computing the numerator of the recipient's support fraction of the taxable year in question. It is sometimes necessary to determine whether the recipient of a grant from a public charity has received such support from the public charity as a grant, or whether the recipient has in fact received such support as an indirect contribution from a donor to the public charity. If the amount received is considered a grant from the public charity, it is fully includible in the numerator of the support fraction under section 509(a)(2)(A). However, if the amount received is considered to be an indirect contribution from one of the public charity's donors which has passed through the public chairty to the recipient organization, such amount will retain its character as a contribution from such donor and, if, for example, the donor is a substantial contributor (as defined in section 507(d)(2)) with respect to the ultimate recipient, such amount shall be excluded from the numerator of the support fraction under section 509(a)(2). If a public charity makes both an indirect contribution from its donor and an additional grant to the ultimate recipient, the indirect contribution shall be treated as made first.

(2) *Indirect contributions.* For purposes of subparagraph (1) of this paragraph, an indirect contribution is one which is expressly or impliedly ear-marked by the donor as being for, or for the benefit of, a particular recipient (rather than for a particular purpose).

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

Example 1. M, a national foundation for the encouragement of the musical arts, is an organization described in section 170(b)(1)(A)(vi). A gives M a donation of $5,000 without imposing any restrictions or conditions upon the gift. M subsequently makes a $5,000 grant to X, an organization devoted to giving public performances of chamber music. Since the grant to X is treated as being received from M, it is fully includible in the numerator of X's support fraction for the taxable year of receipt.

Example 2. Assume M is the same organization described in example 1. B gives M a donation of $10,000, but requires that M spend the money for the purpose of supporting organizations devoted to the advancement of contemporary American music. M has complete discretion as to the organizations of the type described to which it will make a grant. M decides to make grants of $5,000 each to Y and Z, both being organizations described in section 501(c)(3) and devoted to furthering contemporary American music. Since the grants to Y and Z are treated as being received from M, Y and Z may each include one of the $5,000 grants in the numerator of its support fraction for purposes of section 509(a)(2)(A). Although the donation to M was conditioned upon the use of the funds for a particular purpose, M was free to select the ultimate recipient.

Example 3. N is a national foundation for the encouragement of art and is an organization described in section 170(b)(1)(A)(vi). Grants to N are permitted to be earmarked for particular purposes. O, which is an art workshop devoted to training young artists and claiming status under section 509(a)(2), persuades C, a private foundation, to make a grant of $25,000 to N. C is a disqualified person with respect to O. C made the grant to N with the understanding that N would be bound to make a grant to O in the sum of $25,000, in addition to a matching grant of N's funds to O in the sum of $25,000. Only the $25,000 received directly from N is considered a grant from N. The other $25,000 is deemed an indirect contribution from C to O and is to be excluded from the numerator of O's support fraction.

(k) *Method of accounting.* For purposes of section 509(a)(2), an organization's support will be determined under the method of accounting on the basis of which the organization regularly computes its income in keeping its books under section 446. For example, if a grantor makes a grant to an organization payable over a term of years, such grant will be includible in the support fraction of the grantee organization under the method of accounting on the basis of which it regularly computes its income in keeping its books under section 446.

(l) *Gross receipts from section 513(a) (1), (2), or (3) activities.* For purposes of section 509(a)(2)(A)(ii), gross receipts from activities described in section 513(a)(1), (2), or (3) will be considered gross receipts from activities which are not unrelated trade or business.

(m) *Gross receipts distinguished from gross investment income.* (1) For purposes of section 509(a)(2), where the charitable purpose of an organization described in section 501(c)(3) is accomplished through the furnishing of facilities for a rental fee or loans to a particular class of persons, such as aged, sick, or needy persons, the support received from such persons will be considered *gross receipts* (within the meaning of section 509(d)(2)) from an activity which is not an unrelated trade or business, rather than *gross investment income.* However, if such organization also furnishes facilities or loans to persons who are not members of such class and such furnishing does not contribute importantly to the accomplishment of such organization's exempt purposes (aside from the need of such organization for income or funds or the use it makes of the profits derived), the support received from such furnishing will be considered *rents* or *interest* and therefore will be treated as *gross investment income* within the meaning of section 509(d)(4), unless such income is included in computing the tax imposed by section 511.

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

Example. X, an organization described in section 501(c)(3), is organized and operated to provide living facilities for needy widows of deceased servicemen. X charges such widows a small rental fee for the use of such facilities. Since X is accomplishing its exempt purpose through the rental of such facilities, the support received from the widows is considered *gross receipts* within the meaning of section 509(d)(2). However, if X rents part of its facilities to persons having no relationship to X's exempt purpose, the support received from such rental will be considered *gross investment income* within the meaning of section 509(d)(4), unless such income is included in computing the tax imposed by section 511.

(n) *Transition rules.* (1) An organization that received an advance ruling, that expires on or after June 9, 2008, that it will be treated as an organization described in section 509(a)(2) will be treated as meeting the requirements of paragraph (d)(1) of this section for the first five taxable years of its existence as a section 501(c)(3) organization unless the IRS issued to the organization a proposed determination prior to September 9, 2008, that the organization is not described in sections 170(b)(1)(A)(vi) and 509(a)(1) or in section 509(a)(2).

(2) Paragraph (d)(1) of this section shall not apply to an organization that received an advance ruling that expired prior to June 9, 2008, and that did not timely file with the IRS the required information to establish that it is an organization described in sections 170(b)(1)(A)(vi) and 509(a)(1) or in section 509(a)(2).

(3) An organization that fails to meet a public support test for its first taxable year beginning on or after January 1, 2008, under the regulations in this section may use the prior test set forth in §§1.509(a)–3(a)(2) and 1.509(a)–3(a)(3) or §1.170A–9(e)(2) or §1.170A–

9(e)(3) as in effect before September 9, 2008, (as contained in 26 CFR part 1 revised April 1, 2008) to determine whether the organization may be publicly supported for its 2008 taxable year based on its satisfaction of a public support test for taxable year 2007, computed over the period 2003 through 2006.

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

Example 1. (i) Organization M was formed in January 2004, and uses a taxable year ending June 30. Organization M received an advance ruling letter that it is recognized as an organization described in section 501(c)(3) effective as of the date of its formation and that it is treated as a publicly supported organization under section 509(a)(2) during the five-year advance ruling period that will end on June 30, 2008. This date is on or after June 9, 2008.

(ii) Under the transition rule, Organization M is a publicly supported organization described in section 509(a)(2) for the taxable years ending June 30, 2004, through June 30, 2008. Organization M does not need to establish within 90 days after June 30, 2008, that it met a public support test under §1.170A–9(e) or §1.509(a)–3, as in effect prior to September 9, 2008, (as contained in 26 CFR part 1 revised April 1, 2008) for its advance ruling period.

(iii) Organization M can qualify as a public charity beginning with the taxable year ending June 30, 2009, if Organization M can meet the requirements of §1.170A–9(f)(2) or §1.170A–9(f)(3) or paragraphs (a)(2) and (a)(3) of this section for the taxable years ending June 30, 2005, through June 30, 2009, or for the taxable years ending June 30, 2004, through June 30, 2008. In addition, for its taxable year ending June 30, 2009, Organization M may qualify as a publicly supported organization by availing itself of the transition rule contained in paragraph (n)(iii) of this section, which looks to support received by M in the taxable years ending June 30, 2004, through June 30, 2007.

Example 2. (i) Organization N was formed in January 2000 and uses a December 31 taxable year. Organization N received a final determination that it was recognized as tax-exempt under section 501(c)(3) and as a public charity prior to September 9, 2008.

(ii) For taxable year 2008, Organization N will qualify as publicly supported if it meets the requirements under either §1.170A–9(f)(2) or §1.170A–9(f)(3) or paragraphs (a)(2) and (a)(3) of this section for the five-year period January 1, 2004, through December 31, 2008. Organization N will also qualify as publicly supported for taxable year 2008 if it meets the requirements under either §1.170A–9(e)(2) or §1.170A–9(e)(3) or §§1.509(a)–3(a)(2) and 1.509(a)–3(a)(3) as in effect prior to September 9, 2008, (as contained in 26 CFR part 1 revised April 1, 2008) for taxable year 2007, using the four-year period from January 1, 2003, through December 31, 2006.

(o) *Effective/applicability date*. This section shall generally apply to taxable years beginning after December 31, 1969 except paragraphs (a)(2), (a)(3)(i), (c), (d), (e), (k) and (n) of this section shall apply to tax years beginning on or after January 1, 2008. For tax years beginning after December 31, 1969 and beginning before January 1, 2008, §§1.509(a)–3(a)(2), 1.509(a)–3(a)(3)(i), 1.509(a)–3(c), 1.509(a)–3(d), 1.509(a)–3(e), and 1.509(a)–3(k) as in effect on December 31, 2007 (as contained in 26 CFR part 1 revised April 1, 2008) shall apply.

[T.D. 7212, 37 FR 21907, Oct. 17, 1972, as amended by T.D. 7784, 46 FR 37889, July 23, 1981; T.D. 8423, 57 FR 33443, July 29, 1992; T.D. 8991, 67 FR 20437, Apr. 25, 2002; T.D. 9423, 73 FR 52549, Sept. 9, 2008; T.D. 9549, 76 FR 55764, Sept. 8, 2011; T.D. 9549, 76 FR 61946, Oct. 6, 2011]

§1.509(a)–4 Supporting organizations.

(a) *In general*. (1) Section 509(a)(3) excludes from the definition of *private foundation* those organizations which meet the requirements of subparagraphs (A), (B), and (C) thereof.

(2) Section 509(a)(3)(A) provides that a section 509(a)(3) organization must be organized, and at all times thereafter operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a) (1) or (2). Section 509(a)(3)(A) describes the nature of the support or benefit which a section 509(a)(3) organization must provide to one or more section 509(a) (1) or (2) organizations. For purposes of section 509(a)(3)(A), paragraph (b) of this section generally describes the organizational and operational tests; paragraph (c) of this section describes permissible purposes under the organizational test; paragraph (d) of this section describes the requirement of supporting or benefiting one or more *specified* publicly supported organizations; and paragraph (e) of this section describes permissible beneficiaries and activities under the operational test.

(3) Section 509(a)(3)(B) provides that a section 509(a)(3) organization must be operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a) (1) or (2). Section 509(a)(3)(B) and paragraph (f) of this section describe the nature of the relationship which must exist between the section 509(a)(3) and section 509(a) (1) or (2) organizations. For purposes of section 509(a)(3)(B), paragraph (g) of this section defines *operated, supervised, or controlled by*; paragraph (h) of this section defines *supervised or controlled in connection with;* and paragraph (i) of this section defines *operated in connection with*.

(4) Section 509(a)(3)(C) provides that a section 509(a)(3) organization must not be controlled directly or indirectly by disqualified persons (other than foundation managers or organizations described in section 509(a) (1) or (2)). Section 509(a)(3)(C) and paragraph (j) of this section prescribe a limitation on the control over the section 509(a)(3) organization.

(5) For purposes of this section, the term *supporting organization* means either an organization described in section 509(a)(3) or an organization seeking section 509(a)(3) status, depending upon its context. For purposes of this section, the term *publicly supported organization* means an organization described in section 509(a) (1) or (2).

(6) For purposes of paragraph (i) of this section, the term ''supported organization'' means a specified publicly supported organization described in paragraphs (d)(2)(iv) or (d)(4) of this section.

(b) *Organizational and operational tests*. (1) Under subparagraph (A) of section 509(a)(3), in order to qualify as a supporting organization, an organization must be both organized and operated exclusively *for the benefit of, to perform the functions of, or to carry out the purposes of* (hereinafter referred to in this section as being organized and operated *to support or benefit*) one or more specified publicly supported organizations. If an organization fails to meet either the organizational or the operational test, it cannot qualify as a supporting organization.

(2) In the case of supporting organizations created prior to January 1, 1970, the organizational and operational tests shall apply as of January 1, 1970. Therefore, even though the original articles of organization did not limit its purposes to those required under section 509(a)(3)(A) and even though it operated before January 1, 1970, for some purpose other than those required under section 509(a)(3)(A), an organization will satisfy the organizational and operational tests if, on January 1, 1970, and at all times thereafter, it is so constituted as to comply with these tests. For the special rules pertaining to the application of the organizational and operational tests to organizations terminating their private foundation status under the 12-month or 60-month termination period provided under section 507(b)(1)(B) by becoming *public* under section 509(a)(3), see the regulations under section 507(b).

(c) *Organizational test*—(1) *In general*. An organization is organized exclusively for one or more of the purposes specified in section 509(a)(3)(A) only if its articles of organization (as defined in §1.501(c)(3)–1(b)(2)):

(i) Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A);

(ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph;

(iii) State the specified publicly supported organizations on whose behalf such organization is to be operated (within the meaning of paragraph (d) of this section); and

(iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.

(2) *Purposes*. In meeting the organizational test, the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes set forth in section 509(a)(3)(A). Therefore, an organization which, by the terms of its articles, is formed *for the benefit of* one or more specified publicly supported organizations shall, if it otherwise meets the other requirements of this paragraph,

be considered to have met the organizational test. Similarly, articles which state that an organization is formed *to perform the publishing functions* of a specified university are sufficient to comply with the organizational test. An organization which is *operated, supervised, or controlled by* (within the meaning of paragraph (g) of this section) or *supervised or controlled in connection with* (within the meaning of paragraph (h) of this section) one or more sections 509(a) (1) or (2) organizations to carry out the purposes of such organizations, will be considered as meeting the requirements of this paragraph if the purposes set forth in its articles are similar to, but no broader than, the purposes set forth in the articles of its controlling section 509(a) (1) or (2) organizations. If, however, the organization by which it is operated, supervised, or controlled is a publicly supported section 501(c) (4), (5), or (6) organization (deemed to be a section 509(a)(2) organization for purposes of section 509(a)(3) under the provisions of section 509(a)), the supporting organization will be considered as meeting the requirements of this paragraph if its articles require it to carry on charitable, etc., activities within the meaning of section 170(c)(2).

(3) *Limitations.* An organization is not organized exclusively for the purposes set forth in section 509(a)(3)(A) if its articles expressly permit it to operate to support or benefit any organization other than those specified publicly supported organizations referred to in subparagraph (1)(iii) of this paragraph. Thus, for example, an organization will not meet the organizational test under section 509(a)(3)(A) if its articles expressly empower it to pay over any part of its income to, or perform any service for, any organization other than those publicly supported organizations specified in its articles (within the meaning of paragraph (d) of this section). The fact that the actual operations of such organization have been exclusively for the benefit of the specified publicly supported organizations shall not be sufficient to permit it to meet the organizational test.

(d) *Specified organizations*—(1) *In general.* In order to meet the requirements of section 509(a)(3)(A), an organization must be organized and operated exclusively to support or benefit one or more *specified* publicly supported organizations. The manner in which the publicly supported organizations must be *specified* in the articles for purposes of section 509(a)(3)(A) will depend upon whether the supporting organization is *operated, supervised, or controlled by* or *supervised or controlled in connection with* (within the meaning of paragraphs (g) and (h) of this section) such organizations or whether it is *operated in connection with* (within the meaning of paragraph (i) of this section) such organizations.

(2) *Nondesignated publicly supported organizations; requirements.* (i) Except as provided in subdivision (iv) of this subparagraph, in order to meet the requirements of subparagraph (1) of this paragraph, the articles of the supporting organization must designate each of the *specified* organizations by name unless:

(*a*) The supporting organization is operated, supervised, or controlled by (within the meaning of paragraph (g) of this section), or is supervised or controlled in connection with (within the meaning of paragraph (h) of this section) one or more publicly supported organizations; and

(*b*) The articles of organization of the supporting organization require that it be operated to support or benefit one or more beneficiary organizations which are designated by class or purpose and which include:

(*1*) The publicly supported organizations referred to in (*a*) of this subdivision (without designating such organizations by name); or

(*2*) Publicly supported organizations which are closely related in purpose or function to those publicly supported organizations referred to in subdivision (i)(*a*) or this subparagraph (without designating such organization by name).

(ii) If a supporting organization is described in subdivision (i)(*a*) of this subparagraph, it will not be considered as failing to meet the requirements of subparagraph (1) of this paragraph that the publicly supported organizations be specified merely because its articles of organization permit the conditions described in subparagraphs (3) (i), (ii),

and (iii) and (4)(i) (*a*) and (*b*) of this paragraph.

(iii) This subparagraph may be illustrated by the following examples:

Example 1. X is an organization described in section 501(c)(3) which operates for the benefit of institutions of higher learning in the State of Y. X is controlled by these institutions (within the meaning of paragraph (g) of this section) and such institutions are all section 509(a)(1) organizations. X's articles will meet the organizational test if they require X to operate for the benefit of institutions of higher learning or educational organizations in the State of Y (without naming each institution). X's articles would also meet the organizational test if they provided for the giving of scholarships to enable students to attend institutions of higher learning but only in the State of Y.

Example 2. M is an organization described in section 501(c)(3) which was organized and operated by representatives of N church to run a home for the aged. M is controlled (within the meaning of paragraph (g) of this section) by N church, a section 509(a)(1) organization. The care of the sick and the aged are longstanding temporal functions and purposes of organized religion. By operating a home for the aged, M is operating to support or benefit N church in carrying out one of its temporal purposes. Thus M's articles will meet the organizational test if they require M to care for the aged since M is operating to support one of N church's purposes (without designating N church by name).

(iv) A supporting organization will meet the requirements of subparagraph (1) of this paragraph even though its articles do not designate each of the *specified* organizations by name if:

(*a*) There has been an historic and continuing relationship between the supporting organization and the section 509(a) (1) or (2) organizations, and

(*b*) By reason of such relationship, there has developed a substantial identity of interests between such organizations.

(3) *Nondesignated publicly supported organizations; scope of rule.* If the requirements of subparagraph (2)(i) (*a*) of this paragraph are met, a supporting organization will not be considered as failing the test of being organized for the benefit of *specified* organizations solely because its articles:

(i) Permit the substitution of one publicly supported organization within a designated class for another publicly supported organization either in the same or a different class designated in the articles;

(ii) Permit the supporting organization to operate for the benefit of new or additional publicly supported organizations of the same or a different class designated in the articles; or

(iii) Permit the supporting organization to vary the amount of its support among different publicly supported organizations within the class or classes of organizations designated by the articles

For example, X is an organization which operates for the benefit of private colleges in the State of Y. If X is controlled by these colleges (within the meaning of paragraph (g) of this section) and such colleges are all section 509(a)(1) organizations, X's articles will meet the organization test even if they permit X to operate for the benefit of any new colleges created in State Y in addition to the existing colleges or in lieu of one which has ceased to operate, or if they permit X to vary its support by paying more to one college than to another in a particular year.

(4) *Designated publicly supported organizations.* (i) If an organization is organized and operated to support one or more publicly supported organizations and it is *operated in connection with* such organization or organizations, then, except as provided in subparagraph (2)(iv) of this paragraph, its articles of organization must, for purposes of satisfying the organizational test under section 509(a)(3)(A), designate the *specified* organizations by name. Under the circumstances described in this subparagraph, a supporting organization which has one or more *specified* organizations designated by name in its articles, will not be considered as failing the test of being organized for the benefit of *specified* organizations solely because its articles:

(*a*) Permit a publicly supported organization which is designated by class or purpose, rather than by name, to be substituted for the publicly supported organization or organizations designated by name in the articles, but only if such substitution is conditioned upon the occurrence of an event which is beyond the control of the supporting

organization, such as loss of exemption, substantial failure or abandonment of operations, or dissolution of the publicly supported organization or organizations designated in the articles;

(*b*) Permit the supporting organization to operate for the benefit of a beneficiary organization which is not a publicly supported organization, but only if such supporting organization is currently operating for the benefit of a publicly supported organization and the possibility of its operating for the benefit of other than a publicly supported organization is a remote contingency; or

(*c*) Permit the supporting organization to vary the amount of its support between different designated organizations, so long as it meets the requirements of the integral part test set forth in paragraph (i)(3) of this section with respect to at least one beneficiary organization.

(ii) If the beneficiary organization referred to in subdivision (i)(*b*) of this subparagraph is not a publicly supported organization, the supporting organization will not then meet the operational test of paragraph (e)(1) of this section. Therefore, if a supporting organization substituted in accordance with such subdivision (i)(*b*) a beneficiary other than a publicly supported organization and operated in support of such beneficiary organization, the supporting organization would not be described in section 509(a)(3).

(iii) This subparagraph may be illustrated by the following example:

Example. X is a charitable trust described in section 4947(a)(1) organized in 1968. Under the terms of its trust instrument, X's trustees are required to pay over all of X's annual income to M University Medical School for urological research. If M University Medical School is unable or unwilling to devote these funds to urological research, the trustees are required to pay all of such income to N University Medical School. However if N University Medical School is also unable or unwilling to devote these funds to urological research, X's trustees are directed to choose a similar organization willing to apply X's funds for urological research. From 1968 to 1973, X pays all of its net income to M University Medical School pursuant to the terms of the trust. M and N are publicly supported organizations. Although the contingent remainderman may not be a publicly supported organization, the possibility that X may operate for the benefit of other than a publicly supported organization is, in 1973, a remote possibility, and X will be considered as operating for the benefit of a *specified* publicly supported organization under subdivision (i)(*b*) of this subparagraph. However, if, at some future date, X actually substituted a nonpublicly supported organization as beneficiary, X would fail the requirements of the operational test set forth in paragraph (e)(1) of this section.

(e) *Operational test*—(1) *Permissible beneficiaries*. A supporting organization will be regarded as *operated exclusively* to support one or more specified publicly supported organizations (hereinafter referred to as the *operational test*) only if it engages solely in activities which support or benefit the specified publicly supported organizations. Such activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly supported organization. A supporting organization may also, for example, make a payment indirectly through another unrelated organization to a member of a charitable class benefited by the specified publicly supported organization, but only if such a payment constitutes a grant to an individual rather than a grant to an organization. In determining whether a grant is indirectly to an individual rather than to an organization the same standard shall be applied as in §53.4945–4(a)(4) of this chapter. Similarly, an organization will be regarded as *operated exclusively* to support or benefit one or more specified publicly supported organizations even if it supports or benefits an organization, other than a private foundation, which is described in section 501(c)(3) and is operated, supervised, or controlled directly by or in connection with such publicly supported organizations, or which is described in section 511(a)(2)(B). However, an organization will not be regarded as operated exclusively if any part of its activities is in furtherance of a purpose other than supporting or benefiting one or more specified publicly supported organizations.

(2) *Permissible activities*. A supporting organization is not required to pay

over its income to the publicly supported organizations in order to meet the operational test. It may satisfy the test by using its income to carry on an independent activity or program which supports or benefits the specified publicly supported organizations. All such support must, however, be limited to permissible beneficiaries in accordance with subparagraph (1) of this paragraph. The supporting organization may also engage in fund raising activities, such as solicitations, fund raising dinners, and unrelated trade or business to raise funds for the publicly supported organizations, or for the permissible beneficiaries.

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

Example 1. M is a separately incorporated alumni association of X University and is an organization described in section 501(c)(3). X University is designated in M's articles as the sole beneficiary of its support. M uses all of its dues and income to support its own program of educational activities for alumni, faculty, and students of X University and to encourage alumni to maintain a close relationship with the university and to make contributions to it. M does not distribute any of its income directly to X for the latter's general purposes. M pays no part of its funds to, or for the benefit of, any organization other than X. Under these circumstances, M is considered as operated exclusively to perform the functions and carry out the purpose of X. Although it does not pay over any of its funds to X, it carries on a program which both supports and benefits X.

Example 2. N is a separately incorporated religious and educational organization described in section 501(c)(3). It was formed and is operated by Y Church to provide religious training for the members of the church. While it does not maintain a regular faculty, N conducts a Sunday school, weekly adult education lectures on religious subjects, and other similar activities for the benefit of the church members. All of its funds are disbursed in furtherance of such activities and no part of its funds is paid to, or for the benefit of, any organization other than Y Church. N is considered as operated exclusively to perform the educational functions of Y Church and to carry out its religious purposes by providing various forms of religious instruction.

Example 3. P is an organization described in section 501(c)(3). Its primary activity is providing financial assistance to S, a publicly supported organization which aids underdeveloped nations in Central America. P's articles of organization designate S as the principal recipient of P's assistance. However, P also makes a small annual general purpose grant to T, a private foundation engaged in work similar to that carried on by S. T performs a particular function that assists in the overall aid program carried on by S. Even though P is operating primarily for the benefit of S, a specified publicly supported organization, it is not considered as operated exclusively for the purposes set forth in section 509(a)(3)(A). The grant to T, a private foundation, prevents it from complying with the operational test under section 509(a)(3)(A).

Example 4. Assume the same facts as example 3, except that T is a section 501(c)(3) organization other than a private foundation and is operated in connection with S. Under these circumstances, P will be considered as operated exclusively to support S within the meaning of section 509(a)(3)(A).

Example 5. Assume the same facts as example 3 except that instead of the annual general purpose grant made to T, each grant made by P to T is specifically earmarked for the training of social workers and teachers, designated by name, from Central America. Under these circumstances, P's grants to T would be treated as grants to the individual social workers and teachers under section 4945(d)(3) and § 53.4945–4(a)(4), rather than as grants to T under section 4945(d)(4). These social workers and teachers are part of the charitable class benefitted by S. P would thus be considered as operating exclusively to support S within the meaning of section 509(a)(3)(A).

(f) *Nature of relationship required between organizations*—(1) *In general.* Section 509(a)(3)(B) describes the nature of the relationship required between a section 501(c)(3) organization and one or more publicly supported organizations in order for such section 501(c)(3) organization to qualify under the provisions of section 509(a)(3). To meet the requirements of section 509(a)(3), an organization must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations. If an organization does not stand in one of such relationships (as provided in this paragraph) to one or more publicly supported organizations, it is not an organization described in section 509(a)(3).

(2) *Types of relationships.* Section 509(a)(3)(B) sets forth three different types of relationships, one of which must be met in order to meet the requirements of subparagraph (1) of this

paragraph. Thus, a supporting organization may be:

(i) Operated, supervised, or controlled by,

(ii) Supervised or controlled in connection with, or

(iii) Operated in connection with, one or more publicly supported organizations.

(3) *Requirements of relationships.* Although more than one type of relationship may exist in any one case, any relationship described in section 509(a)(3)(B) must insure that:

(i) The supporting organization will be responsive to the needs of demands of one or more publicly supported organizations; and

(ii) The supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations.

(4) *General description of relationships.* In the case of supporting organizations which are *operated, supervised, or controlled by* one or more publicly supported organizations, the distinguishing feature of this type of relationship is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization, as described in paragraph (g) of this section. In the case of supporting organizations which are *supervised or controlled in connection with* one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors, as described in paragraph (h) of this section. In the case of a supporting organization which is *operated in connection with* one or more publicly supported organizations, the distinguishing feature is that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization, as described in paragraph (i) of this section.

(5) *Contributions from controlling donors*—(i) *In general.* For any taxable year, a supporting organization shall not be considered to be operated, supervised, or controlled by, or operated in connection with, one or more publicly supported organizations, if the supporting organization accepts any gift or contribution from any person who is—

(A) A person (other than an organization described in section 509(a)(1), (2), or (4)) who directly or indirectly controls, either alone or together with persons described in paragraphs (f)(5)(i)(B) or (f)(5)(i)(C) of this section, the governing body of a specified publicly supported organization supported by such supporting organization;

(B) A member of the family (determined under section 4958(f)(4)) of an individual described in paragraph (f)(5)(i)(A) of this section; or

(C) A 35-percent controlled entity (as defined in section 4958(f)(3) by substituting ''clause (i) or (ii) of section 509(f)(2)(B)'' for ''subparagraph (A) or (B) of paragraph (1)'' in paragraph (f)(3)(A)(i) thereof).

(ii) *Meaning of control.* [Reserved]

(g) *Meaning of operated, supervised, or controlled by.* (1)(i) Each of the items *operated by, supervised by,* and *controlled by,* as used in section 509(a)(3)(B), presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required under any one of these terms is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.

(ii) A supporting organization may be *operated, supervised, or controlled by* one or more publicly supported organizations within the meaning of section 509(a)(3)(B) even though its governing body is not comprised of representatives of the specified publicly supported organizations for whose benefit it is operated within the meaning of section 509(a)(3)(A). A supporting organization may be *operated, supervised, or*

controlled by one or more publicly supported organizations (within the meaning of section 509(a)(3)(B)) and be operated *for the benefit of* one or more different publicly supported organizations (within the meaning of section 509(a)(3)(A)) only if it can be demonstrated that the purposes of the former organizations are carried out by benefitting the latter organizations.

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

Example 1. X is a university press which is organized and operated as a nonstock educational corporation to perform the publishing and printing for M University, a publicly supported organization. Control of X is vested in a Board of Governors appointed by the Board of Trustees of M University upon the recommendation of the president of the university. X is considered to be operated, supervised, or controlled by M University within the meaning of section 509(a)(3)(B).

Example 2. Y Council was organized under the joint sponsorship of seven independent publicly supported organizations, each of which is dedicated to the advancement of knowledge in a particular field of social science. The sponsoring organizations organized Y Council as a means of pooling their ideas and resources for the attainment of common objectives, including the conducting of scholarly studies and formal discussions in various fields of social science. Under Y Council's by-laws, each of the seven sponsoring organizations elects three members to Y's board of trustees for 3-year terms. Y's board also includes the president of Y Council and eight other individuals elected at large by the board. Pursuant to policies established or approved by the board, Y Council engages in research, planning, and evaluation in the social sciences and sponsors or arranges conferences, seminars, and similar programs for scholars and social scientists. It carries out these activities through its own full-time professional staff, through a part-time committee of scholars, and through grant recipients. Under the above circumstances, Y Council is subject to a substantial degree of direction by the sponsoring publicly supported organizations. It is therefore considered to be operated, supervised, or controlled by such sponsoring organizations within the meaning of section 509(a)(3)(B).

Example 3. Z is a charitable trust created by A in 1972. It has three trustees, all of whom are appointed by M University, a publicly supported organization. The trust was organized and is operated to pay over all of its net income for medical research to N, O, and P, each of which is specified in the trust, is a hospital described in section 509(a)(1), and is located in the same city as M. Members of M's biology department are permitted to use the research facilities of N, O, and P. Under subparagraph (1)(ii) of this paragraph, Z is considered to be operated, supervised, or controlled by M within the meaning of section 509(a)(3)(B), even though it is operated for the benefit of N, O, and P within the meaning of section 509(a)(3)(A).

(h) *Meaning of supervised or controlled in connection with.* (1) In order for a supporting organization to be *supervised or controlled in connection with* one or more publicly supported organizations, there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations to insure that the supporting organization will be responsive to the needs and requirements of the publicly supported organizations. Therefore, in order to meet such requirement, the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations.

(2) A supporting organization will not be considered to be *supervised or controlled in connection with* one or more publicly supported organizations if such organization merely makes payments (mandatory or discretionary) to one or more named publicly supported organizations, even if the obligation to make payments to the named beneficiaries is enforceable under State law by such beneficiaries and the supporting organization's governing instrument contains provisions whose effect is described in section 508(e)(1) (A) and (B). Such arrangements do not provide a sufficient *connection* between the payor organization and the needs and requirements of the publicly supported organizations to constitute supervision or control in connection with such organizations.

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

Example 1. A, a philanthropist, founded X school for orphan boys (a publicly supported organization). At the same time A founded X school, he also established Y trust into which he transferred all of the operating assets of the school, together with a substantial endowment for it. Under the provisions

of the trust instrument, the same persons who control and manage the school also control and manage the trust. The sole function of Y trust is to hold legal title to X school's operating and endowment assets, to invest the endowment assets and to apply the income from the endowment to the benefit of the school in accordance with direction from the school's governing body. Under these circumstances, Y trust is organized and operated *for the benefit of* X school and is *supervised or controlled in connection with* such organization within the meaning of section 509(a)(3). The fact that the same persons control both X and Y insures Y's responsiveness to X's needs.

Example 2. In 1972, B, a philanthropist, created P, a charitable trust for the benefit of Z, a symphony orchestra described in section 509(a)(2). B transferred 100 shares of common stock to P. Under the terms of the trust instrument, the trustees (none of whom is under the control of B) were required to pay over all of the income produced by the trust assets to Z. The governing instrument of P contains certain provisions whose effect is described in section 508(e)(1) (A) and (B). Under applicable State law, Z can enforce the provisions of the trust instrument and compel payment to Z in a court of equity. There is no relationship between the trustees of P and the governing body of Z. Under these circumstances P is not supervised or controlled in connection with a publicly supported organization. Because of the lack of any common supervision or control by the trustees of P and the governing body of Z, P is not supervised or controlled in connection with Z within the meaning of section 509(a)(3)(B).

Example 3. T is a charitable trust described in section 501(c)(3) and created under the will of D. Prior to his death, D was a leader and very active in C church, a publicly supported organization. D created T to perpetuate his interest in, and assistance to, C. The sole purpose of T was to provide financial support for C and its related institutions. All of the original named trustees of T are members of C, are leaders in C, and hold important offices in one or more of C's related institutions. Successor trustees of T are by the terms of the charitable trust instrument to be chosen by the remaining trustees and are also to be members of C. All of the original trustees have represented that any successor trustee will be a leader in C and will hold an important office in one or more of C's related institutions. By reason of the foregoing relationship T and its trustees are responsive to the needs and requirements of C and its related institutions. Under these circumstances, T trust is organized and operated *for the benefit of* C and is *supervised or controlled in connection with* C and its related institutions within the meaning of section 509(a)(3)(B).

(i) *Meaning of operated in connection with*—(1) *General rule.* For each taxable year, a supporting organization is operated in connection with one or more supported organizations (that is, is a ''Type III supporting organization'') only if it is not disqualified by reason of paragraph (f)(5) (relating to acceptance of contributions from controlling donors) or paragraph (i)(10) (relating to foreign supported organizations) of this section, and it satisfies—

(i) The notification requirement, which is set forth in paragraph (i)(2) of this section;

(ii) The responsiveness test, which is set forth in paragraph (i)(3) of this section; and

(iii) The integral part test, which is satisfied by maintaining significant involvement in the operations of one or more supported organizations and providing support on which the supported organization(s) are dependent; in order to satisfy this test, the supporting organization must meet the requirements either for—

(A) Functionally integrated Type III supporting organizations set forth in paragraph (i)(4) of this section; or

(B) Non-functionally integrated Type III supporting organizations set forth in paragraph (i)(5) of this section.

(2) *Notification requirement*—(i) *Annual notification.* For each taxable year, a Type III supporting organization must provide the following documents to each of its supported organizations:

(A) A written notice addressed to a principal officer of the supported organization describing the type and amount of all of the support the supporting organization provided to the supported organization during the supporting organization's taxable year immediately preceding the taxable year in which the written notice is provided (and during any other taxable year of the supporting organization ending after December 28, 2012, for which such support information has not previously been provided);

(B) A copy of the supporting organization's Form 990, ''Return of Organization Exempt from Income Tax,'' or other annual information return required to be filed under section 6033 (although the supporting organization may redact from the return the name

and address of any contributor to the organization) that was most recently filed as of the date the notification is provided (and any such return for any other taxable year of the supporting organization ending after December 28, 2012, that has not previously been provided to the supported organization); and

(C) A copy of the supporting organization's governing documents as in effect on the date the notification is provided, including its articles of organization and bylaws (if any) and any amendments to such documents, unless such documents have been previously provided and not subsequently amended.

(ii) *Electronic media*. The notification documents required by this paragraph (i)(2) may be provided by electronic media.

(iii) *Due date*. The notification documents required by this paragraph (i)(2) for any taxable year shall be postmarked or electronically transmitted by the last day of the fifth calendar month following the close of that taxable year.

(iv) *Principal officer*. For purposes of paragraph (i)(2)(i)(A) of this section, a principal officer includes, but is not limited to, a person who, regardless of title, has ultimate responsibility for—

(A) Implementing the decisions of the governing body of a supported organization;

(B) Supervising the management, administration, or operation of the supported organization; or

(C) Managing the finances of the supported organization.

(3) *Responsiveness test*—(i) *General rule*. A supporting organization meets the responsiveness test if it is responsive to the needs or demands of a supported organization. Except as provided in paragraph (i)(3)(v) of this section, in order to meet this test, a supporting organization must satisfy the requirements of paragraphs (i)(3)(ii) and (i)(3)(iii) of this section.

(ii) *Relationship of officers, directors, or trustees*. A supporting organization satisfies the requirements of this paragraph (i)(3)(ii) with respect to a supported organization only if—

(A) One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the supported organization;

(B) One or more members of the governing body of the supported organization are also officers, directors, or trustees of, or hold other important offices in, the supporting organization; or

(C) The officers, directors, or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organization.

(iii) *Significant voice*. A supporting organization satisfies the requirements of this paragraph (i)(3)(iii) only if, by reason of paragraphs (i)(3)(ii)(A), (i)(3)(ii)(B), or (i)(3)(ii)(C) of this section, the officers, directors, or trustees of the supported organization have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making grants, and the selection of grant recipients by such supporting organization, and in otherwise directing the use of the income or assets of the supporting organization.

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

Example 1. X, an organization described in section 501(c)(3), is a trust created under the last will and testament of Decedent. The trustee of X (Trustee) is a bank. Under the trust instrument, X supports M, a private university described in section 509(a)(1). The trust instrument provides that Trustee has discretion regarding the timing and amount of distributions consistent with the Trustee's fiduciary duties. Representatives of Trustee and an officer of M have quarterly face-to-face or telephonic meetings during which they discuss M's projected needs and ways in which M would like X to use its income and invest its assets. Additionally, Trustee communicates regularly with that officer of M regarding X's investments and plans for distributions from X. Trustee provides the officer of M with quarterly investment statements, the information required under paragraph (i)(2) of this section, and an annual accounting statement. Based on these facts, X meets the responsiveness test of this paragraph (i)(3) with respect to M.

Example 2. Y is an organization described in section 501(c)(3) and is a trust under State law. The trustee of Y (Trustee) is a bank. Y supports charities P, Q, and R, each an organization described in section 509(a)(1). Y

makes annual cash payments to P, Q, and R. Once a year, Trustee sends to P, Q, and R the cash payment, the information required under paragraph (i)(2) of this section, and an accounting statement. Trustee has no other communication with P, Q, or R. Y does not meet the responsiveness test of this paragraph (i)(3).

(v) *Exception for pre-November 20, 1970 organizations.* In the case of a supporting organization that was supporting or benefiting a supported organization before November 20, 1970, additional facts and circumstances, such as a historic and continuing relationship between the organizations, may be taken into account, in addition to the factors described in paragraphs (i)(3)(ii) and (i)(3)(iii) of this section, to establish compliance with the responsiveness test.

(4) *Integral part test—functionally integrated Type III supporting organization*—(i) *General rule.* A supporting organization meets the integral part test and will be considered functionally integrated within the meaning of section 4943(f)(5)(B), if it—

(A) Engages in activities substantially all of which directly further the exempt purposes of one or more supported organizations and otherwise meets the requirements described in paragraph (i)(4)(ii) of this section;

(B) Is the parent of each of its supported organizations, as described in paragraph (i)(4)(iii) of this section; or

(C) Supports a governmental supported organization and otherwise meets the requirements of paragraph (i)(4)(iv) of this section.

(ii) *Substantially all activities directly further exempt purposes*—(A) *In general.* A supporting organization meets the requirements of this paragraph (i)(4)(ii) if it engages in activities substantially all of which—

(*1*) Directly further the exempt purposes of one or more supported organizations to which the supporting organization is responsive by performing the functions of, or carrying out the purposes of, such supported organization(s); and

(*2*) But for the involvement of the supporting organization, would normally be engaged in by such supported organization(s).

(B) *Meaning of substantially all.* For purposes of paragraph (i)(4)(ii)(A) of this section, in determining whether substantially all of a supporting organization's activities directly further the exempt purposes of one or more supported organization(s) to which the supporting organization is responsive, all pertinent facts and circumstances will be taken into consideration.

(C) *Meaning of directly further.* Activities ''directly further'' the exempt purposes of one or more supported organizations for purposes of this paragraph (i)(4) only if they are conducted by the supporting organization itself, rather than by a supported organization. Holding title to and managing exempt-use assets described in paragraph (i)(8)(ii) of this section are activities that directly further the exempt purposes of the supported organization within the meaning of this paragraph (i)(4). Conversely, except as provided in paragraph (i)(4)(ii)(D) of this section, fundraising, making grants (whether to the supported organization or to third parties), and investing and managing non-exempt-use assets are not activities that directly further the exempt purposes of the supported organization within the meaning of this paragraph (i)(4).

(D) *Payments to individual beneficiaries.* The making or awarding of grants, scholarships, or other payments to individual beneficiaries who are members of the charitable class benefited by a supported organization will be treated as an activity that directly furthers the exempt purposes of that supported organization for purposes of this paragraph (i)(4) only if—

(*1*) The individual beneficiaries are selected on an objective and nondiscriminatory basis (as described in § 53.4945–4(b));

(*2*) The officers, directors, or trustees of the supported organization have a significant voice in the timing of the payments, the manner of making them, and the selection of recipients; and

(*3*) The making or awarding of such payments is part of an active program of the supporting organization that directly furthers the exempt purposes of the supported organization and in which the supporting organization maintains significant involvement, as defined in § 53.4942(b)–1(b)(2)(ii) (except

that ''supporting organization'' shall be substituted for ''foundation'').

(iii) *Parent of supported organization(s).* For purposes of paragraph (i)(4)(i)(B) of this section, a supporting organization is the parent of a supported organization if the supporting organization exercises a substantial degree of direction over the policies, programs, and activities of the supported organization and a majority of the officers, directors, or trustees of the supported organization is appointed or elected, directly or indirectly, by the governing body, members of the governing body, or officers (acting in their official capacity) of the supporting organization.

(iv) *Supporting a governmental entity.* [Reserved]

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

Example 1. N, an organization described in section 501(c)(3), is the parent organization of a healthcare system consisting of two hospitals (Q and R) and an outpatient clinic (S), each of which is described in section 509(a)(1), and a taxable subsidiary (T). N is the sole member of each of Q, R, and S. Under the charter and bylaws of each of Q, R, and S, N appoints all members of the board of directors of each corporation. N engages in the overall coordination and supervision of the healthcare system's exempt subsidiary corporations Q, R, and S in approval of their budgets, strategic planning, marketing, resource allocation, securing tax-exempt bond financing, and community education. N also manages and invests assets that serve as endowments of Q, R, and S. Based on these facts, N qualifies as a functionally integrated Type III supporting organization under paragraph (i)(4)(i)(B) of this section.

Example 2. V, an organization described in section 501(c)(3), is organized and operated as a supporting organization to L, a church described in section 509(a)(1). V meets the responsiveness test described in paragraph (i)(3) of this section with respect to L. L transferred to V title to the buildings in which L conducts religious services, Bible study, and community enrichment programs. Substantially all of V's activities consist of holding and maintaining these buildings, which L continues to use, free of charge, to further its exempt purposes. But for the activities of V, L would hold and maintain the buildings. Based on these facts, V satisfies the requirements of paragraph (i)(4)(ii) of this section.

Example 3. O is a local nonprofit food pantry described in section 501(c)(3). O collects donated food from local growers, grocery stores, and individuals and distributes this food free of charge to poor and needy people in O's community. O is organized and operated as a supporting organization to eight churches of a particular denomination located in O's community, each of which is described in section 509(a)(1). Control of O is vested in a five-member Board of Directors, which includes an official from one of the churches as well as four lay members of the churches' congregations. The officers of O maintain a close and continuing working relationship with each of the eight churches and as a result of such relationship, each of the eight churches has a significant voice in directing the use of the income and assets of O. As a result, O is responsive to its supported organizations. All of O's activities directly further the exempt purposes of the eight supported organizations to which it is responsive. Additionally, but for the activities of O, the churches would normally operate food pantries themselves. Based on these facts, O satisfies the requirements of paragraph (i)(4)(ii) of this section.

Example 4. M, an organization described in section 501(c)(3), was created by B, an individual, to provide scholarships for students of U, a private secondary school and an organization described in section 509(a)(1). U establishes the scholarship criteria, publicizes the scholarship program, solicits and reviews applications, and selects the scholarship recipients. M invests its assets and disburses the funds for scholarships to the recipients selected by U. M does not provide the scholarships as part of an active program in which it maintains significant involvement, as defined in § 53.4942(b)–1(b)(2)(ii). Based on these facts, M does not satisfy the requirements of paragraph (i)(4)(ii) of this section.

Example 5. J, an organization described in section 501(c)(3), is organized as a supporting organization to community foundation G, an organization described in section 509(a)(1). J meets the responsiveness test described in paragraph (i)(3) of this section with respect to G. In addition to maintaining field-of-interest funds, sponsoring donor advised funds, and conducting general grantmaking activities, G also engages in activities to beautify and maintain local parks. Substantially all of J's activities consist of maintaining all of the local parks in the area of community foundation G by performing activities such as establishing and maintaining trails, planting trees, and removing trash. But for the activities of J, G would normally engage in these efforts to beautify and maintain the local parks. Based on these facts, J satisfies the requirements of paragraph (i)(4)(ii) of this section.

(5) *Integral part test—non-functionally integrated Type III supporting organization*—(i) *General rule*. A supporting organization meets the integral part test and will be considered non-functionally integrated if it satisfies either—

(A) The distribution requirement of paragraph (i)(5)(ii) of this section and the attentiveness requirement of paragraph (i)(5)(iii) of this section; or

(B) The pre-November 20, 1970 trust requirements of paragraph (i)(9) of this section.

(ii) *Distribution requirement*—(A) *Annual distribution*. With respect to each taxable year, a supporting organization must distribute to or for the use of one or more supported organizations an amount equaling or exceeding the supporting organization's distributable amount for the taxable year, as defined in paragraph (i)(5)(ii)(B) of this section, on or before the last day of the taxable year.

(B) *Distributable amount*. Except as provided in paragraphs (i)(5)(ii)(D) and (E) of this section, the distributable amount for a taxable year is an amount equal to the greater of 85 percent of the supporting organization's adjusted net income (as determined by applying the principles of section 4942(f) and § 53.4942(a)–2(d) of this chapter) for the taxable year immediately preceding the taxable year of the required distribution (immediately preceding taxable year) or its minimum asset amount (as defined in paragraph (i)(5)(ii)(C) of this section) for the immediately preceding taxable year, reduced by the amount of taxes imposed on the supporting organization under subtitle A of the Internal Revenue Code during the immediately preceding taxable year.

(C) *Minimum asset amount*. For purposes of this paragraph (i)(5), a supporting organization's minimum asset amount for the immediately preceding taxable year is 3.5 percent of the excess of the aggregate fair market value of all of the supporting organization's non-exempt-use assets (determined under paragraph (i)(8) of this section) in that immediately preceding taxable year over the acquisition indebtedness with respect to such non-exempt-use assets (determined under section 514(c)(1) without regard to the taxable year in which the indebtedness was incurred), increased by—

(*1*) Amounts received or accrued during the immediately preceding taxable year as repayments of amounts which were taken into account by the organization to meet the distribution requirement imposed in this paragraph (i)(5)(ii) for any taxable year;

(*2*) Amounts received or accrued during the immediately preceding taxable year from the sale or other disposition of property to the extent that the acquisition of such property was taken into account by the organization to meet the distribution requirement imposed in this paragraph (i)(5)(ii) for any taxable year; and

(*3*) Any amount set aside under paragraph (i)(6)(v) of this section to the extent it is determined during the immediately preceding taxable year that such amount is not necessary for the purposes for which it was set aside and such amount was taken into account by the organization to meet the distribution requirement imposed in this paragraph (i)(5)(ii) for any taxable year.

(D) *First taxable year*. The distributable amount for the first taxable year an organization is treated as a non-functionally integrated Type III supporting organization is zero. Notwithstanding the foregoing, for purposes of determining whether an excess amount is created under paragraph (i)(7)(ii) of this section, the distributable amount for the first taxable year an organization is treated as a non-functionally integrated Type III supporting organization is the distributable amount that would apply under paragraph (i)(5)(ii)(B) of this section in the absence of this paragraph (i)(5)(ii)(D).

(E) *Emergency temporary reduction*. The Secretary may provide by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) for a temporary reduction in the distributable amount in the case of a disaster or emergency.

(F) *Reasonable cause exception*. A non-functionally integrated Type III supporting organization that fails to meet the distribution requirement of this paragraph (i)(5)(ii) will not be classified as a private foundation for the taxable

year in which it fails to meet the distribution requirement if the organization establishes to the satisfaction of the Secretary that—

(*1*) The failure was due solely to unforeseen events or circumstances that are beyond the organization's control, a clerical error, or an incorrect valuation of assets;

(*2*) The failure was due to reasonable cause and not to willful neglect; and

(*3*) The distribution requirement is met within 180 days after the organization is first able to distribute its distributable amount notwithstanding the unforeseen events or circumstances, or 180 days after the date the incorrect valuation or clerical error was or should have been discovered; however, no amounts paid to meet a distribution requirement for a prior taxable year under this paragraph (i)(5)(ii)(F)(*3*) may be counted toward the distribution requirement for the taxable year in which such amounts are paid.

(iii) *Attentiveness requirement*—(A) *General rule*. With respect to each taxable year, a non-functionally integrated Type III supporting organization must distribute one-third or more of its distributable amount to one or more supported organizations that are attentive to the operations of the supporting organization (within the meaning of paragraph (i)(5)(iii)(B) of this section) and to which the supporting organization is responsive (within the meaning of paragraph (i)(3) of this section).

(B) *Attentiveness*. A supported organization is attentive to the operations of the supporting organization during a taxable year if, in the taxable year, at least one of the following requirements is satisfied:

(*1*) The supporting organization distributes to the supported organization amounts equaling or exceeding 10 percent of the supported organization's total support (or, in the case of a particular department or school of a university, hospital, or church, the total support of the department or school) received during the supported organization's last taxable year ending before the beginning of the supporting organization's taxable year.

(*2*) The amount of support received from the supporting organization is necessary to avoid the interruption of the carrying on of a particular function or activity of the supported organization. The support is necessary if the supporting organization or the supported organization earmarks the support for a particular program or activity of the supported organization, even if such program or activity is not the supported organization's primary program or activity, as long as such program or activity is a substantial one.

(*3*) Based on the consideration of all pertinent factors, including the number of supported organizations, the length and nature of the relationship between the supported organization and supporting organization, and the purpose to which the funds are put, the amount of support received from the supporting organization is a sufficient part of a supported organization's total support (or, in the case of a particular department or school of a university, hospital, or church, the total support of the department or school) to ensure attentiveness. Normally the attentiveness of a supported organization is influenced by the amounts received from the supporting organization. Thus, the more substantial the amount involved in terms of a percentage of the supported organization's total support, the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from the supporting organization is sufficient to ensure the attentiveness of the supported organization to the operations of the supporting organization (including attentiveness to the nature and yield of the supporting organization's investments), evidence of actual attentiveness by the supported organization is of almost equal importance. A supported organization is not considered to be attentive solely because it has enforceable rights against the supporting organization under state law.

(C) *Distribution to donor advised fund disregarded*. Notwithstanding paragraph (i)(5)(iii)(B) of this section, in determining whether a supported organization will be considered attentive to the operations of a supporting organization, any amount received from the supporting organization that is held by the supported organization in a donor

advised fund described in section 4966(d)(2) will be disregarded.

(D) *Examples*. This paragraph (i)(5)(iii) is illustrated by the following examples:

Example 1. K, an organization described in section 501(c)(3), annually pays an aggregate amount equaling or exceeding its distributable amount described in paragraph (i)(5)(ii)(B) of this section to L, a museum described in section 509(a)(2). K meets the responsiveness test described in paragraph (i)(3) of this section with respect to L. In recent years, L has earmarked the income received from K to underwrite the cost of carrying on a chamber music series consisting of 12 performances a year that are performed for the general public free of charge at its premises. The chamber music series is not L's primary activity but it is a substantial activity. L could not continue the performances without K's support. Based on these facts, K meets the requirements of paragraph (i)(5)(iii)(B)(*2*) of this section.

Example 2. M, an organization described in section 501(c)(3), annually pays an aggregate amount equaling or exceeding its distributable amount described in paragraph (i)(5)(ii)(B) of this section to the Law School of N University, an organization described in section 509(a)(1). M meets the responsiveness test described in paragraph (i)(3) of this section with respect to N. M has earmarked the income paid over to N's Law School to endow a chair in International Law. Without M's continued support, N could not continue to maintain this chair. The chair is not N's primary activity but it is a substantial activity. Based on these facts, M meets the requirements of paragraph (i)(5)(iii)(B)(*2*) of this section.

Example 3. R is a charitable trust created under the will of B, who died in 1969. R's purpose is to hold assets as an endowment for S (a hospital), T (a university), and U (a national medical research organization), all organizations described in section 509(a)(1) and specifically named in the trust instrument, and to distribute all of the income each year in equal shares among the three named beneficiaries. Each year, R pays to S, T, and U an aggregate amount equaling or exceeding its distributable amount described in paragraph (i)(5)(ii)(B) of this section. Such payments equal less than one percent of the total support that each supported organization received in its most recently completed taxable year. Based on these facts, R does not meet the requirements of paragraph (i)(5)(iii)(B)(*1*) of this section. However, because B died prior to November 20, 1970, R could meet the requirements of paragraph (i)(5)(i)(B) of this section upon meeting all of the requirements of paragraph (i)(9) of this section.

Example 4. O is an organization described in section 501(c)(3). O is organized to support five private universities, V, W, X, Y, and Z, each of which is described in section 509(a)(1). O meets the responsiveness test under paragraph (i)(3) of this section only as to V. Each year, O distributes an aggregate amount that equals its distributable amount described in paragraph (i)(5)(ii)(B) of this section and distributes an equal amount to each of the five universities. Accordingly, O distributes only one-fifth of its distributable amount to a supported organization to which O is also responsive (V). Because O does not distribute at least one-third of its distributable amount to supported organizations that are both attentive to the operations of O and to which the O is responsive, O does not meet the attentiveness requirements of this paragraph (i)(5)(iii).

(6) *Distributions that count toward distribution requirement*. For purposes of this paragraph (i)(6), the amount of a distribution made to a supported organization is the amount of cash distributed or the fair-market value of the property distributed as of the date the distribution is made. The amount of a distribution will be determined solely on the cash receipts and disbursements method of accounting described in section 446(c)(1). Distributions by the supporting organization that count toward the distribution requirement imposed in paragraph (i)(5)(ii) of this section shall include, but not be limited to—

(i) Any amount paid to a supported organization to accomplish the supported organization's exempt purposes;

(ii) Any amount paid by the supporting organization to perform an activity that satisfies the requirements of paragraph (i)(4)(ii) of this section, but only to the extent such amount exceeds any income derived by the supporting organization from the activity;

(iii) Any reasonable and necessary administrative expenses paid to accomplish the exempt purposes of the supported organization(s), which do not include expenses incurred in the production of investment income;

(iv) Any amount paid to acquire an exempt-use asset described in paragraph (i)(8)(ii) of this section; and

(v) Any amount set aside for a specific project that accomplishes the exempt purposes of a supported organization to which the supporting organization is responsive, with such set aside

counting toward the distribution requirement for the taxable year in which the amount is set aside but not in the year in which it is actually paid, if at the time of the set-aside, the supporting organization—

(A) Obtains a written statement from each supported organization whose exempt purposes the specific project accomplishes, signed under penalty of perjury by one of the supported organization's principal officers, as defined in paragraph (i)(2)(iv) of this section, stating that the supported organization approves the project as one that accomplishes one or more of the supported organization's exempt purposes and also approves the supporting organization's determination that the project is one that can be better accomplished by such a set-aside than by the immediate payment of funds;

(B) Establishes to the satisfaction of the Commissioner, by meeting the approval and information requirements described in § 53.4942(a)–3(b)(7)(i) of this chapter and by providing the written statement described in paragraph (i)(6)(v)(A) of this section, that the amount set aside will be paid for the specific project within 60 months after it is set aside and that the project is one that can better be accomplished by the set-aside than by the immediate payment of funds; and

(C) Evidences the set-aside by the entry of a dollar amount on the books and records of the supporting organization as a pledge or obligation to be paid at a future date or dates within 60 months of the set aside.

(7) *Carryover of excess amounts*—(i) *In general*. If with respect to any taxable year, an excess amount, as defined in paragraph (i)(7)(ii) of this section, is created, such excess amount may be used to reduce the distributable amount in any of the five taxable years immediately following the taxable year in which the excess amount is created. An excess amount created in a taxable year can only be carried over for five taxable years.

(ii) *Excess amount*. An excess amount is created for any taxable year beginning after December 28, 2012, if the total distributions made in that taxable year that count toward the distribution requirement exceed the supporting organization's distributable amount for the taxable year, as determined under paragraph (i)(5)(ii)(B) of this section. With respect to any taxable year to which an excess amount is carried over, in determining whether an excess amount is created in that taxable year, the distributable amount is first reduced by any excess amounts carried over (with the oldest excess amounts applied first) and then by any distributions made in that taxable year.

(8) *Valuation of non-exempt-use assets*. For purposes of determining its distributable amount for a taxable year, a supporting organization determines its minimum asset amount, as defined in paragraph (i)(5)(ii)(C) of this section, by determining the aggregate fair market value of all of its non-exempt-use assets in the immediately preceding taxable year. For these purposes, the determination of the aggregate fair market value of all non-exempt-use assets shall be made using the valuation methods described in § 53.4942(a)–2(c) of this chapter. The aggregate fair market value of the supporting organization's non-exempt-use assets shall not be reduced by any amount that is set aside under paragraph (i)(6)(v) of this section. For these purposes, the non-exempt use assets of the supporting organization are all assets of the supporting organization other than—

(i) Assets described in § 53.4942(a)–2(c)(2)(i) through (iv) of this chapter (with the term ''supporting organization'' being substituted for ''foundation'' or ''private foundation'' and the date ''August 17, 2006'' being substituted for ''December 31, 1969''); and

(ii) Exempt-use assets, which are assets that are used (or held for use) directly in carrying out the exempt purposes of the supporting organization's supported organization(s) (determined by applying the principles described in § 53.4942(a)–2(c)(3) of this chapter) by either—

(A) The supporting organization; or

(B) One or more supported organizations, but only if the supporting organization makes the asset available to the supported organization(s) at no cost (or nominal rent) to the supported organization(s).

(9) *Alternate integral part test for certain trusts.* A trust (whether or not exempt from taxation under section 501(a)) that on November 20, 1970, met and continues to meet the requirements of paragraphs (i)(9)(i) through (i)(9)(v) of this section, shall be treated as meeting the requirements of paragraph (i)(5) of this section if for taxable years beginning after October 16, 1972, the trustee of such trust makes annual written reports to all of the trust's supported organizations, setting forth a description of the trust's assets, including a detailed list of the assets and the income produced by such assets. A trust that meets the requirements of this paragraph (i)(9) may request a ruling that it is described in section 509(a)(3) in such manner as the Commissioner may prescribe. The requirements of this paragraph (i)(9) are as follows:

(i) All the unexpired interests in the trust are devoted to one or more purposes described in section 170(c)(1) or (c)(2)(B) and a deduction was allowed with respect to such interests under sections 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), 2522, or corresponding provisions of prior law (or would have been allowed such a deduction if the trust had not been created before 1913).

(ii) The trust was created prior to November 20, 1970, and did not receive any grant, contribution, bequest or other transfer on or after such date. For purposes of this paragraph (i)(9)(ii), a split-interest trust described in section 4947(a)(2) that was created prior to November 20, 1970, was irrevocable on such date, and that becomes a charitable trust described in section 4947(a)(1) after such date shall be treated as having been created prior to such date.

(iii) The trust is required by its governing instrument to distribute all of its net income currently to a designated beneficiary supported organization. If more than one beneficiary supported organization is designated in the governing instrument of a trust, all of the net income must be distributable and must be distributed currently to each of such supported organizations in fixed shares pursuant to such governing instrument. For purposes of this paragraph (i)(9)(iii), the governing instrument of a charitable trust shall be treated as requiring distribution to a designated supported organization when the trust instrument describes the charitable purpose of the trust so completely that such description can apply to only one existing supported organization and is of sufficient particularity as to vest in such organization rights against the trust enforceable in a court possessing equitable powers.

(iv) The trustee of the trust does not have discretion to vary either the beneficiary supported organizations or the amounts payable to the supported organizations. For purposes of this paragraph (i)(9)(iv), a trustee shall not be treated as having such discretion if the trustee has discretion to make payments of principal to the single supported organization that is currently entitled to receive all of the trust's income or if the trust instrument provides that the trustee may cease making income payments to a particular supported organization in the event of certain specific occurrences, such as the loss of exemption under section 501(c)(3) or classification under section 509(a)(1) or (a)(2) by the supported organization or the failure of the supported organization to carry out its charitable purpose properly.

(v) None of the trustees would be disqualified persons within the meaning of section 4946(a) (other than foundation managers under section 4946(a)(1)(B)) with respect to the trust if such trust were treated as a private foundation.

(10) *Foreign supported organizations.* A supporting organization is not operated in connection with one or more supported organizations if it supports any supported organization organized outside of the United States.

(11) *Transition rules*—(i) *Notification requirement.* A Type III supporting organization will be treated as having satisfied the notification requirement described in paragraph (i)(2) of this section for its taxable year that includes December 28, 2012, if the required notification is postmarked or electronically transmitted by the later of the last day of the fifth calendar month following the close of that taxable year or the due date (including extensions) of the supporting organization's annual

information return described in section 6033 for that taxable year.

(ii) *Integral part test*—(A) *Qualification as a functionally integrated Type III supporting organization.* A Type III supporting organization in existence on December 28, 2012, that met and continues to meet the requirements of Treas. Reg. §1.509(a)–4(i)(3)(ii), as in effect prior to December 28, 2012, will be treated as meeting the requirements of paragraph (i)(4) of this section until the first day of the organization's second taxable year beginning after December 28, 2012.

(B) *Qualification as a non-functionally integrated Type III supporting organization.* A Type III supporting organization in existence on December 28, 2012, that met and continues to meet the requirements of Treas. Reg. §1.509(a)–4(i)(3)(iii), as in effect prior to December 28, 2012, will be treated as meeting the requirements of paragraph (i)(5)(i)(A) of this section until the first day of its second taxable year beginning after December 28, 2012. Notwithstanding the foregoing, in determining whether an excess amount is created under paragraph (i)(7)(ii) of this section in the first taxable year beginning after December 28, 2012, the distributable amount for that taxable year of a Type III supporting organization treated as meeting the requirements of paragraph (i)(5)(i)(A) of this section under this paragraph (i)(11)(ii)(B) is the amount described in §1.509(a)–4T(i)(5)(ii)(B).

(C) *Transitioning to a non-functionally integrated Type III supporting organization in the first taxable year after effective date.* A Type III supporting organization in existence on December 28, 2012, that meets the requirements of Treas. Reg. §1.509(a)–4(i)(3)(ii), as in effect prior to December 28, 2012, in its taxable year including December 28, 2012, but not in its first taxable year beginning after December 28, 2012, is a non-functionally integrated Type III supporting organization and will be treated as having a distributable amount of zero for purposes of meeting the requirements of paragraph (i)(5)(i)(A) of this section during the organization's first taxable year beginning after December 28, 2012. Notwithstanding the foregoing, in determining whether an excess amount is created under paragraph (i)(7)(ii) of this section in the first taxable year beginning after December 28, 2012, the distributable amount for that taxable year of a Type III supporting organization described in this paragraph (i)(11)(ii)(C) is the amount described in §1.509(a)–4T(i)(5)(ii)(B), determined without regard to paragraph (i)(5)(ii)(D) of this section.

(D) *Second taxable year after effective date.* Beginning in the second taxable year beginning after December 28, 2012, and in all succeeding taxable years, all Type III supporting organizations described in this paragraph (i)(11)(ii) must meet either the requirements of paragraph (i)(4) or (i)(5) of this section. If a Type III supporting organization described in paragraph (i)(11)(ii)(A) of this section does not meet the requirements of paragraph (i)(4) of this section during its second taxable year beginning after December 28, 2012, its distributable amount for that second taxable year will be determined under §1.509(a)–4T(i)(5)(ii)(B), without regard to paragraph (i)(5)(ii)(D) of this section. Any Type III supporting organization intending to meet the requirements of paragraph (i)(5) of this section in its second taxable year beginning after December 28, 2012, must value its assets in accordance with §1.509(a)–4T(i)(8) beginning in its first taxable year beginning after December 28, 2012.

(E) *Judicial proceedings to reform instruments.* During any taxable years in which there is pending a judicial proceeding that meets the requirements of this paragraph (i)(11)(ii)(E), a non-functionally integrated Type III supporting organization organized before September 24, 2009, will not have to comply with the distribution requirement under paragraph (i)(5)(ii) of this section to the extent such compliance would be inconsistent with mandatory provisions of a governing instrument or other instrument executed before September 24, 2009, that prohibits distributing capital or corpus. Beginning with the first taxable year following the taxable year in which such judicial proceeding is terminated, such a non-functionally integrated Type III supporting organization must satisfy the distribution requirement under paragraph

(i)(5)(ii) of this section, regardless of the outcome of the judicial proceeding. Thus, if, during a taxable year after such a judicial proceeding, an organization fails to comply with paragraph (i)(5)(ii) of this section, the organization will not qualify as a non-functionally integrated Type III supporting organization, regardless of whether such failure to comply was a result of the organization operating in accordance with its governing instrument or other instrument. To meet the requirements of this paragraph (i)(11)(ii)(E), a judicial proceeding must be—

(*1*) Necessary to reform, or to excuse the supporting organization from compliance with, a governing instrument or other instrument (as in effect on September 24, 2009, and all times thereafter) in order to permit the organization to satisfy paragraph (i)(5)(ii) of this section;

(*2*) Commenced before June 26, 2013; and

(*3*) Not subject to any unreasonable delay for which the supporting organization is responsible.

(j) *Control by disqualified persons*—(1) *In general.* Under the provisions of section 509(a)(3)(C) a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations. If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization. An organization will be considered *controlled*, for purposes of section 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operation or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except as provided in subparagraph (2) of this paragraph, a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

(2) *Proof of independent control.* Notwithstanding subparagraph (1) of this paragraph, an organization shall be permitted to establish to the satisfaction of the Commissioner that disqualified persons do not directly or indirectly control it. For example, in the case of a religious organization operated in connection with a church, the fact that the majority of the organization's governing body is composed of lay persons who are substantial contributors to the organization will not disqualify the organization under section 509(a)(3)(C) if a representative of the church, such as a bishop or other official, has control over the policies and decisions of the organization.

(k) *Organizations operated in conjunction with certain section 501(c) (4), (5), or*

(6) organizations. (1) For purposes of section 509(a)(3), an organization which is operated in conjunction with an organization described in section 501(c)(4), (5), or (6) (such as a social welfare organization, labor or agricultural organization, business league, or real estate board) shall, if it otherwise meets the requirements of section 509(a)(3), be considered an organization described in section 509(a)(3) if such section 501(c)(4), (5), or (6) organization would be described in section 509(a)(2) if it were an organization described in section 501(c)(3). The section 501(c) (4), (5), or (6) organization, which the supporting organization is operating in conjunction with, must therefore meet the one-third tests of a publicly supported organization set forth in section 509(a)(2).

(2) This paragraph may be illustrated by the following example:

Example. X medical association, described in section 501(c)(6), is supported by membership dues and funds resulting from the performance of its exempt activities. This support, which is entirely from permitted sources, constitutes more than one-third of X's support. X does not normally receive more than one-third of its support from items described in section 509(a)(2)(B). X organized and operated an endowment fund for the sole purpose of furthering medical education. The fund is an organization described in section 501(c)(3). Since more than one-third of X's support is derived from membership dues and from funds resulting from the performance of exempt purposes (all of which are from permitted sources) and not more than one-third of its support is from items described in section 509(a)(2)(B), it would be a publicly supported organization described in section 509(a)(2) if it were described in section 501(c)(3) rather than section 501(c)(6). Accordingly, if the fund otherwise meets the requirements of section 509(a)(3) with respect to X, it will be considered an organization described in section 509(a)(3).

(l) *Effective/applicability dates.* Paragraphs (a)(6), (f)(5), (i)(1) through (i)(4)(ii)(B), (i)(4)(ii)(D) through (i)(5)(i), (i)(5)(ii)(E) through (i)(5)(iii)(C), (i)(6)(i) through (iii), (i)(6)(v) through (i)(7)(i), and (i)(9) through (11) of this section are applicable on December 28, 2012. Paragraphs (i)(4)(ii)(C), (i)(5)(ii)(A) through (i)(5)(ii)(D), (i)(5)(iii)(D), (i)(6)(iv), (i)(7)(ii) and (i)(8) of this section are applicable on December 21, 2015. See paragraphs (i)(5)(ii)(B), (i)(5)(ii)(C), and (i)(8) of §1.509(a)–4T contained in 26 CFR part 1, revised as of April 1, 2015, for certain rules regarding non-functionally integrated Type III supporting organizations effective before December 21, 2015.

[T.D. 7212, 37 FR 21916, Oct. 17, 1972, as amended by T.D. 7784, 46 FR 37890, July 23, 1981; 77 FR 76394, Dec. 28, 2012; T.D. 9746, 80 FR 79686, Dec. 23, 2015]

§ 1.509(a)–5 Special rules of attribution.

(a) *Retained character of gross investment income.* (1) For purposes of determining whether an organization meets the not-more-than-one-third support test set forth in section 509(a)(2)(B), amounts received by such organization from:

(i) An organization which seeks to be described in section 509(a)(3) by reason of its support of such organization; or

(ii) A charitable trust, corporation, fund, or association described in section 501(c)(3) (including a charitable trust described in section 4947(a)(1)) or a split interest trust described in section 4947(a)(2), which is required by its governing instrument or otherwise to distribute, or which normally does distribute, at least 25 percent of its adjusted net income (within the meaning of section 4942(f)) to such organization, and such distribution normally comprises at least 5 percent of such distributee organization's adjusted net income

will retain their character as gross investment income (rather than gifts or contributions) to the extent that such amounts are characterized as gross investment income in the possession of the distributing organization described in subdivision (i) or (ii) of this subparagraph or, if the distributing organization is a split interest trust described in section 4947(a)(2), to the extent that such amounts would be characterized as gross investment income attributable to transfers in trust after May 26, 1969, if such trust were a private foundation. For purposes of this section, all income which is characterized as gross investment income in the possession of the distributing organization shall be deemed to be distributed first by such organization and shall retain its character as such in the possession

of the recipient of amounts described in this paragraph. If an organization described in subdivision (i) or (ii) of this subparagraph makes distributions to more than one organization, the amount of gross investment income deemed distributed shall be prorated among the distributees.

(2) For purposes of subparagraph (1) of this paragraph, amounts paid by an organization to provide goods, services, or facilities for the direct benefit of an organization seeking section 509(a)(2) status (rather than for the direct benefit of the general public) shall be treated in the same manner as amounts received by the latter organization. Such amounts will be treated as gross investment income to the extent that such amounts are characterized as gross investment income in the possession of the organization spending such amounts. For example, X is an organization described in subparagraph (1)(i) of this paragraph. It uses part of its funds to provide Y, an organization seeking section 509(a)(2) status, with certain services which Y would otherwise be required to purchase on its own. To the extent that the funds used by X to provide such services for Y are characterized as gross investment income in the possession of X, such funds will be treated as gross investment income received by Y.

(3) An organization seeking section 509(a)(2) status shall file a separate statement with its return required by section 6033, setting forth all amounts received from organizations described in paragraph (a)(1) (i) or (ii) of this section.

(b) *Relationships created for avoidance purposes*. (1) If a relationship between an organization seeking section 509(a)(3) status and an organization seeking section 509(a)(2) status:

(i) Is established or availed of after October 9, 1969, and

(ii) One of the purposes of establishing or utilizing such relationship is to avoid classification as a private foundation with respect to either organization, the character and amount of support received by the section 509(a)(3) organization will be attributed to the section 509(a)(2) organization for purposes of determining whether the latter meets the one-third support test and the not-more-than-one-third support test under section 509(a)(2). If a relationship described in this subparagraph is established or utilized by an organization seeking section 509(a)(3) status and two or more organizations seeking section 509(a)(2) status, the amount of support received by the former organization will be prorated among the latter organizations and the character of each class of support (as defined in section 509(d)) will be attributed pro rata to each such organization. The provisions of this paragraph and of paragraph (a) of this section are not mutually exclusive.

(2) In determining whether a relationship between one or more organizations seeking section 509(a)(2) status (hereinafter referred to as *beneficiary organizations*) and an organization seeking section 509(a)(3) status (hereinafter referred to as the *supporting organization*) has been established or availed of to avoid classification as a private foundation (within the meaning of subparagraph (1) of this paragraph), all pertinent facts and circumstances, including the following, shall be taken into account as evidence that a relationship was not established or availed of to avoid classification as a private foundation:

(i) The supporting organization is operated to support or benefit several specified beneficiary organizations.

(ii) The beneficiary organization has a substantial number of dues-paying members (in relation to the public it serves and the nature of its activities) and such members have an effective voice in the management of both the supporting and beneficiary organizations.

(iii) The beneficiary organization is composed of several membership organizations, each of which has a substantial number of members (in relation to the public it serves and the nature of its activities), and such membership organizations have an effective voice in the management of the supporting and beneficiary organizations.

(iv) The beneficiary organization receives a substantial amount of support from the general public, public charities, or governmental grants.

(v) The supporting organization uses its funds to carry on a meaningful program of activities to support or benefit the beneficiary organization and such use would, if such supporting organization were a private foundation, be sufficient to avoid the imposition of any tax upon such organization under section 4942.

(vi) The supporting organization is not able to exercise substantial control or influence over the beneficiary organization by reason of the former's receiving support or holding assets which are disproportionately large in comparison with the support received or the assets held by the latter.

(vii) Different persons manage the operations of the beneficiary and supporting organizations and each organization performs a different function.

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

Example 1. M, an organization described in section 509(a)(2), is a council composed of 10 learned societies. Each member society has a large membership of scholars interested in a particular academic area. In 1970 M established N, an organization seeking section 509(a)(3) status, for the purpose of carrying on research and study projects of interest to the member societies. The principal source of funds for N's activities is from foundation and government grants and contracts. The principal source of funds for M's activities after the creation of N is membership dues. M continued to maintain a wide variety of activities for its members, such as publishing periodicals and carrying on seminars and conferences. N is subject to complete control by the governing body of M. Under these circumstances, the relationship between these organizations is not one which is described in subparagraph (1) of this paragraph.

Example 2. Q is a local medical research organization described in section 509(a)(2). Its fixed assets are negligible and it carries on research activities on a limited scale. It also makes a limited number of grants to scientists and doctors who are engaged in medical research of interest to Q. It receives support through small government grants and a few research contracts from private foundations. R is an organization described in section 501(c)(3). As of January 1, 1970, R was classified as a private foundation under section 509. It has a substantial endowment which it uses to make grants to various charitable and scientific organizations described in section 501(c)(3). During 1970, R agrees to subsidize the research activities of Q. R amends its governing instrument to provide specifically that all of R's support will be used for research activities which are approved and supervised by Q. R also amends its bylaws to permit a minority of Q's board of directors to be members of R's governing body. R then gives timely notification under section 507(b)(1)(B)(ii) that R is terminating its private foundation status by meeting the requirements of section 509(a)(3) by the end of the 12-month period described in section 507(b)(1)(B)(i). For purposes of determining whether R has met the requirements of section 509(a)(3) by the end of the 12-month period, as well as determining Q's status under section 509(a)(2), the character and amount of support received by R will be attributed to Q.

(c) *Effect on organizations claiming section 509(a)(3) status.* If an organization claiming section 509(a)(2) status fails to meet either the one-third support test or the not-more-than-one-third support test under section 509(a)(2) by reason of the application of the provisions of paragraph (a) or (b) of this section, and such organization is one of the specified organizations (within the meaning of section 509(a)(3)(A)) for whose support or benefit an organization claiming section 509(a)(3) status is operated, the organization claiming section 509(a)(3) status will not be considered to be operated exclusively to support or benefit one or more section 509(a) (1) or (2) organizations.

[T.D. 7212, 37 FR 21922, Oct. 17, 1972, as amended by T.D. 7290, 38 FR 31834, Nov. 19, 1973; T.D. 7784, 46 FR 37890, July 23, 1981]

§ 1.509(a)–6 Classification under section 509(a).

If an organization is described in section 509(a)(1) and also in another paragraph of section 509(a), it will be treated as described in section 509(a)(1). For purposes of this section, the parenthetical language *other than in clauses (vii) and (viii)* used in section 509(a)(1) shall be construed to mean *other than an organization which is described only in clause (vii) or (viii)*. For example, X is an organization which is described in section 170(b)(1)(A)(vi), but could also meet the description of section 170(b)(1)(A)(viii) as an organization described in section 509(a)(2). For purposes of the one-third support test in section 509(a)(2)(A), contributions from

X to other organizations will be treated as support from an organization described in section 170(b)(1)(A)(vi) rather than from an organization described in section 170(b)(1)(A)(viii).

[T.D. 7212, 37 FR 21923, Oct. 17, 1972]

§ 1.509(a)–7 Reliance by grantors and contributors to section 509(a) (1), (2), and (3) organizations.

(a) *General rule.* Once an organization has received a final ruling or determination letter classifying it as an organization described in section 509(a) (1), (2), or (3), the treatment of grants and contributions and the status of grantors and contributors to such organization under sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 will not be affected by reason of a subsequent revocation by the service of the organization's classification as described in section 509(a) (1), (2), or (3) until the date on which notice of change of status is made to the public (such as by publication in the Internal Revenue Bulletin) or another applicable date, if any, specified in such public notice. In appropriate cases, however, the treatment of grants and contributions and the status of grantors and contributors to an organization described in section 509(a) (1), (2), or (3) may be affected pending verification of the continued classification of such organization under section 509(a) (1), (2), or (3). Notice to this affect will be made in a public announcement by the service. In such cases the effect of grants and contributions made after the date of the announcement will depend upon the statutory qualification of the organization as an organization described in section 509(a) (1), (2), or (3).

(b) *Exceptions.* (1) Paragraph (a) of this section shall not apply if the grantor or contributor:

(i) Had knowledge of the revocation of the ruling or determination letter classifying the organization as an organization described in section 509(a) (1), (2), or (3), or

(ii) Was in part responsible for, or was aware of, the act, the failure to act, or the substantial and material change on the part of the organization which gave rise to the revocation of the ruling or determination letter classifying the organization as an organization described in section 509(a) (1), (2), or (3).

(2) Paragraph (a) of this section shall not apply where a different rule is otherwise expressly provided in the regulations under sections 170(b)(1)(A), 507(b)(1)(B), or 509.

[T.D. 7212, 37 FR 21923, Oct. 17, 1972]

§ 1.509(b)–1 Continuation of private foundation status.

(a) *In general.* If an organization is a private foundation (within the meaning of section 509(a)) on October 9, 1969, or becomes a private foundation on any subsequent date, such organization shall be treated as a private foundation for all periods after October 9, 1969, or after such subsequent date, unless its status as such is terminated under section 507. Therefore, if an organization was described in section 501(c)(3) and was a private foundation within the meaning of section 509(a) on October 9, 1969, it shall be treated as a private foundation for all periods thereafter, even though it may also satisfy the requirements of an organization described in some other paragraph of section 501(c). For example, if on October 9, 1969, an organization was described in section 501(c)(3), but because of its activities, it could also have qualified as an organization described in section 501(c)(4), such organization will continue to be treated as a private foundation, if it was a private foundation within the meaning of section 509(a) on October 9, 1969.

(b) *Taxable private foundations.* If an organization is a private foundation on October 9, 1969, and it is determined that it is not exempt under section 501(a) as an organization described in section 501(c)(3) as of any date after October 9, 1969, such organization, even though it may operate thereafter as a taxable entity, will continue to be treated as a private foundation unless its status as such is terminated under section 507. For example, X organization is a private foundation on October 9, 1969. It is subsequently determined that, as of July 1, 1972, X is no longer exempt under section 501(a) as an organization described in section 501(c)(3)

because, for example, it has not conformed its governing instrument pursuant to section 508(e). X will continue to be treated as a private foundation after July 1, 1972, unless its status as such is terminated under section 507. However, if an organization is not exempt under section 501(a) as an organization described in section 501(c)(3) on October 9, 1969, then it will not be treated as a private foundation within the meaning of section 509(a) by reason of section 509(b), unless it becomes a private foundation on a subsequent date.

[T.D. 7212, 37 FR 21924, Oct. 17, 1972]

§ 1.509(c)–1 Status of organization after termination of private foundation status.

(a) *In general.* For purposes of part II of subchapter F of this chapter, an organization whose status as a private foundation is terminated under section 507 shall be treated as an organization created on the day after the date of such termination. An organization whose private foundation status has been terminated under the provisions of section 507(a) will, if it continues to operate, be treated as a new organization and must, if it desires to be classified under section 501(c)(3), give notification that it is applying for recognition of section 501(c)(3) status pursuant to the provisions of section 508(a).

(b) *Effect upon section 507(d)(1).* If the private foundation status of an organization has been terminated under section 507(b)(1)(B) and the regulations thereunder, and:

(1) Such organization does not continue at all times thereafter to meet the requirements of section 509(a) (1), (2), or (3) (and is therefore no longer excluded from the definition of a private foundation); and

(2) The status of such organization as a private foundation is thereafter terminated under section 507(a)

then the tax imposed under section 507(c)(1) upon the aggregate tax benefit (described in section 507(d)(1)) resulting from section 501(c)(3) status shall be computed only upon the aggregate tax benefit resulting after the date on which the organization again becomes a private foundation under subparagraph (1) of this paragraph.

[T.D. 7212, 37 FR 21924, Oct. 17, 1972]

§ 1.509(d)–1 Definition of support

For purposes of section 509(a)(2), the term *support* does not include amounts received in repayment of the principal of a loan or other indebtedness. See, however, section 509(e) as to amounts received as interest on a loan or other indebtedness.

[T.D. 7212, 37 FR 21924, Oct. 17, 1972]

§ 1.509(e)–1 Definition of gross investment income.

For the distinction between gross receipts and gross investment income, see § 1.509(a)–3(m).

(Sec. 7805, Internal Revenue Code of 1954, 68A Stat. 917; 26 U.S.C. 7805)

[T.D. 7212, 37 FR 21925, Oct. 17, 1972]

TAXATION OF BUSINESS INCOME OF CERTAIN EXEMPT ORGANIZATIONS

§ 1.511–1 Imposition and rates of tax.

Section 511(a) imposes a tax upon the unrelated business taxable income of certain organizations otherwise exempt from Federal income tax. Under section 511(a)(1), organizations described in section 511(a)(2)(A) and in paragraph (a) of § 1.511–2 and organizations described in section 511(a)(2)(B) are subject to normal tax and surtax at the corporate rates provided by section 11. Under section 511(b)(1), trusts described in section 511(b)(2) are subject to tax at the individual rates prescribed in section 1(d) of the Code as amended by the Tax Reform Act of 1969 (section 1 for taxable years ending before Jan. 1, 1971). The deduction for personal exemption provided in section 642(b) in the case of a trust taxable under subchapter J, chapter 1 of the Code, is not allowed in computing unrelated business taxable income.

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

§ 1.511–2 Organizations subject to tax.

(a) *Organizations other than trusts and title holding companies.* (1)(i) The taxes imposed by section 511(a)(1) apply in the case of any organization (other than a trust described in section

511(b)(2) or an organization described in section 501(c)(1)) which is exempt from taxation under section 501(a) (except as provided in sections 507 through 515). For special rules concerning corporations described in section 501(c)(2), see paragraph (c) of this section.

(ii) In the case of an organization described in section 501(c)(4), (7), (8), (9), (10), (11), (12), (13), (14)(A), (15), (16), or (18), the taxes imposed by section 511(a)(1) apply only for taxable years beginning after December 31, 1969. In the case of an organization described in section 501(c)(14) (B) or (C), the taxes imposed by section 511(a)(1) apply only for taxable years beginning after February 2, 1966.

(2) The taxes imposed by section 511(a) apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof or by any agency or instrumentality of any one or more governments or political subdivisions. Such taxes also apply in the case of any corporation wholly owned by one or more such colleges or universities. As here used, the word *government* includes any foreign government (to the extent not contrary to any treaty obligation of the United States) and all domestic governments (the United States and any of its Territories or possessions, any State, and the District of Columbia). Elementary and secondary schools operated by such governments are not subject to the tax on unrelated business income.

(3)(i) For taxable years beginning before January 1, 1970, churches and associations or conventions of churches are exempt from the taxes imposed by section 511. The exemption is applicable only to an organization which itself is a church or an association or convention of churches. Subject to the provisions of subdivision (ii) of this subparagraph, religious organizations, including religious orders, if not themselves churches or associations or conventions of churches, and all other organizations which are organized or operated under church auspices, are subject to the tax imposed by section 511, whether or not they engage in religious, educational, or charitable activities approved by a church.

(ii) The term *church* includes a religious order or a religious organization if such order or organization (*a*) is an integral part of a church, and (*b*) is engaged in carrying out the functions of a church, whether as a civil law corporation or otherwise. In determining whether a religious order or organization is an integral part of a church, consideration will be given to the degree to which it is connected with, and controlled by, such church. A religious order or organization shall be considered to be engaged in carrying out the functions of a church if its duties include the ministration of sacerdotal functions and the conduct of religious worship. If a religious order or organization is not an integral part of a church, or if such an order or organization is not authorized to carry out the functions of a church (ministration of sacerdotal functions and conduct of religious worship) then it is subject to the tax imposed by section 511 whether or not it engages in religious, educational, or charitable activities approved by a church. What constitutes the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of a particular religious body constituting a church. If a religious order or organization can fully meet the requirements stated in this subdivision, exemption from the tax imposed by section 511 will apply to all its activities, including those which it conducts through a separate corporation (other than a corporation described in section 501(c)(2)) or other separate entity which it wholly owns and which is not operated for the primary purpose of carrying on a trade or business for profit. Such exemption from tax will also apply to activities conducted through a separate corporation (other than a corporation described in section 501(c)(2)) or other separate entity which is wholly owned by more than one religious order or organization, if all such orders or organizations fully meet the requirements stated in this subdivision and if such corporation or other entity is not operated for the primary purpose of carrying on a trade or business for profit.

(iii) For taxable years beginning after December 31, 1969, churches and conventions or associations of churches are subject to the taxes imposed by section 511, unless otherwise entitled to the benefit of the transitional rules of section 512(b)(14) and § 1.512(b)–1(i).

(b) *Trusts*—(1) *In general.* The taxes imposed by section 511(b) apply in the case of any trust which is exempt from taxation under section 501(a) (except as provided in sections 507 through 515), and which, if it were not for such exemption, would be subject to the provisions of subchapter J, chapter 1, of the Code. An organization which is considered as *trustee* of a stock bonus, pension, or profit-sharing plan described in section 401(a), a supplemental unemployment benefit trust described in section 501(c)(17), or a pension plan described in section 501(c)(18) (regardless of the form of such organization) is subject to the taxes imposed by section 511(b)(1) on its unrelated business income. However, if such an organization conducts a business which is a separate taxable entity on the basis of all the facts and circumstances, for example, an association taxable as a corporation, the business will be taxable as a feeder organization described in section 502.

(2) *Effective dates.* In the case of a trust described in section 501(c)(3), the taxes imposed by section 511(b) apply for taxable years beginning after December 31, 1953. In the case of a trust described in section 401(a), the taxes imposed by section 511(b) apply for taxable years beginning after June 30, 1954. In the case of a trust described in section 501(c)(17), the taxes imposed by section 511(b) apply for taxable years beginning after December 31, 1959. In the case of any other trust described in subparagraph (1) of this paragraph, the taxes imposed by section 511(b) apply for taxable years beginning after December 31, 1969.

(c) *Title Holding Companies*—(1) *In general.* If a corporation described in section 501(c)(2) pays any amount of its net income for a taxable year to an organization exempt from taxation under section 501(a) (or would pay such an amount but for the fact that the expenses of collecting its income exceed its income), and if such corporation and such organization file a consolidated income tax return for such taxable year, then such corporation shall be treated, for purposes of the tax imposed by section 511(a), as being organized and operated for the same purposes as such organization, as well as for its title-holding purpose. Therefore, if an item of income of the section 501(c)(2) corporation is derived from a source which is related to the exempt function of the exempt organization to which such income is payable and with which such corporation files a consolidated return, such item is, together with all deductions directly connected therewith, excluded from the determination of unrelated business taxable income under section 512 and shall not be subject to the tax imposed by section 511(a). If, however, such item of income is derived from a source which is not so related, then such item, less all deductions directly connected therewith, is, subject to the modifications provided in section 512(b), unrelated business taxable income subject to the tax imposed by section 511(a).

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. The income of X, a section 501(c)(2) corporation, is required to be distributed to exempt organization A. During the taxable year X realizes net income of $900,000 from source M and $100,000 from source N. Source M is related to A's exempt function, while source N is not so related. X and A file a consolidated return for such taxable year. X has net unrelated business income of $100,000, subject to the modifications in section 512(b).

(3) *Cross reference.* For rules relating generally to the filing of consolidated returns by certain organizations exempt from taxation under section 501(a), see section 1504(e) of the Code and § 1.1502–100.

(4) *Effective dates.* Subparagraphs (1) through (3) of this paragraph apply with respect to taxable years beginning after December 31, 1969. For taxable years beginning before January 1, 1970, a corporation described in section 501(c)(2) and otherwise exempt from taxation under section 501(a) is taxable upon its unrelated business taxable income only if such income is payable either:

(i) To a church or convention or association of churches, or

(ii) To any organization subject, for taxable years beginning before January 1, 1970, to the tax imposed by section 511(a)(1).

(d) The fact that any class of organizations exempt from taxation under section 501(a) is subject to the unrelated business income tax under section 511 and this section does not in any way enlarge the permissible scope of business activities of such class for purposes of the continued qualification of such class under section 501(a).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7183, 37 FR 7884, Apr. 21, 1972; T.D. 7632, 44 FR 42681, July 20, 1979]

§ 1.511–3 Provisions generally applicable to the tax on unrelated business income.

(a) *Assessment and collections.* Since the taxes imposed by section 511 are taxes imposed by subtitle A of the Code, all provisions of law and of the regulations applicable to the taxes imposed by subtitle A are applicable to the assessment and collection of the taxes imposed by section 511. Organizations subject to the tax imposed by section 511(a)(1) are subject to the same provisions, including penalties, as are provided in the case of the income tax of other corporations. In the case of a trust subject to the tax imposed by section 511(b)(1), the fiduciaries for such trust are subject to the same provisions, including penalties, as are applicable to fiduciaries in the case of the income tax of other trusts. See section 6151, *et seq.*, and the regulations prescribed thereunder, for provisions relating to payment of tax.

(b) *Returns.* For requirements of filing annual returns with respect to unrelated business taxable income by organizations subject to the tax on such income, see section 6012, paragraph (e) of § 1.6012–2, and paragraph (a)(5) of § 1.6012–3.

(c) *Taxable years, method of accounting, etc.* The taxable year (fiscal year or calendar year, as the case may be) of an organization shall be determined without regard to the fact that such organization may have been exempt from tax during any prior period. See sections 441 and 446, and the regulations thereunder in this part, and section 7701 and the regulations in part 301 of this chapter (Regulations on Procedure and Administration). Similarly, in computing unrelated business taxable income, the determination of the taxable year for which an item of income or expense is taken into account shall be made under the provisions of sections 441, 446, 451, and 461, and the regulations thereunder, whether or not the item arose during a taxable year beginning before, on, or after the effective date of the provisions imposing a tax upon unrelated business taxable income. If a method for treating bad debts was selected in a return of income (other than an information return) for a previous taxable year, the taxpayer must follow such method in its returns under section 511, unless such method is changed in accordance with the provisions of § 1.166–1. A taxpayer which has not previously selected a method for treating bad debts may, in its first return under section 511, exercise the option granted in § 1.166–1.

(d) *Foreign tax credit.* See section 515 for provisions applicable to the credit for foreign taxes provided in section 901.

§ 1.511–4 Minimum tax for tax preferences.

The tax imposed by section 56 applies to an organization subject to tax under section 511 with respect to items of tax preference which enter into the computation of unrelated business taxable income. For this purpose, only those items of income and those deductions entering into the determination of the tax imposed by this section are considered in the determination of the items of tax preference under section 57. For rules relating to the minimum tax for tax preferences, see sections 56 through 58 and the regulations thereunder.

[T.D. 7564, 43 FR 40494, Sept. 12, 1978]

§ 1.512(a)–1 Definition.

(a) *In general.* Except as otherwise provided in § 1.512(a)–3, § 1.512(a)–4, or paragraph (f) of this section, section 512(a)(1) defines *unrelated business taxable income* as the gross income derived from any unrelated trade or business

regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain modifications referred to in §1.512(b)–1. To be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business. Except as provided in paragraph (d)(2) of this section, to be *directly connected with* the conduct of unrelated business for purposes of section 512, an item of deduction must have proximate and primary relationship to the carrying on of that business. In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities. For the treatment of amounts of income or loss of common trust funds, see §1.584–2(c)(3).

(b) *Expenses attributable solely to unrelated business activities.* Expenses, depreciation, and similar items attributable solely to the conduct of unrelated business activities are proximately and primarily related to that business activity, and therefore qualify for deduction to the extent that they meet the requirements of section 162, section 167, or other relevant provisions of the Code, connected with the conduct of that activity and are deductible in computing unrelated business activities are directly connected with the conduct of that activity and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of section 162. Similarly, depreciation of a building used entirely in the conduct of unrelated business activities would be an allowable deduction to the extent otherwise permitted by section 167.

(c) *Dual use of facilities or personnel.* Where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities (as, for example, items of overhead), shall be allocated between the two uses on a reasonable basis. Similarly, where personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable to such personnel (as, for example, items of salary) shall be allocated between the two uses on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business activity is proximately and primarily related to that business activity, and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by section 162, section 167, or other relevant provisions of the Code. Thus, for example, assume that X, an exempt organization subject to the provisions of section 511, pays its president a salary of $20,000 a year. X derives gross income from the conduct of unrelated trade or business activities. The president devotes approximately 10 percent of his time during the year to the unrelated business activity. For purposes of computing X's unrelated business taxable income, a deduction of $2,000 (10 percent of $20,000), would be allowable for the salary paid to its president.

(d) *Exploitation of exempt activities*—(1) *In general.* In certain cases, gross income is derived from an unrelated trade or business activity which exploits an exempt activity. One example of such exploitation is the sale of advertising in a periodical of an exempt organization which contains editorial material related to the accomplishment of the organization's exempt purpose. Except as specified in subparagraph (2) of this paragraph and paragraph (f) of this section, in such cases, expenses, depreciation and similar items attributable to the conduct of the exempt activities are not deductible in computing unrelated business taxable income. Since such items are incident to an activity which is carried on in furtherance of the exempt purpose of the organization, they do not possess the necessary proximate and primary relationship to the unrelated trade or business activity and are

therefore not directly connected with that business activity.

(2) *Allowable deductions*. Where an unrelated trade or business activity is of a kind carried on for profit by taxable organizations and where the exempt activity exploited by the business is a type of activity normally conducted by taxable organizations in pursuance of such business, expenses, depreciation, and similar items which are attributable to the exempt activity qualify as directly connected with the carrying on of the unrelated trade or business activity to the extent that:

(i) The aggregate of such items exceeds the income (if any) derived from or attributable to the exempt activity; and

(ii) The allocation of such excess to the unrelated trade or business activity does not result in a loss from such unrelated trade or business activity

Under the rule of the preceding sentence, expenses, depreciation and similar items paid or incurred in the performance of an exempt activity must be allocated first to the exempt activity to the extent of the income derived from or attributable to the performance of that activity. Furthermore, such items are in no event allocable to the unrelated trade or business activity exploiting such exempt activity to the extent that their deduction would result in a loss carryover or carryback with respect to that trade or business activity. Similarly, they may not be taken into account in computing unrelated business taxable income attributable to any unrelated trade or business activity not exploiting the same exempt activity. See paragraph (f) of this section for the application of these rules to periodicals published by exempt organizations.

(e) *Examples*. This section is illustrated by the following examples:

Example 1. W is an exempt business league with a large membership. Under an arrangement with an advertising agency W regularly mails brochures, pamphlets and other advertising materials to its members, charging the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of the purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from an unrelated trade or business activity. In computing W's unrelated business taxable income, the expenses attributable solely to the conduct of the business, or allocable to such business under the rule of paragraph (c) of this section, are allowable as deductions in accordance with the provisions of section 162. Such deductions include the costs of handling and mailing, the salaries of personnel used full-time in the unrelated business activity and an allocable portion of the salaries of personnel used both to carry on exempt activities and to conduct the unrelated business activity. However, costs of developing W's membership and carrying on its exempt activities are not deductible. Those costs are necessary to the maintenance of the intangible asset exploited in the unrelated business activity—W's membership—but are incurred primarily in connection with W's fundamental purpose as an exempt organization. As a consequence, they do not have proximate and primary relationship to the conduct of the unrelated business activity and do not qualify as directly connected with it.

Example 2. (i) P, a manufacturer of photographic equipment, underwrites a photography exhibition organized by M, an art museum described in section 501(c)(3). In return for a payment of $100,000, M agrees that the exhibition catalog sold by M in connection with the exhibit will advertise P's product. The exhibition catalog will also include educational material, such as copies of photographs included in the exhibition, interviews with photographers, and an essay by the curator of M's department of photography. For purposes of this example, assume that none of the $100,000 is a qualified sponsorship payment within the meaning of section 513(i) and §1.513–4, that M's advertising activity is regularly carried on, and that the entire amount of the payment is unrelated business taxable income to M. Expenses directly connected with generating the unrelated business taxable income (i.e., direct advertising costs) total $25,000. Expenses directly connected with the preparation and publication of the exhibition catalog (other than direct advertising costs) total $110,000. M receives $60,000 of gross revenue from sales of the exhibition catalog. Expenses directly connected with the conduct of the exhibition total $500,000.

(ii) The computation of unrelated business taxable income is as follows:

(A) Unrelated trade or business (sale of advertising):		
Income	$100,000	
Directly-connected expenses	(25,000)	
Subtotal	75,000	$75,000
(B) Exempt function (publication of exhibition catalog):		
Income (from catalog sales)	60,000	

Directly-connected expenses	(110,000)	
Net exempt function income (loss)	(50,000)	(50,000)
Unrelated business taxable income		25,000

(iii) Expenses related to publication of the exhibition catalog exceed revenues by $50,000. Because the unrelated business activity (the sale of advertising) exploits an exempt activity (the publication of the exhibition catalog), and because the publication of editorial material is an activity normally conducted by taxable entities that sell advertising, the net loss from the exempt publication activity is allowed as a deduction from unrelated business income under paragraph (d)(2) of this section. In contrast, the presentation of an exhibition is not an activity normally conducted by taxable entities engaged in advertising and publication activity for purposes of paragraph (d)(2) of this section. Consequently, the $500,000 cost of presenting the exhibition is not directly connected with the conduct of the unrelated advertising activity and does not have a proximate and primary relationship to that activity. Accordingly, M has unrelated business taxable income of $25,000.

(f) *Determination of unrelated business taxable income derived from sale of advertising in exempt organization periodicals*—(1) *In general.* Under section 513 (relating to the definition of unrelated trade or business) and §1.513–1, amounts realized by an exempt organization from the sale of advertising in a periodical constitute gross income from an unrelated trade or business activity involving the exploitation of an exempt activity; namely, the circulation and readership of the periodical developed through the production and distribution of the readership content of the periodical. Paragraph (d) of this section provides for the allowance of deductions attributable to the production and distribution of the readership content of the periodical. Thus, subject to the limitations of paragraph (d)(2) of this section, where the circulation and readership of an exempt organization periodical are utilized in connection with the sale of advertising in the periodical, expenses, depreciation, and similar items of deductions attributable to the production and distribution of the editorial or readership content of the periodical shall qualify as items of deductions directly connected with the unrelated advertising activity. Subparagraphs (2) through (6) of this paragraph provide rules for determining the amount of unrelated business taxable income attributable to the sale of advertising in exempt organization periodicals. Subparagraph (7) of this paragraph provides rules for determining when the unrelated business taxable income of two or more exempt organization periodicals may be determined on a consolidated basis.

(2) *Computation of unrelated business taxable income attributable to sale of advertising*—(i) *Excess advertising costs.* If the direct advertising costs of an exempt organization periodical (determined under subparagraph (6)(ii) of this paragraph) exceed gross advertising income (determined under subparagraph (3)(ii) of this paragraph), such excess shall be allowable as a deduction in determining unrelated business taxable income from any unrelated trade or business activity carried on by the organization.

(ii) *Excess advertising income.* If the gross advertising income of an exempt organization periodical exceeds direct advertising costs, paragraph (d)(2) of this section provides that items of deduction attributable to the production and distribution of the readership content of an exempt organization periodical shall qualify as items of deduction directly connected with unrelated advertising activity in computing the amount of unrelated business taxable income derived from the advertising activity to the extent that such items exceed the income derived from or attributable to such production and distribution, but only to the extent that such items do not result in a loss from such advertising activity. Furthermore, such items of deduction shall not qualify as directly connected with such advertising activity to the extent that their deduction would result in a loss carryback or carryover with respect to such advertising activity. Similarly, such items of deduction shall not be taken into account in computing unrelated business taxable income attributable to any unrelated trade or business activity other than such advertising activity. Thus:

(*a*) If the circulation income of the periodical (determined under subparagraph (3)(iii) of this paragraph) equals

or exceeds the readership costs of such periodical (determined under subparagraph (6)(iii) of this paragraph), the unrelated business taxable income attributable to the periodical is the excess of the gross advertising income of the periodical over direct advertising costs; but

(*b*) If the readership costs of an exempt organization periodical exceed the circulation income of the periodical, the unrelated business taxable income is the excess, if any, of the total income attributable to the periodical (determined under subparagraph (3) of this paragraph) over the total periodical costs (as defined in subparagraph (6)(i) of this paragraph)

See subparagraph (7) of this paragraph for rules relating to the consolidation of two or more periodicals.

(iii) *Examples.* The application of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the production and distribution of the readership content of the periodical is related to the organization's exempt purpose.

Example 1. X, an exempt trade association, publishes a single periodical which carries advertising. During 1971, X realizes a total of $40,000 from the sale of advertising in the periodical (gross advertising income) and $60,000 from the sales of the periodical to members and nonmembers (circulation income). The total periodical costs are $90,000 of which $50,000 is directly connected with the sale and publication of advertising (direct advertising costs) and $40,000 is attributable to the production and distribution of the readership content (readership costs). Since the direct advertising costs of the periodical ($50,000) exceed gross advertising income ($40,000), pursuant to subdivision (i) of this subparagraph, the unrelated business taxable income attributable to advertising is determined solely on the basis of the income and deductions directly connected with the production and sale of the advertising:

Gross advertising revenue	$40,000
Direct advertising costs	(50,000)
Loss attributable to advertising	(10,000)

X has realized a loss of $10,000 from its advertising activity. This loss is an allowable deduction in computing X's unrelated business taxable income derived from any other unrelated trade or business activity.

Example 2. Assume the facts as stated in example 1, except that the circulation income of X periodical is $100,000 instead of $60,000, and that of the total periodical costs, $25,000 are direct advertising costs, and $65,000 are readership costs. Since the circulation income ($100,000) exceeds the total readership costs ($65,000), pursuant to subdivision (ii)(*a*) of this subparagraph the unrelated business taxable income attributable to the advertising activity is $15,000, the excess of gross advertising income ($40,000) over direct advertising costs ($25,000).

Example 3. Assume the facts as stated in example 1, except that of the total periodical costs, $20,000 are direct advertising costs and $70,000 are readership costs. Since the readership costs of the periodical ($70,000), exceed the circulation income ($60,000), pursuant to subdivision (ii) (*b*) of this subparagraph the unrelated business taxable income attributable to advertising is the excess of the total income attributable to the periodical over the total periodical costs. Thus, X has unrelated business taxable income attributable to the advertising activity of $10,000 ($100,000 total income attributable to the periodical less $90,000 total periodical costs).

Example 4. Assume the facts as stated in example 1, except that the total periodical costs are $120,000 of which $30,000 are direct advertising costs and $90,000 are readership costs. Since the readership costs of the periodical ($90,000), exceed the circulation income ($60,000), pursuant to subdivision (ii) (*b*) of this subparagraph the unrelated business taxable income attributable to advertising is the excess, if any, of the total income attributable to the periodical over the total periodical costs. Since the total income of the periodical ($100,000) does not exceed the total periodical costs ($120,000), X has not derived any unrelated business taxable income from the advertising activity. Further, only $70,000 of the $90,000 of readership costs may be deducted in computing unrelated business taxable income since as provided in subdivision (ii) of this subparagraph, such costs may be deducted, to the extent they exceed circulation income, only to the extent they do not result in a loss from the advertising activity. Thus, there is no loss from such activity, and no amount may be deducted on this account in computing X's unrelated trade or business income derived from any other unrelated trade or business activity.

(3) *Income attributable to exempt organization periodicals*—(i) *In general.* For purposes of this paragraph the total income attributable to an exempt organization periodical is the sum of its gross advertising income and its circulation income.

(ii) *Gross advertising income.* The term *gross advertising income* means all amounts derived from the unrelated

advertising activities of an exempt organization periodical (or for purposes of this paragraph in the case of a taxable organization, all amounts derived from the advertising activities of the taxable organization).

(iii) *Circulation income*. The term *circulation income* means the income attributable to the production, distribution or circulation of a periodical (other than gross advertising income) including all amounts realized from or attributable to the sale or distribution of the readership content of the periodical, such as amounts realized from charges made for reprinting or republishing articles and special items in the periodical and amounts realized from sales of back issues. Where the right to receive an exempt organization periodical is associated with membership or similar status in such organization for which dues, fees or other charges are received (hereinafter referred to as *membership receipts*), circulation income includes the portion of such membership receipts allocable to the periodical (hereinafter referred to as *allocable membership receipts*). Allocable membership receipts is the amount which would have been charged and paid if:

(*a*) The periodical was that of a taxable organization.

(*b*) The periodical was published for profit, and

(*c*) The member was an unrelated party dealing with the taxable organization at arm's length

See subparagraph (4) of this paragraph for a discussion of the factors to be considered in determining allocable membership receipts of an exempt organization periodical under the standard described in the preceding sentence.

(4) *Allocable membership receipts*. The allocable membership receipts of an exempt organization periodical shall be determined in accordance with the following rules:

(i) *Subscription price charged to nonmembers*. If 20 percent or more of the total circulation of a periodical consist of sales to nonmembers, the subscription price charged to such nonmembers shall determine the price of the periodical for purposes of allocating membership receipts to the periodical.

(ii) *Subscription price to nonmembers*. If paragraph (f)(4)(i) of this section does not apply and if the membership dues from 20 percent or more of the members of an exempt organization are less than those received from the other members because the former members do not receive the periodical, the amount of the reduction in membership dues for a member not receiving the periodical shall determine the price of the periodical for purposes of allocating membership receipts to the periodical.

(iii) *Pro rata allocation of membership receipts*. Since it may generally be assumed that membership receipts and gross advertising income are equally available for all the exempt activities (including the periodical) of the organization, the share of membership receipts allocated to the periodical, where paragraphs (f)(4) (i) and (ii) of this section do not apply, shall be an amount equal to the organization's membership receipts multiplied by a fraction the numerator of which is the total periodical costs and the denominator of which is such costs plus the cost of other exempt activities of the organization. For example, assume that an exempt organization has total periodical costs of $30,000 and other exempt costs of $70,000. Further assume that the membership receipts of the organization are $60,000 and that paragraphs (f)(4) (i) and (ii) of this section do not apply. Under these circumstances $18,000 ($60,000 times $30,000/$100,000) is allocated to the periodical's circulation income.

(5) *Examples*. The rules set forth in paragraph (f)(4) of this section may be illustrated by the following examples. For purposes of these examples it is assumed that the exempt organization periodical contains advertising, and that the production and distribution of the readership content of the periodical is related to the organization's exempt purpose.

Example 1. U is an exempt scientific organization with 10,000 members who pay annual dues of $15 per year. One of U's activities is the publication of a monthly periodical which is distributed to all of its members. U also distributes 5,000 additional copies of its periodical to nonmember subscribers at a cost of $10 per year. Pursuant to paragraph (f)(4)(i) of this section, since the nonmember

circulation of U's periodical represents 33⅓ percent of its total circulation the subscription price charged to nonmembers will be used to determine the portion of U's membership receipts allocable to the periodical. Thus, U's allocable membership receipts will be $100,000 ($10 times 10,000 members), and U's total circulation income for the periodical will be $150,000 ($100,000 from members plus $50,000 from sales to nonmembers).

Example 2. Assume the facts as stated in example 1, except that U sells only 500 copies of its periodical to nonmembers, at a price of $10 per year. Assume further that U's members may elect not to receive the periodical, in which case their annual dues are reduced from $15 per year to $6 per year, and that only 3,000 members elect to receive the periodical and pay the full dues of $15 per year. U's stated subscription price to members of $9 consistently results in an excess of total income (including gross advertising income) attributable to the periodical over total costs of the periodical. Since the 500 copies of the periodical distributed to nonmembers represents only 14 percent of the 3,500 copies distributed, pursuant to paragraph (f)(4)(i) of this section, the $10 subscription price charged to nonmembers will not be used in determining the portion of membership receipts allocable to the periodical. On the other hand, since 70 percent of the members elect not to receive the periodical and pay $9 less per year in dues, pursuant to paragraph (f)(4)(ii) of this section, such $9 price will be used in determining the subscription price charged to members. Thus, the allocable membership receipts will be $9 per member, or $27,000 ($9 times 3,000 copies) and U's total circulation income will be $32,000 ($27,000 plus $5,000).

Example 3. (a) W, an exempt trade association, has 800 members who pay annual dues of $50 per year. W publishes a monthly journal the editorial content and advertising of which are directed to the business interests of its own members. The journal is distributed to all of W's members and no receipts are derived from nonmembers.

(b) W has total receipts of $100,000 of which $40,000 ($50 × 800) are membership receipts and $60,000 are gross advertising income. W's total costs for the journal and other exempt activities is $100,000. W has total periodical costs of $76,000 of which $41,000 are direct advertising costs and $35,000 are readership costs.

(c) Paragraph (f)(4)(i) of this section will not apply since no copies are available to nonmembers. Therefore, the allocation of membership receipts shall be made in accordance with paragraph (f)(4)(iii) of this section. Based upon pro rata allocation of membership receipts (40,000) by a fraction the numerator of which is total periodical costs ($76,000) and the denominator of which is the total costs of the journal and the other exempt activities ($100,000), $30,400 ($76,000/$100,000 times $40,000) of membership receipts is circulation income.

(6) *Deductions attributable to exempt organization periodicals*—(i) *In general.* For purposes of this paragraph the term *total periodical costs* means the total deductions attributable to the periodical. For purposes of this paragraph the total periodical costs of an exempt organization periodical are the sum of the direct advertising costs of the periodical (determined under subdivision (ii) of this subparagraph) and the readership costs of the periodical (determined under subdivision (iii) of this subparagraph). Items of deduction properly attributable to exempt activities other than the publication of an exempt organization periodical may not be allocated to such periodical. Where items are attributable both to an exempt organization periodical and to other activities of an exempt organization, the allocation of such items must be made on a reasonable basis which fairly reflects the portion of such item properly attributable to each such activity. The method of allocation will vary with the nature of the item, but once adopted, a reasonable method of allocation with respect to an item must be used consistently. Thus, for example, salaries may generally be allocated among various activities on the basis of the time devoted to each activity; occupancy costs such as rent, heat and electricity may be allocated on the basis of the portion of space devoted to each activity; and depreciation may be allocated on the basis of space occupied and the portion of the particular asset utilized in each activity. Allocations based on dollar receipts from various exempt activities will generally not be reasonable since such receipts are usually not an accurate reflection of the costs associated with activities carried on by exempt organizations.

(ii) *Direct advertising costs. (a)* The direct advertising costs of an exempt organization periodical include all expenses, depreciation, and similar items of deduction which are directly connected with the sale and publication of advertising as determined in accordance with paragraphs (a), (b), and (c) of this section. These items are allowable as deductions in the computation of

unrelated business income of the organization for the taxable year to the extent they meet the requirements of section 162, section 167, or other relevant provisions of the Code. The items allowable as deductions under this subdivision do not include any items of deduction attributable to the production or distribution of the readership content of the periodical.

(*b*) The items allowable as deductions under this subdivision would include agency commissions and other direct selling costs, such as transportation and travel expenses, office salaries, promotion and research expenses, and direct office overhead directly connected with the sale of advertising lineage in the periodical. Also included would be other items of deduction commonly classified as advertising costs under standard account classification, such as art work and copy preparation, telephone, telegraph, postage, and similar costs directly connected with advertising.

(*c*) In addition to the items of deduction normally included in standard account classifications relating to advertising costs, it is also necessary to ascertain the portion of mechanical and distribution costs attributable to advertising lineage. For this purpose, the general account classifications of items includible in mechanical and distribution costs ordinarily employed in business-paper and consumer publication accounting provide a guide for the computation. Thus, the mechanical and distribution costs in such cases would include the portion of the costs and other expenses of composition, presswork, binding, mailing (including paper and wrappers used for mailing), and the bulk postage attributable to the advertising lineage of the publication. The portion of mechanical and distribution costs attributable to advertising lineage of the periodical will be determined on the basis of the ratio of advertising lineage to total lineage of the periodical, and the application of that ratio to the total mechanical and distribution costs of the periodical, where records are not kept in such a manner as to reflect more accurately the allocation of mechanical and distributions costs to advertising lineage of the periodical, and where there is no factor in the character of the periodical to indicate that such an allocation would be unreasonable.

(iii) *Readership costs.* The *readership costs* of an exempt organization periodical include expenses, depreciation or similar items which are directly connected with the production and distribution of the readership content of the periodical and which would otherwise be allowable as deductions in determining unrelated business taxable income under section 512 and the regulations thereunder if such production and distribution constituted an unrelated trade or business activity. Thus, readership costs include all the items of deduction attributable to an exempt organization periodical which are not allocated to direct advertising costs under subdivision (ii) of this subparagraph, including the portion of such items attributable to the readership content of the periodical, as opposed to the advertising content, and the portion of mechanical and distribution costs which is not attributable to advertising lineage in the periodical.

(7) *Consolidation*—(i) *In general.* Where an exempt organization subject to unrelated business income tax under section 511 publishes two or more periodicals for the production of income, it may treat the gross income from all (but not less than all) of such periodicals and the items of deduction directly connected with such periodicals (including readership costs of such periodicals), on a consolidated basis as if such periodicals were one periodical in determining the amount of unrelated business taxable income derived from the sale of advertising in such periodical. Such treatment must, however, be followed consistently and once adopted shall be binding unless the consent of the Commissioner is obtained as provided in sections 446(e) and § 1.446–1(e).

(ii) *Production of income.* For purposes of this subparagraph, an exempt organization periodical is *published for the production of income* if:

(*a*) The organization generally receives gross advertising income from the periodical equal to at least 25 percent of the readership costs of such periodical, and

(*b*) The publication of such periodical is an activity engaged in for profit

For purposes of the preceding sentence, the determination whether the publication of a periodical is an activity engaged in for profit is to be made by reference to objective standards taking into account all the facts and circumstances involved in each case. The facts and circumstances must indicate that the organization carries on the activity with the objective that the publication of the periodical will result in economic profit (without regard to tax consequences), although not necessarily in a particular year. Thus, an exempt organization periodical may be treated as having been published with such an objective even though in a particular year its total periodical costs exceed its total income. Similarly, if an exempt organization begins publishing a new periodical, the fact that the total periodical costs exceed the total income for the startup years because of a lack of advertising sales does not mean that the periodical was published without an objective of economic profit. The organization may establish that the activity was carried on with such an objective. This might be established by showing, for example, that there is a reasonable expectation that the total income, by reason of an increase in advertising sales, will exceed costs within a reasonable time. See §1.183–2 for additional factors bearing on this determination.

(iii) *Example*. This subparagraph may be illustrated by the following example:

Example. Y, an exempt trade association, publishes three periodicals which it distributes to its members: a weekly newsletter, a monthly magazine, and quarterly journal. Both the monthly magazine and the quarterly journal contain advertising which accounts for gross advertising income equal to more than 25 percent of their respective readership costs. Similarly, the total income attributable to each such periodical has exceeded the total deductions attributable to each such periodical for substantially all the years they have been published. The newsletter carries no advertising and its annual subscription price is not intended to cover the cost of publication. The newsletter is a service of Y distributed to all of its members in an effort to keep them informed of changes occurring in the business world and is not engaged in for profit. Under these circumstances, Y may consolidate the income and deductions from the monthly and quarterly journals in computing its unrelated business taxable income, but may not consolidate the income and deductions attributable to the publication of the newsletter with the income and deductions of its other periodicals since the newsletter is not published for the production of income.

(g) *Foreign organizations*—(1) *In general*. The unrelated business taxable income of a foreign organization exempt from taxation under section 501(a) consists of:

(i) The organization's unrelated business taxable income which is derived from sources within the United States but which is not effectively connected with the conduct of a trade or business within the United States, plus

(ii) The organization's unrelated business taxable income effectively connected with the conduct of a trade or business within the United States (whether or not such income is derived from sources within the United States)

To determine whether income realized by a foreign organization is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, see part 1, subchapter N, chapter 1 of the Code (section 861 and following) and the regulations thereunder.

(2) *Effective dates*. Subparagraph (1) of this paragraph applies to taxable years beginning after December 31, 1969. For taxable years beginning on or before December 31, 1969, the unrelated business taxable income of a foreign organization exempt from taxation under section 501(a) consists of the organization's unrelated business taxable income which:

(i) For taxable years beginning after December 31, 1966, is effectively connected with the conduct of a trade or business within the United States, whether or not such income is derived from sources within the United States;

(ii) For taxable years beginning on or before December 31, 1966, is derived from sources within the United States.

(h) *Effective date*. Paragraphs (a) through (f) of this section are applicable with respect to taxable years beginning after December 12, 1967. However,

if a taxpayer wishes to rely on the rules stated therein for taxable years beginning before December 13, 1967, he may do so.

[T.D. 7392, 40 FR 58638, Dec. 18, 1975, as amended by T.D. 7438, 41 FR 44392, Oct. 8, 1976; T.D. 7935, 49 FR 1694, Jan. 13, 1984; T.D. 8991, 67 FR 20437, Apr. 25, 2002]

§ 1.512(a)–2 Definition applicable to taxable years beginning before December 13, 1967.

(a) *In general*. The unrelated business taxable income which is subject to the tax imposed by section 511 is the gross income, derived by any organization to which section 511 applies, from any unrelated trade or business regularly carried on by it, less the deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain exceptions, additions, and limitations referred to below. In the case of an organization which regularly carries on two or more unrelated businesses, its unrelated business taxable income is the aggregate of its gross income from all such unrelated businesses, less the aggregate of the deductions allowed with respect to all such unrelated businesses. For provisions generally applicable to the unrelated business tax, see § 1.511–3, and for rules applicable to the determination of the adjusted basis of property, see paragraph (a)(2) of § 1.514(a)–1.

(b) *Effective date*. Except as provided in paragraph (f) of § 1.512(a)–1, this section is applicable with respect to taxable years beginning before December 13, 1967.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6939, 32 FR 17660, Dec. 12, 1967]

§ 1.512(a)–3 [Reserved]

§ 1.512(a)–4 Special rules applicable to war veterans organizations.

(a) *In general*. For taxable years beginning after December 31, 1969, this section provides special rules for the determination of the unrelated business taxable income of an organization described in section 501(c)(19). In general, the rules contained in sections 511 through 514 which are applicable to any organization listed in section 501(c) apply in determining the unrelated business taxable income of an organization described in section 501(c)(19). However, that amount which is paid by members to the organization for the purpose described in paragraph (b)(1) of this section, if set aside from other organizational monies and accounts in an insurance set aside, may be excluded from the unrelated business taxable income of the organization. The insurance set aside shall be used exclusively for providing insurance benefits, for the purposes specified in section 170(c)(4) of the Code, for the reasonable costs of administering the insurance program that are directly related to such set aside, or for the reasonable costs of distributing funds for section 170(c)(4) purposes. If an amount so set aside is used for any purposes other than those described in the preceding sentence, it shall be included in unrelated business taxable income without regard to any modifications provided by section 512(b), in the taxable year in which it is withdrawn from such set aside. Amounts will be considered to have been withdrawn from an insurance set aside if they are used in any manner inconsistent with providing insurance benefits, paying the reasonable costs of administering the insurance program for section 170(c)(4) purposes and for costs of distributing funds for section 170(c)(4) purposes. An example of a use of funds which would be considered a withdrawal would be the use of such funds as security for a loan.

(b) *Insurance set aside*—(1) *Purpose of payments by members*. Payments by members (including commissions on such payments earned by the set aside as agent for an insurance company) into an insurance set aside must be for the sole purpose of obtaining life, sick, accident or health insurance benefits from the organization or for the reasonable costs of administration of the insurance program, except that such purpose is not violated when excess funds from an experience gain are utilized for those purposes specified in section 170(c)(4) or the reasonable costs of distributing funds for such purposes. Funds for any other purpose may not be set aside in the insurance set aside.

(2) *Income from set aside*. In addition to the payments by members described

in paragraph (b)(1) of this section, only income from amounts in the insurance set aside (including commissions earned as agent for an insurance company) may be so set aside. Moreover unless such income is used for providing insurance benefits, for those purposes specified in section 170(c)(4), or for reasonable costs of administration, such income must be set aside within the period described in paragraph (b)(3) of this section in order to avoid being included as an item of unrelated business taxable income under section 512(a)(4).

(3) *Time within which income must be set aside.* Income from amounts in the insurance set aside generally must be set aside in the taxable year in which it would be includible in gross income but for this section. However, income set aside on or before the date prescribed for filing the organization's return of unrelated business taxable income (whether or not it had such income) for the taxable year (including any extension of time) may, at the election of the organization, be treated as having been set aside in such taxable year.

(4) *Computation of income from set aside.* Income from amounts in the insurance set aside shall consist solely of items of investment income from, and other gains derived from dealings in, property in the set aside. The deductions allowed against such items of income or other gains are those amounts which are related to the production of such income or other gains. Only the amounts of income or other gain which are in excess of such deductions may be set aside in the insurance set aside.

(5) *Requirements for set aside.* An amount is not properly set aside if the organization commingles it with any amount which is not to be set aside. However, adequate records describing the amount set aside and indicating that it is to be used for the designated purpose are sufficient. Amounts that are set aside need not be permanently committed to such use either under state law or by contract. Thus, for example, it is not necessary that the organization place these funds in an irrevocable trust. Although set aside income may be accumulated, any accumulation which is unreasonable in amount or duration is evidence that the income was not accumulated for the purposes set forth. For purposes of the preceding sentence, accumulations which are reasonably necessary for the purpose of providing life, sick, health, or accident insurance benefits on the basis of recognized mortality or morbidity tables and assumed rates of interest under an actuarially acceptable method would not be unreasonable even though such accumulations are quite large and the time between the receipt by the organization of such amounts and the date of payment of the benefits is quite long. For example, an accumulation of income for 20 years or longer which is determined to be reasonable necessary to pay life insurance benefits to members, their dependents or designated beneficiaries, generally would not be an unreasonable accumulation. Income which has been set aside may be invested, pending the action contemplated by the set aside, without being regarded as having been used for other purposes.

[T.D. 7438, 41 FR 44393, Oct. 8, 1976]

§ 1.512(a)–5T Questions and answers relating to the unrelated business taxable income of organizations described in paragraphs (9), (17) or (20) of Section 501(c) (temporary).

Q–1: What does section 512(a)(3), as amended by the Tax Reform Act of 1984 (Act), provide with respect to organizations described in paragraphs (9), (17) or (20) of section 501(c)?

A–1: In general, section 512(a)(3), as amended by section 511 of the Act, extends the rules for determining the unrelated business income tax of voluntary employees' beneficiary associations (VEBAs) to supplemental unemployment compensation benefit trusts (SUBs) and group legal service organizations (GLSOs). The section also restricts the amount of income that may be set aside by such organizations for exempt purposes.

Q–2: What is the effective date of the amendments to section 512(a)(3)?

A–2: The amendments to section 512(a)(3) will apply to income earned by VEBAs, SUBs or GLSOs after December 31, 1985, in the taxable years of such organizations ending after such date. For purposes of applying section 512(a)(3) to the first taxable year of such an organization ending after December 31, 1985, the income of the VEBA, SUB or GLSO earned after December 31, 1985, will be determined by allocating the total income earned

for such taxable year on the basis of the calendar year 1985 and 1986 months in such taxable year. However, if a VEBA, SUB or GLSO is part of a plan that is maintained pursuant to one or more collective bargaining agreements (a) between employee representatives and one or more employers, and (b) which are in effect on July 1, 1985 (or ratified on or before that date), the amendments do not apply to income earned in a taxable year of a VEBA, SUB or GLSO beginning before the termination of the last of the collective bargaining agreements pursuant to which the plan is maintained (determined without regard to any extension of the contract agreed to after July 1, 1985). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added under section 511 of the Tax Reform Act 1984 (i.e., requirements under section 419, 419A, 512(a)(3)(E), and 4976) shall not be treated as a termination of such collective bargaining agreements.

Q–3: What amount of income may a VEBA, SUB or GLSO set aside for exempt purposes?

A–3: (a) Pursuant to section 512(a)(3)(E)(i), the amounts set aside in a VEBA, SUB, or GLSO (including a VEBA, SUB, or GLSO that is part of a 10 or more employer plan, as defined in section 419A(f)(6)(B)) as of the close of a taxable year of such VEBA, SUB, or GLSO to provide for the payment of life, sick, accident, or other benefits may not be taken into account for purposes of determining *exempt function income* to the extent that such amounts exceed the qualified asset account limit, determined under sections 419A(c) and 419A(f)(7), for such taxable year of the VEBA, SUB, or GLSO. In calculating the qualified asset account limit for this purpose, a reserve for post-retirement medical benefits under section 419A(c)(2)(A) is not to be taken into account.

(b) The exempt function income of a VEBA, SUB, or GLSO for a taxable year of such an organization, under section 512(a)(3)(B), includes: (1) Certain amounts paid by members of the VEBA, SUB, or GLSO within the meaning of the first sentence of section 512(a)(3)(B) (*member contributions*); and (2) other income of the VEBA, SUB, or GLSO (including earnings on member contributions) that is set aside for the payment of life, sick, accident, or other benefits to the extent that the total amount set aside in the VEBA, SUB or GLSO as of the close of the taxable year for any purpose (including member contributions and other income set aside in the VEBA, SUB, or GLSO as of the close of the year) does not exceed the qualified asset account limit for such taxable year of the organization. For purposes of section 512(a)(3)(B), member contributions include both employee contributions and employer contributions to the VEBA, SUB, or GLSO. In calculating the total amount set aside in a VEBA, SUB, or GLSO as of the close of a taxable year, certain assets with useful lives extending substantially beyond the end of the taxable year (e.g., buildings, and licenses) are not to be taken into account to the extent they are used in the provision of life, sick, accident, or other benefits. For example, cash and securities (and similar investments) held by a VEBA, SUB or GLSO are not disregarded in calculating the total amount set aside for this purpose because they are used to pay welfare benefits, rather than merely used in the provision of such benefits. Accordingly, the unrelated business taxable income of a VEBA, SUB, or GLSO for a taxable year of such an organization generally will equal the lesser of two amounts: the income of the VEBA, SUB, or GLSO for the taxable year (excluding member contributions); or, the excess of the total amount set aside as of the close of the taxable year (including member contributions, and excluding certain assets with a useful life extending substantially beyond the end of the taxable year to the extent they are used in the provision of welfare benefits) over the qualified asset account limit (calculated without regard to the otherwise permitted reserve for post-retirement medical benefits) for the taxable year. See §1.419A–2T for special rules relating to collectively bargained welfare benefit funds.

(c) The income of a VEBA, SUB, or GLSO for any taxable year includes gain realized by the organization on the sale or disposition of any asset during such year. The gain realized by a VEBA, SUB, or GLSO on the sale or disposition of an asset is equal to the amount realized by the organization over the basis of such asset (in the hands of the organization), reduced by any qualified direct costs attributable to such asset (under paragraphs (b), (c), and (d) of Q&A–6 of §1.419–1T).

Q–4: What transition rules apply to *existing reserves for post-retirement medical or life insurance benefits*?

A–4: (a) Section 512(a)(3)(E)(iii)(I) provides that income that is either directly or indirectly attributable to *existing reserves for post-retirement medical or life insurance benefits* will not be treated as unrelated business taxable income. An *existing reserve for post-retirement medical or life insurance benefits* (as defined in section 512(a)(3)(E)(iii)(II)) is the total amount of assets actually set aside in a VEBA, SUB, or GLSO on July 18, 1984 (calculated in the manner set forth in Q&A–3 of the regulation, and adjusted under paragraph (c) of Q&A–11 of §1.419–1T), reduced by employer contributions to the fund on or before such date to the extent such contributions are not deductible for the taxable year of the employer containing July 18, 1984, and for any prior taxable year of the employer, for purposes of providing such post-retirement

benefits. For purposes of the preceding sentence only, an amount that was not actually set aside on July 18, 1984, will be treated as having been actually set aside on such date if (1) such amount was incurred by the employer (without regard to section 461(h)) as of the close of the last taxable year of the VEBA, SUB, or GLSO ending before July 18, 1984, and (2) such amount was actually contributed to the VEBA, SUB, or GLSO within 8½ months following the close of such taxable year.

(b) In addition, section 512(a)(3)(E)(iii)(I) applies to existing reserves for such post-retirement benefits only to the extent that such *existing reserves* do not exceed the amount that could be accumulated under the principles set forth in Revenue Rulings 69–382, 1969–2, C.B. 28; 69–478, 1969–2 C.B. 29; and 73–599, 1973–2 C.B. 40. Thus, amounts attributable to such excess *existing reserves* are not within this transition rule eventhough they were actually set aside on July 18, 1984.

(c) All post-retirement medical or life insurance benefits (or other benefits to the extent paid with amounts set aside to provide post-retirement medical or life insurance benefits) provided after July 18, 1984 (whether or not the employer has maintained a reserve or fund for such benefits) are to be charged, first, against the *existing reserves* within this transition rule (including amounts attributable to *existing reserves* within this transition rule) for post-retirement medical benefits or for post-retirement life insurance benefits (as the case may be) and, second, against all other amounts. For this purpose, the qualified direct cost of an asset with a useful life extending substantially beyond the end of the taxable year (as determined under Q&A–6 of §1.419–1T) will be treated as a benefit provided and thus charged against the *existing reserve* based on the extent to which such asset is used in the provision of post-retirement medical benefits or post-retirement life insurance benefits (as the case may be). All plans of an employer providing post-retirement medical benefits are to be treated as one plan for purposes of section 512(a)(3)(E)(iii)(III), and all plans of an employer providing post-retirement life insurance benefits are to be treated as one plan for purposes of section 512(a)(3)(E)(iii)(III).

(d) In calculating the unrelated business taxable income of a VEBA, SUB, or GLSO for a taxable year of such organization, the total income of the VEBA, SUB, or GLSO for the taxable year is reduced by the income attributable to *existing reserves* within the transition rule before such income is compared to the excess of the total amount set aside as of the close of the taxable year over the qualified asset account limit for the taxable year. Thus, for example, assume that the total income of a VEBA for a taxable year is $1,000, and that the excess of the total amount of the VEBA set aside as of the close of the taxable year over the applicable qualified asset account limit is $600. Assume also that of the $1,000 of total income, $500 is attributable to *existing reserves* within the transition rule of section 512(a)(3)(E)(iii)(I). The unrelated business income of this VEBA for the taxable year is equal to the lesser of the following two amounts: (1) the total income of the VEBA for the taxable year ($1,000), reduced to the extent that such income is attributable to *existing reserves* within the transition rule ($500); or (2) the excess of the total amount set aside as of the close of the taxable year over the applicable qualified asset account limit ($600). Thus, the unrelated business income of this VEBA for the taxable year is $500.

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§ 1.512(b)–1 Modifications.

Whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case. For example, if a payment termed *rent* by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or joint venturer, such payment is not within the modification for rents. The modifications provided in section 512(b) are as follows:

(a) *Certain Investment Income*—(1) *In general*. Dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), annuities, income from notional principal contracts (as defined in Treasury Regulations 26 CFR 1.863–7 or regulations issued under section 446), other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner, and all deductions directly connected with any of the foregoing items of income shall be excluded in computing unrelated business taxable income.

(2) *Limitations*. The exclusions under paragraph (a)(1) of this section do not apply to income derived from and deductions in connection with debt-financed property (as defined in section 514(b)). Moreover, the exclusions under paragraph (a)(1) of this section do not apply to gains or losses from the sale,

exchange, or other disposition of any property, or to gains or losses from the lapse or termination of options to buy or sell securities. For rules regarding the treatment of these gains and losses, see section 512(b)(5) and §1.512(b)–1(d). Furthermore, the exclusions under paragraph (a)(1) of this section do not apply to interest and annuities derived from and deductions in connection with controlled organizations. For rules regarding the treatment of such amounts, see section 512(b)(13) and §1.512(b)–1(l). Finally, the exclusions under paragraph (a)(1) of this section of income from notional principal contracts and income that the Commissioner determines to be substantially similar income from ordinary and routine investments do not apply to income earned by brokers or dealers (including organizations that make a market in derivative financial products, as described in Treasury Regulations 26 CFR 1.954–2T(a)(4)(iii)(B)).

(3) *Effective dates.* The effective dates of the rules of paragraphs (a)(1) and (a)(2) of this section that were in effect prior to August 30, 1991, remain the same. The exclusion under paragraph (a)(1) of this section of income from notional principal contracts is effective for amounts received after August 30, 1991. However, an organization may apply the exclusion under paragraph (a)(1) of this section of income from notional principal contracts prior to that date, provided that such amounts are treated consistently for all open taxable years. Unless otherwise provided by the Commissioner, the exclusion under paragraph (a)(1) of this section of income that the Commissioner determines to be substantially similar income from ordinary and routine investments is effective for amounts received after the date of the Commissioner's determination.

(b) *Royalties.* Royalties, including overriding royalties, and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income. However, for taxable years beginning after December 31, 1969, certain royalties from and certain deductions in connection with either, debt-financed property (as defined in section 514(b)) or controlled organizations (as defined in paragraph (l) of this section) shall be included in computing unrelated business taxable income. Mineral royalties shall be excluded whether measured by production or by gross or taxable income from the mineral property. However, where an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded. To the extent not treated as a loan under section 636, payments in discharge of mineral production payments shall be treated in the same manner as royalty payments for the purpose of computing unrelated business taxable income. To the extent treated as a loan under section 636, the amount of any payment in discharge of a production payment which is the equivalent of interest shall be treated as interest for purposes of section 512(b)(1) and paragraph (a) of this section.

(c) *Rents*—(1) *Taxable years beginning before January 1, 1970.* For taxable years beginning before January 1, 1970, rents from real property (including personal property leased with the real property) and the deductions directly connected therewith shall be excluded in computing unrelated business taxable income, except that certain rents from, and certain deductions in connection with, a business lease (as defined in section 514(f)) shall be included in computing unrelated business taxable income. See subparagraph (5) of this paragraph for rules governing amounts received for the rendering of services.

(2) *Taxable years beginning after December 31, 1969*—(i) *In general.* For taxable years beginning after December 31, 1969, except as provided in subdivision (iii) of this subparagraph, rents from property described in subdivision (ii) of this subparagraph, and the deductions directly connected therewith, shall be excluded in computing unrelated business taxable income. However, notwithstanding subdivision (ii) of this subparagraph, certain rents from and certain deductions in connection with either debt-financed property (as defined in section 514(b)) or property rented to controlled organizations (as defined in paragraph (l) of this section)

shall be included in computing unrelated business taxable income.

(ii) *Excluded rents*. The rents which are excluded from unrelated business income under section 512(b)(3)(A) and this paragraph are:

(*a*) *Real property*. All rents from real property; and

(*b*) *Personal property*. All rents from personal property leased with real property if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time sonal property are an incidental amount service by the lessee

For purposes of the preceding sentence, rents attributable to personal property generally are not an incidental amount of the total rents if such rents exceed 10 percent of the total rents from all the property leased. For example, if the rents attributable to the personal property leased are determined to be $3,000 per year, and the total rents from all property leased are $10,000 per year, then such $3,000 amount is not to be excluded from the computation of unrelated business taxable income by operation of section 512(b)(3)(A)(ii) and this paragraph, since such amount is not an incidental portion of the total rents.

(iii) *Exception*. Subdivision (ii) of this subparagraph shall not apply, if either:

(*a*) *Excess personal property rents*. More than 50 percent of the total rents are attributable to personal property, determined at the time such personal property is first placed in service by the lessee; or

(*b*) *Net profits*. The determination of the amount of such rents depends in whole or in part on the income or profits derived by any person from the property leased, other than an amount based on a fixed percentage or percentages of the gross receipts or sales. For purposes of the preceding sentence, the rules contained in paragraph (b) (3) and (6) (other than paragraph (b)(6)(ii)) of § 1.856–4 shall apply.

(iv) *Illustration*. This subparagraph may be illustrated by the following example:

Example. A, an exempt organization, owns a printing factory which consists of a building housing two printing presses and other equipment necessary for printing. On January 1, 1971, A rents the building and the printing equipment to B for $10,000 a year. The lease states that $9,000 of such rent is for the building and $1,000 for the printing equipment. However, it is determined that notwithstanding the terms of the lease $4,000, or 40 percent ($4,000/$10,000), of the rent is actually attributable to the printing equipment. During 1971, A has $3,000 of deductions, all of which are properly allocable to the land and building. Under these circumstances, A shall not take into account in computing its unrelated business taxable income the $6,000 of rent attributable to the building and the $3,000 of deductions directly connected with such rent. However, the $4,000 of rent attributable to the printing equipment is not excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3)(A)(ii) or this paragraph since such rent represents more than an incidental portion of the total rents.

(3) *Definitions and special rules*. For purposes of subparagraph (2) of this paragraph:

(i) *Real property defined*. The term *real property* means all real property, including any property described in sections 1245(a)(3)(C) and 1250(c) and the regulations thereunder.

(ii) *Personal property defined*. The term *personal property* means all personal property, including any property described in section 1245(a)(3)(B) and the regulations thereunder.

(iii) *Multiple leases*. If separate leases are entered into with respect to real and personal property, and such properties have an integrated use (e.g., one or more leases for real property and another lease or leases for personal property to be used upon such real property), all such leases shall be considered as one lease.

(iv) *Placed in service*. Property is *placed in service* by the lessee when it is first subject to his use in accordance with the terms of the lease. For example, property subject to a lease entered into on November 1, 1971, for a term commencing on January 1, 1972, shall be considered as placed in service on January 1, 1972, regardless of when the property is first actually used by the lessee.

(v) *Changes in rent charged or personal property rented*. If:

(*a*) By reason of the placing of additional or substitute personal property in service, there is an increase of 100

percent or more in the rent attributable to all the personal property leased, or

(*b*) There is a modification of the lease by which there is a change in the rent charged (whether or not there is a change in the amount of personal property rented), the rent attributable to personal property shall be recomputed to determine whether the exclusion under subparagraph (2)(ii)(*b*) of this paragraph or the exception under subparagraph (2)(iii)(*a*) of this paragraph applies. Any change in the treatment of rents, attributable to a recomputation under this subdivision, shall be effective only with respect to rents for the period beginning with the event which occasioned the recomputation.

(4) *Examples*. Subparagraphs (2) and (3) of this paragraph may be illustrated by the following examples:

Example 1. On January 1, 1971, A, an exempt organization, executes two leases with B. One is for the rental of a computer, with a stated annual rent of $750. The other is for the rental of office space in which to use the computer, at a stated annual rent of $7,250. The total annual rent under both leases for 1971 is $8,000. At the time the computer is first placed in service, however, taking both leases into consideration, it is determined that notwithstanding the terms of the leases $3,000, or 37.5 percent ($3,000/$8,000), of the rent is actually attributable to the computer. Therefore, for 1971, only the $5,000 ($8,000 − $3,000) attributable to the rental of the office space is excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example 2. Assume the facts as stated in example 1. Assume further that the leases to which the computer and office space are subject in example 1 provide that the rent may be increased or decreased, depending upon the prevailing rental value for similar computers and office space. On January 1, 1972, the total annual rent is increased in the computer lease to $2,000, and in the office space lease to $9,000. For 1972, it is determined that notwithstanding the terms of the leases $6,000, or 54.5 percent ($6,000/$11,000), of the total rent is actually attributable to the computer as of that time. Even though the rent attributable to personal property now exceeds 50 percent of the total rent, the rent attributable to real property will continue to be excluded, since there was no modification of the terms of the leases and since the increase in the rent was not attributable to the placing of new personal property in service. See subparagraph (3)(v) of this paragraph. Thus, for 1972 the $5,000 of rent attributable to the office space continues to be excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example 3. Assume the facts as stated in example 1, except that on January 1, 1973, B rents a second computer from A, which is placed in service on that date. The total rent is increased to $2,000 for the computer lease and to $10,000 for the office space lease. It is determined at the time the second computer is first placed in service that notwithstanding the terms of the leases $7,000 of the rent is actually attributable to the computers. Since the rent attributable to personal property has increased by more than 100 percent ($4,000 / $3,000 = 133 percent), a redetermination must be made pursuant to subparagraph (3)(v) (*a*) of this paragraph. As a result, 58.3 percent ($7,000/$12,000) of the total rent is determined to be attributable to personal property. Accordingly, since more than 50 percent of the total rent A receives is attributable to the personal property leased, none of the rents are excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example 4. Assume the facts as stated in example 3, except that on June 30, 1975, the lease between B and A is modified. The total rent for the computer lease is reduced to $1,500 and the total rent for the office space lease is reduced to $7,500. Pursuant to subdivision (3)(v)(*b*) of this paragraph, a redetermination is made as of June 30, 1975. As of the modification date, it is determined that notwithstanding the terms of the leases, the rent actually attributable to the computers is $4,000, or 44.4 percent ($4,000/$9,000), of the total rent. Since less than 50 percent of the total rent is now attributable to personal property, the rent attributable to real property ($5,000), for periods after June 30, 1975, is excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3). However, the rent attributable to personal property ($4,000) is not excluded from unrelated business taxable income for such periods by operation of section 512(b)(3), since it represents more than an incidental portion of the total rent.

(5) *Rendering of services*. For purposes of this paragraph, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts, or motels, or for the use of occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property.

Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exists, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.

(d)(1) *Gains and losses from the sale, etc. of property*. There shall also be excluded from the computation of unrelated business taxable income gains or losses from the sale, exchange, or other disposition of property other than (i) stock in trade or other property of a kind which would properly be included in the inventory of the organization if on hand at the close of the taxable year, or (ii) property held primarily for sale to customers in the ordinary course of the trade or business. This exclusion does not apply with respect to the cutting of timber which is considered, upon the application of section 631(a), as a sale or exchange of such timber. In addition, for taxable years beginning after December 31, 1969, this exclusion does not apply to the gain derived from the sale or other disposition of debt-financed property (as defined in section 514(b)). Otherwise, the exclusion under section 512(b)(5) applies with respect to gains and losses from involuntary conversions, casualties, etc.

(2) There shall be excluded from the computation of unrelated business taxable income any gain from the lapse or termination after December 31, 1975, of options to buy or sell securities (as that term is defined in section 1236(c)). An option is considered terminated when the organization's obligation under the option ceases by any means other than by reason of the exercise or lapse of such option. If the exclusion is otherwise available it will apply whether or not the organization owns the securities upon which the option is written, that is, whether or not the option is *covered*. However, income from the lapse or termination of an option is excludable only if the option is written in connection with the organization's investment activities. Thus, for example, if the securities upon which the options are written are held by the organization as inventory or for sale to customers in the ordinary course of a trade or business, the income from the lapse or termination will not be excludable under the provisions of this paragraph. Similarly, if an organization is engaged in the trade or business of writing options (whether or not such options are covered) the exclusion will not be available.

(e) *Net operating losses*. (1) The net operating loss deduction provided in section 172 shall be allowed in computing unrelated business taxable income. However, the net operating loss carryback or carryover (from a taxable year for which the taxpayer is subject to the provisions of section 511) shall be determined under section 172 without taking into account any amount of income or deduction which is not included under section 511 in computing unrelated business taxable income. For example, a loss attributable to an unrelated trade or business shall not be diminished by reason of the receipt of dividend income.

(2) For the purpose of computing the net operating loss deduction provided by section 172, any prior taxable year for which an organization was not subject to the provisions of section 511, or a corresponding provision of prior law, shall not be taken into account. Thus, if the organization was not subject to the provisions of section 511 or supplement U of the Internal Revenue Code of 1939 for a preceding taxable year, the net operating loss is not a carryback to such preceding taxable year, and the net operating loss carryover to succeeding taxable years is not reduced by the taxable income for such preceding taxable year.

(3) A net operating loss carryback or carryover shall be allowed only from a taxable year for which the taxpayer is subject to the provisions of section 511, or a corresponding provision of prior law.

(4) In determining the span of years for which a net operating loss may be carried for purposes of section 172, taxable years in which an organization was not subject to the provisions of section 511 or a corresponding provision of prior law shall be taken into account. Thus, for example, if an organization is subject to the provisions of section 511 for the taxable year 1955 and has a net operating loss for that year, the last taxable year to which any part thereof may be carried over is the year 1960 regardless of whether the organization is subject to the provisions of section 511 in any of the intervening taxable years.

(f) *Research*. (1) Income derived from research for the United States or any of its agencies or instrumentalities or a State or political subdivision thereof, and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income.

(2) In the case of a college, university, or hospital, all income derived from research performed for any person and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income.

(3) In the case of an organization operated primarily for the purpose of carrying on fundamental research (as distinguished from applied research) the results of which are freely available to the general public, all income derived from research performed for any person and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income.

(4) For the purpose of §§1.512(a)–1, 1.512(a)–2, and this section, the term *research* does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc. The term *fundamental research* does not include research carried on for the primary purpose of commercial or industrial application.

(g) *Charitable, etc., contributions*. (1) In computing the unrelated business taxable income of an organization described in section 511(a)(2) the deduction from gross income allowed by section 170 (relating to charitable contributions and gifts) shall be allowed, whether or not the contribution is directly connected with the carrying on of the trade or business. Section 512(b)(10) provides that this deduction shall not exceed 5 percent of the organization's unrelated business taxable income computed without regard to that deduction. The provisions of section 170(b)(2) are not applicable to contributions by the organizations described in section 511(a)(2).

(2) In computing the unrelated business taxable income of a trust described in section 511(b)(2), the deduction allowed by section 170 (relating to charitable contributions and gifts) shall be allowed whether or not the contribution is directly connected with the carrying on of the trade or business. The deduction is limited as provided in section 170(b)(1) (A) and (B), except that the amounts so allowed are determined on the basis of unrelated business taxable income computed without regard to this deduction (rather than on the basis of adjusted gross income). For purposes of this deduction, a distribution by a trust described in section 511(b)(2) made pursuant to the trust instrument to a beneficiary described in section 170 shall be treated in the same manner as gifts or contributions.

(3) The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university described in section 501(c)(3) which is exempt from tax and which operates an unrelated business, shall be allowed a deduction, not in excess of 5 percent of its unrelated business taxable income, for gifts or contributions to another university described in section 501(c)(3) for educational work but shall not be allowed any deduction for amounts expended in administering its own educational program.

(h) *Specific deduction*—(1) *In general*. In computing unrelated business taxable income a specific deduction from gross income of $1,000 is allowed. However, for taxable years beginning after December 31, 1969, such specific deduction is not allowed in computing the

net operating loss under section 172 and paragraph (6) of section 512(b).

(2) *Special rule for a diocese, province of a religious order, or a convention or association of churches.* (i) In the case of a diocese, province of a religious order, or a convention or association of churches, there shall be allowed with respect to each parish, individual church, district, or other local unit a specific deduction equal to the lower of $1,000 or the gross income derived from an unrelated trade or business regularly conducted by such local unit. However, a diocese, province of a religious order, or a convention or association of churches shall not be entitled to a specific deduction for a local unit which, for a taxable year, files a separate return. In the case of a local unit which, for a taxable year, files a separate return, such local unit may claim a specific deduction equal to the lower of $1,000 or the gross income derived from any unrelated trade or business which it regularly conducts.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. X is an association of churches on the calendar year basis. X is divided into local units A, B, C, and D. During 1973, A, B, C, and D derive gross income of, respectively, $1,200, $800, $1,500, and $700 from unrelated businesses which they regularly conduct. Furthermore, for such taxable year, D files a separate return. X may claim a specific deduction of $1,000 with respect to A, $800 with respect to B, and $1,000 with respect to C. X may not claim a specific deduction with respect to D. D, however, may claim a specific deduction of $700 on its return.

(i) *Transitional period for churches.* (1)(i) In the case of an unrelated trade or business (as defined in section 513) carried on before May 27, 1969, by a church or convention or association of churches (as defined in §1.511–2(a)(3)(ii)), or by the predecessor of a church or convention or association of churches which predecessor was itself a church or convention or association of churches, all gross income derived from such unrelated trade or business and all deductions directly connected with the carrying on of such unrelated trade or business shall be excluded from the determination of unrelated business taxable income under section 512(a) for all taxable years beginning before January 1, 1976. Notwithstanding the preceding sentence, in the case of income from debt-financed property (and the deductions attributable thereto), as defined in section 514, of a church or convention or association of churches or by the predecessor of a church or convention or association of churches, the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b) shall apply for taxable years beginning after December 31, 1969.

(ii) The provisions of subdivision (i) may be illustrated by the following example:

Example. X, a church as defined in §1.511–2(a)(3)(ii), realizes gross income from an unrelated business (as defined in section 513) of $100,000 for calendar year 1972. X's predecessor church, Y, began conducting such unrelated business in January 1, 1968. Of the $100,000 realized for calendar year 1972, $40,000 is attributable to debt-financed property (as defined in section 514). Since the unrelated business was conducted by Y prior to May 27, 1969, and since X's taxable year begins before January 1, 1976, that amount of the income realized from such business (and all deductions directly connected therewith) which is not attributable to debt-financed property shall be excluded from the determination of unrelated business taxable income under section 512(a). Therefore, of the $100,000 realized, $60,000 ($100,000 less $40,000 attributable to debt-financed property), and all deductions directly connected therewith shall be excluded from the determination of such unrelated business taxable income for purposes of imposition of the tax under section 511(a). The remaining $40,000 and the deductions attributable thereto shall be subject to the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b).

(2) This paragraph shall not apply in the case of income from property, or deductions directly connected with such income, if title to the property is held by a corporation described in section 501(c)(2) for a church or convention or association of churches. Thus, if such income is derived from an unrelated trade or business, the corporation shall be liable for tax imposed by section 511(a) on such income.

(j) *Special rule for certain unrelated trades or businesses carried on by a religious order or by an educational institution maintained by such order.* (1) Except as provided in subparagraph (2) of this

paragraph, gross income realized by a religious order (or an educational organization described in section 170(b)(1)(A)(ii) maintained by such order) from an unrelated trade or business, together with all deductions directly connected therewith, shall be excluded from the determination of unrelated business taxable income under section 512(a), if:

(i) The trade or business has been operated by such order or by such institution since before May 27, 1959,

(ii) The trade or business consists of providing services under a license issued by a Federal regulatory agency,

(iii) More than 90 percent of the net income from the business is, for each taxable year for which gross income from such business is so excluded by reason of section 512(b)(15) and this paragraph, devoted to religious, charitable, or educational purposes, and

(iv) It is established to the satisfaction of an officer no lower than the Regional Commissioner that the rates or other charges for such services are fully competitive with rates or other charges charged for such services by persons not exempt from taxation. Rates or other charges for such services shall be considered as fully competitive with rates or other charges charged for such services by persons not exempt from taxation if the rates charged by such unrelated trade or business are neither materially higher nor materially lower than the rates charged by similar businesses operating in the same general area.

(2) The provisions of this paragraph shall not apply with respect to income from debt-financed property (as defined in section 514) and the deductions attributable thereto. For taxable years beginning after December 31, 1969, such income and deductions are subject to the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b).

(k) *Income and deductions from debt-financed property*. For taxable years beginning after December 31, 1969, in the case of debt-financed property (as defined in section 514(b)), there shall be included in the unrelated business taxable income of an exempt organization, as an item of gross income derived from an unrelated trade or business, the amount of unrelated debt-financed income determined under section 514(a)(1) and §1.514(a)–1(a), and there shall be allowed, as a deduction with respect to such income, the amount determined under section 514(a)(2) and §1.514(a)–1(b).

(l) *Interest, annuities, royalties, and rents from controlled organizations*—(1) *In general*. For taxable years beginning after December 31, 1969, if an exempt organization (hereinafter referred to as the *controlling organization*) has control (as defined in subparagraph (4) of this paragraph) of another organization (hereinafter referred to as the *controlled organization*), the controlling organization shall include as an item of gross income in computing its unrelated business taxable income, the amount of interest, annuities, royalties, and rents derived from the controlled organization determined under subparagraph (2) or (3) of this paragraph. The preceding sentence shall apply whether or not the activity conducted by the controlling organization to derive such amounts represents a trade or business or is regularly carried on. Thus, amounts received by a controlling organization from the rental of its real property to a controlled organization may be included in the unrelated business taxable income of the controlling organization, even though the rental of such property is not an activity regularly carried on by the controlling organization.

(2) *Exempt controlled organization*—(i) *In general*. If the controlled organization is exempt from taxation under section 501(a), the amount referred to in subparagraph (1) of this paragraph is an amount which bears the same ratio to the interest, annuities, royalties, and rents received by the controlling organization from the controlled organization as the unrelated business taxable income of the controlled organization bears to whichever of the following amounts is the greater:

(*a*) The taxable income of the controlled organization, computed as though the controlled organization were not exempt from taxation under section 501(a), or

(*b*) The unrelated business taxable income of the controlled organization

both determined without regard to any amounts paid directly or indirectly to the controlling organization. The controlling organization shall be allowed all deductions directly connected with amounts included in gross income under the preceding sentence.

(ii) *Examples*. This subparagraph may be illustrated by the following examples:

Example 1. A, an exempt scientific organization described in section 501(c)(3), owns all the stock of B, another exempt scientific organization described in section 501(c)(3). During 1971, A rents space for a laboratory to B for $15,000 a year. A's total deductions for 1971 with respect to the leased property are $3,000: $1,000 for maintenance and $2,000 for depreciation. If B were not an exempt organization, its total taxable income would be $300,000, disregarding rent paid to A. B's unrelated business taxable income, disregarding rent paid to A, is $100,000. Under these circumstances, $4,000 of the rent paid by B will be included by A as net rental income in determining its unrelated business taxable income, computed as follows:

B's unrelated business taxable income (disregarding rent paid to A)	$100,000
B's taxable income (computed as though B were not exempt and disregarding rent paid to A)	300,000
Ratio ($100,000/$300,000)	⅓
Total rent	15,000
Total deductions	3,000
Rental income treated as gross income from an unrelated trade or business (⅓ of $15,000)	5,000
Less deductions directly connected with such income (⅓ of $3,000)	1,000
Net rental income included by A in computing its unrelated business taxable income	$4,000

Example 2. Assume the facts as stated in example 1, except that B's taxable income is $90,000 (computed as though B were not an exempt organization, and disregarding rents paid to A). B's unrelated business taxable income ($100,000) is therefore greater than its taxable income ($90,000). Thus, the ratio used to determine the portion of rent received by A which is to be taken into account is one since both the numerator and denominator of such ratio is B's unrelated business taxable income. Consequently, all the rent received by A from B ($15,000), and all the deductions directly connected therewith ($3,000), are included by A in computing its unrelated business taxable income.

(3) *Nonexempt controlled organization*—(i) *In general*. If the controlled organization is not exempt from taxation under section 501(a), the amount referred to in subparagraph (1) of this paragraph is an amount which bears the same ratio to the interest, annuities, royalties, and rents received by the controlling organization from the controlled organization as the *excess taxable income* (as defined in subdivision (ii) of this subparagraph) of the controlled organization bears to whichever of the following amounts is the greater:

(*a*) The taxable income of the controlled organization, or

(*b*) The excess taxable income of the controlled organization

both determined without regard to any amount paid directly or indirectly to the controlling organization. The controlling organization shall be allowed all deductions which are directly connected with amounts included in gross income under the preceding sentence.

(ii) *Excess taxable income*. For purposes of this paragraph, the term *excess taxable income* means the excess of the controlled organization's taxable income over the amount of such taxable income which, if derived directly by the controlling organization, would not be unrelated business taxable income.

(iii) *Examples*. This subparagraph may be illustrated by the following examples:

Example 1. A, an exempt university described in section 501(c)(3), owns all the stock of M, a nonexempt organization. During 1971, M leases a factory and a dormitory from A for a total annual rent of $100,000. During the taxable year, M has $500,000 of taxable income, disregarding the rent paid to A: $150,000 from a dormitory for students of A university, and $350,000 from the operation of a factory which is a business unrelated to A's exempt purpose. A's deductions for 1971 with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. Under these circumstances, $56,000 of the rent paid by M will be included by A as net rental income in determining its unrelated business taxable income, computed as follows:

M's taxable income (disregarding rent paid to A)	$500,000
Less taxable income from dormitory	150,000
Excess taxable income	$350,000
Ratio ($350,000/$500,000)	7/10
Total rent paid to A	$100,000
Total deductions ($4,000 + $16,000)	20,000
Rental income treated as gross income from an unrelated trade or business (7/10 of $100,000)	70,000
Less deductions directly connected with such income (7/10 of $20,000)	14,000

Net rental income included by A in computing its unrelated business taxable income	$56,000

Example 2. Assume the facts as stated in example 1, except that M's taxable income (disregarding rent paid to A) is $300,000, consisting of $350,000 from the operation of the factory and a $50,000 loss from the operation of the dormitory. Thus, M's *excess taxable income* is also $300,000, since none of M's taxable income would be excluded from the computation of A's unrelated business taxable income if received directly by A. The ratio of M's *excess taxable income* to its taxable income is therefore one ($300,000/$300,000). Thus, all the rent received by A from M ($100,000), and all the deductions directly connected therewith ($20,000), are included in the computation of A's unrelated business taxable income.

(4) *Control*—(i) *In general.* For purposes of this paragraph—

(*a) Stock corporation.* In the case of an organization which is a stock corporation, the term *control* means ownership by an exempt organization of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation.

(*b) Nonstock organization.* In the case of a nonstock organization, the term *control* means that at least 80 percent of the directors or trustees of such organization are either representatives of or directly or indirectly controlled by an exempt organization. A trustee or director is a representative of an exempt organization if he is a trustee, director, agent, or employee of such exempt organization. A trustee or director is controlled by an exempt organization if such organization has the power to remove such trustee or director and designate a new trustee or director.

(ii) *Gain or loss of control.* If control of an organization (as defined in subdivision (i) of this subparagraph) is acquired or relinquished during the taxable year, only the interest, annuities, royalties, and rents paid or accrued to the controlling organization in accordance with its method of accounting for that portion of the taxable year it has control shall be subject to the tax on unrelated business income.

(5) *Amounts taxable under other provisions of the Code*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, section 512(b)(13) and this paragraph do not apply to amounts which are included in the computation of unrelated business taxable income by operation of any other provision of the Code. However, amounts which are not included in unrelated business taxable income by operation of section 512(a)(1), or which are excluded by operation of section 512(b) (1), (2), or (3), may be included in unrelated business taxable income by operation of section 512(b)(13) and this paragraph.

(ii) *Debt-financed property.* Rents deprived from the lease of debt-financed property by a controlling organization to a controlled organization are subject to the rules contained in section 512(b)(13) and this paragraph. Thus, if a controlling organization leases debt-financed property to a controlled organization, the amount of rents includible in the controlling organization's unrelated business taxable income shall first be determined under section 512(b)(13) and this paragraph, and only the portion of such rents not taken into account by operation of section 512(b)(13) are taken into account by operation of section 514. See example 3 of § 1.514(b)–1(b)(3).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6939, 32 FR 17661, Dec. 12, 1967; T.D. 7177, 37 FR 7089, Apr. 8, 1972; T.D. 7183, 37 FR 7885, Apr. 21, 1972; T.D. 7261, 38 FR 5466, Mar. 1, 1973; 38 FR 6387, Mar. 9, 1973; T.D. 7632, 44 FR 42681, July 20, 1979; T.D. 7767, 46 FR 11265, Feb. 6, 1981; T.D. 8423, 57 FR 33443, July 29, 1992; 57 FR 42490, Sept. 15, 1992]

§ 1.512(c)–1 Special rules applicable to partnerships; in general.

In the event an organization to which section 511 applies is a member of a partnership regularly engaged in a trade or business which is an unrelated trade or business with respect to such organization, the organization shall include in computing its unrelated business taxable income so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto. For this purpose, both the gross income and the deductions shall be computed with the necessary adjustments for the exceptions, additions, and limitations referred to in section

512(b) and in § 1.512(b)–1. For example, if an exempt educational institution is a partner in a partnership which operates a factory and if such partnership also holds stock in a corporation, the exempt organization shall include in computing its unrelated business taxable income its share of the gross income from the operation of the factory, but not its share of any dividends received by the partnership from the corporation. If the taxable year of the organization differs from that of the partnership, the amounts included or deducted in computing unrelated business taxable income shall be based upon the income and deductions of the partnership for each taxable year of the partnership ending within or with the taxable year of the organization.

§ 1.513–1 Definition of unrelated trade or business.

(a) *In general.* As used in section 512 the term *unrelated business taxable income* means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the modifications provided in section 512. Section 513 specifies with certain exceptions that the phrase *unrelated trade or business* means, in the case of an organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)). (For certain exceptions from this definition, see paragraph (e) of this section. For a special definition of *unrelated trade or business* applicable to certain trusts, see section 513(b).) Therefore, unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

(b) *Trade or business.* The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute *trade or business* within the meaning of section 162—and which, in addition, is notsubstantially related to the performance of exempt functions—presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term *trade or business* has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Thus, the term *trade or business* in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or

within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacydoes not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2). Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization. However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

(c) *Regularly carried on*—(1) *General principles.* In determining whether trade or business from which a particular amount of gross income derives is *regularly carried on*, within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be *regularly carried on* if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

(2) *Application of principles in certain cases*—(i) *Normal time span of activities.* Where income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business. For example, the operation of a sandwich stand by a hospital auxiliary for only 2 weeks at a state fair would not be the regular conduct of trade or business. However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular conduct of trade or business. Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarilyconstitutes the regular conduct of trade or business. For example, the operation of a track for horse racing for several weeks of a year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season.

(ii) *Intermittent activities; in general.* In determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors. For example, the publication of advertising in programs for sports events or music or drama performances will not ordinarily be deemed to be the regular carrying on of business. Similarly, where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions or *primarily for the convenience* of such persons within the meaning of section 513(a)(2) (as, for example, the sale of books by a college bookstore to students or the sale of pharmaceutical supplies by a hospital pharmacy to patients of the hospital), casual sales in the course of such activity which do not qualify as related to the

exempt function involved or as described in section 513(a)(2) will not be treated as regular. On the other hand, where the nonqualifyingsales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the section 512 requirement of regularity.

(iii) *Intermittent activities; special rule in certain cases of infrequent conduct.* Certain intermittent income producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on. For example, income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically. Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fund raising event for charity would not be income from trade or business regularly carried on.

(d) *Substantially related*—(1) *In general.* Gross income derives from *unrelated trade or business*, within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question—the activities, that is, of producing or distributing the goods or performing the services involved—and the accomplishment of the organization's exempt purposes.

(2) *Type of relationship required.* Trade or business is *related* to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is *substantially related,* for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

(3) *Size and extent of activities.* In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Such income is not derived from the production or distribution of goods or the performance of services which contribute importantly to the accomplishment of any exempt purpose of the organization.

(4) *Application of principles*—(i) *Income from performance of exempt functions.* Gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business. The following examples illustrate the application of this principle:

Example 1. M, an organization described in section 501(c)(3), operates a school for training children in the performing arts, such as acting, singing, and dancing. It presents performances by its students and derives gross

income from admission charges for the performances. The students' participation in performances before audiences is an essential part of their training. Since the income realized from the performances derives from activities which contribute importantly to the accomplishment of M's exempt purposes, it does not constitute gross income from unrelated trade or business. (For specific exclusion applicable in certain cases of contributed services, see section 513(a)(1) and paragraph (e)(1) of this section.)

Example 2. N is a trade union qualified for exemption under section 501(c)(5). To improve the trade skills of its members, N conducts refresher training courses and supplies handbooks and technical manuals. N receives payments from its members for these services and materials. However, the development and improvement of the skills of its members is one of the purposes for which exemption is granted N; and the activities described contribute importantly to that purpose. Therefore, the income derived from these activities does not constitute gross income from unrelated trade or business.

Example 3. O is an industry trade association qualified for exemption under section 501(c)(6). It presents a trade show in which members of its industry join in an exhibition of industry products. O derives income from charges made to exhibitors for exhibit space and admission fees charged patrons or viewers of the show. The show is not a sales facility for individual exhibitors; its purpose is the promotion and stimulation of interest in, and demand for, the industry's products in general, and it is conducted in a manner reasonably calculated to achieve that purpose. The stimulation of demand for the industry's products in general is one of the purposes for which exemption is granted O. Consequently, the activities productive of O's gross income from the show—that is, the promotion, organization and conduct of the exhibition—contribute importantly to the achievement of an exempt purpose, and the income does not constitute gross income from unrelated trade or business. See also section 513(d) and regulations thereunder regarding sales activity.

(ii) *Disposition of product of exempt functions.* Ordinarily, gross income from the sale of products which result from the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business if the product is sold in substantially the same state it is in on completion of the exempt functions. Thus, in the case of an organization described in section 501(c)(3) and engaged in a program of rehabilitation of handicapped persons, income from sale of articles made by such persons as a part of their rehabilitation training would not be gross income from conduct of unrelated trade or business. The income in such case would be from sale of products, the production of which contributed importantly to the accomplishment of purposes for which exemption is granted the organization—namely, rehabilitation of the handicapped. On the other hand, if a product resulting from an exempt function is utilized or exploitedin further business endeavor beyond that reasonably appropriate or necessary for disposition in the state it is in upon completion of exempt functions, the gross income derived therefrom would be from conduct of unrelated trade or business. Thus, in the case of an experimental dairy herd maintained for scientific purposes by a research organization described in section 501(c)(3), income from sale of milk and cream produced in the ordinary course of operation of the project would not be gross income from conduct of unrelated trade or business. On the other hand, if the organization were to utilize the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the gross income from the sale of such products would be from the conduct of unrelated trade or business unless the manufacturing activities themselves contribute importantly to the accomplishment of an exempt purpose of the organization.

(iii) *Dual use of assets or facilities.* In certain cases, an asset or facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor. In such cases, the mere fact of the use of the asset or facility in exempt functions does not, by itself, make the income from the commercial endeavor gross income from related trade or business. The test, instead, is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes. Assume, for example, that a museum exempt under section 501(c)(3) has a theater auditorium which is specially designed and equipped for showing of educational films in connection with its program of public education in the arts and

sciences. The theater is a principal feature of the museum and is in continuous operation during the hours the museum is open to the public. If the organization were to operate the theater as an ordinary motion picture theater for public entertainment during the evening hours when the museum was closed, gross income from such operation would be gross income from conduct of unrelated trade or business.

(iv) *Exploitation of exempt functions.* In certain cases, activities carried on by an organization in the performance of exempt functions may generate good will or other intangibles which are capable of being exploited in commercial endeavors. Where an organization exploits such an intangible in commercial activities, the mere fact that the resultant income depends in part upon an exempt function of the organization does not make it gross income from related trade or business. In such cases, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is gross income from the conduct of unrelated trade or business. The application of this subdivision is illustrated in the following examples:

Example 1. U, an exempt scientific organization, enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of various items of laboratory equipment to manufacturers. The endorsing of laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted U. Accordingly, the income derived from the sale of endorsements is gross income from unrelated trade or business.

Example 2. V, an exempt university, has a regular faculty and a regularly enrolled student body. During the school year, V sponsors the appearance of professional theater companies and symphony orchestras which present drama and musical performances for the students and faculty members. Members of the general public are also admitted. V advertises these performances and supervises advance ticket sales at various places, including such university facilities as the cafeteria and the university bookstore. V derives gross income from the conduct of the performances. However, while the presentation of the performances makes use of an intangible generated by V's exempt educational functions—the presence of the student body and faculty—the presentation of such drama and music events contributes importantly to the overall educational and cultural function of the university. Therefore, the income which V receives does not constitute gross income from the conduct of unrelated trade or business.

Example 3. W is an exempt business league with a large membership. Under an arrangement with an advertising agency, W regularly mails brochures, pamphlets and other commercial advertising materials to its members, for which service W charges the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of any purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from unrelated trade or business.

Example 4. X, an exempt organization for the advancement of public interest in classical music, owns a radio station and operates it in a manner which contributes importantly to the accomplishment of the purposes for which the organization is granted exemption. However, in the course of the operation of the station the organization derives gross income from the regular sale of advertising time and services to commercial advertisers in the manner of an ordinary commercial station. Neither the sale of such time nor the performance of such services contributes importantly to the accomplishment of any purpose for which the organization is granted exemption. Notwithstanding the fact that the production of the advertising income depends upon the existence of the listening audience resulting from performance of exempt functions, such income is gross income from unrelated trade or business.

Example 5. Y, an exempt university, provides facilities, instruction and faculty supervision for a campus newspaper operated by its students. In addition to news items and editorial commentary, the newspaper publishes paid advertising. The solicitation, sale, and publication of the advertising are conducted by students, under the supervision and instruction of the university. Although the services rendered to advertisers are of a commercial character, the advertising business contributes importantly to the university's educational program through the training of the students involved. Hence, none of the income derived from publication of the newspaper constitutes gross income from unrelated trade or business. The same result would follow even though the newspaper is published by a separately incorporated section 501(c)(3) organization, qualified under the university rules for recognition of student activities, and even though such organization utilizes its own facilities and is independent of faculty supervision, but carries out its educational purposes by

means of student instruction of other students in the editorial and advertising activities and student participation in those activities.

Example 6. Z is an association exempt under section 501(c)(6), formed to advance the interests of a particular profession and drawing its membership from the members of that profession. Z publishes a monthly journal containing articles and other editorial material which contribute importantly to the accomplishment of purposes for which exemption is granted the organization. Income from the sale of subscriptions to members and others in accordance with the organization's exempt purposes, therefore, does not constitute gross income from unrelated trade or business. In connection with the publication of the journal, Z also derives income from the regular sale of space and services for general consumer advertising,including advertising of such products as soft drinks, automobiles, articles of apparel, and home appliances. Neither the publication of such advertisements nor the performance of services for such commercial advertisers contributes importantly to the accomplishment of any purpose for which exemption is granted. Therefore, notwithstanding the fact that the production of income from advertising utilizes the circulation developed and maintained in performance of exempt functions, such income is gross income from unrelated trade or business.

Example 7. The facts are as described in the preceding example, except that the advertising in Z's journal promotes only products which are within the general area of professional interest of its members. Following a practice common among taxable magazines which publish advertising, Z requires its advertising to comply with certain general standards of taste, fairness, and accuracy; but within those limits the form, content, and manner of presentation of the advertising messages are governed by the basic objective of the advertisers to promote the sale of the advertised products. While the advertisements contain certain information, the informational function of the advertising is incidental to the controlling aim of stimulating demand for the advertised products and differs in no essential respect from the informational function of any commercial advertising. Like taxable publishers of advertising, Z accepts advertising only from those who are willing to pay its prescribed rates. Although continuing education of itsmembers in matters pertaining to their profession is one of the purposes for which Z is granted exemption, the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute; it differs fundamentally from such an activity both in its governing objective and in its method. Accordingly, Z's publication of advertising does not contribute importantly to the accomplishment of its exempt purposes; and the income which it derives from advertising constitutes gross income from unrelated trade or business.

(e) *Exceptions.* Section 513(a) specifically states that the term *unrelated trade or business* does not include:

(1) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) Any trade or business carried on by an organization described in section 501(c)(3) or by a governmental college or university described in section 511(a)(2)(B), primarily for the convenience of its members, students, patients, officers, or employees; or, any trade or business carried on by a local association of employees described in section 501(c)(4) organized before May 27, 1969, which consists of the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or

(3) Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions

An example of the operation of the first of the exceptions mentioned above would be an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on such business is performed for the organization by volunteers without compensation. An example of the first part of the second exception, relating to an organization described in section 501(c)(3) or a governmental college or university described in section 511(a)(2)(B), would be a laundry operated by a college for the purpose of laundering dormitory linens and the clothing of students. The latter part of the second exception, dealing with certain sales by local employee associations, will not apply to sales of these items at locations other than the

usual place of employment of the employees; therefore sales at such other locations will continue to be treated as unrelated trade or business. The third exception applies to so-called *thrift shops* operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, et cetera, to be sold to the general public with the proceeds going to the exempt organization.

(f) *Special rule respecting publishing businesses prior to 1970.* For a special rule for taxable years beginning before January 1, 1970, with respect to publishing businesses carried on by an organization, see section 513(c) of the Code prior to its amendment by section 121(c) of the Tax Reform Act of 1969 (83 Stat. 542).

(g) *Effective date.* This section is applicable with respect to taxable years beginning after December 12, 1967. However, if a taxpayer wishes to rely on the rules stated in this section for taxable years beginning before December 13, 1967, it may do so.

[T.D. 6939, 32 FR 17657, Dec. 12, 1967; 32 FR 17890, Dec. 14, 1967; 32 FR 17938, Dec. 15, 1967; T.D. 7107, 36 FR 6421, Apr. 3, 1971; T.D. 7392, 40 FR 58642, Dec. 18, 1975; T.D. 7896, 48 FR 23817, May 27, 1983]

§ 1.513–2 Definition of unrelated trade or business applicable to taxable years beginning before December 13, 1967.

(a) *In general.* (1) As used in section 512(a), the term *unrelated business taxable income* includes only income from an unrelated trade or business regularly carried on, and the term *trade or business* has the same meaning as it has in section 162.

(2) The income of an exempt organization is subject to the tax on unrelated business income only if two conditions are present with respect to such income. The first condition is that the income must be from a trade or business which is regularly carried on by the organization. The second condition is that the trade or business must not be substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501, or in the case ofan organization described in section 511(a)(2)(B) (governmental colleges, etc.) to the exercise or performance of any purpose or function described in section 501(c)(3). Whether or not an organization is subject to the tax imposed by section 511 shall be determined by the application of these tests to the particular circumstances involved in each individual case. For certain exceptions from the term *unrelated trade or business*, see paragraph (b) of this section.

(3) A trade or business is regularly carried on when the activity is conducted with sufficient consistency to indicate a continuing purpose of the organization to derive some of its income from such activity. An activity may be regularly carried on even though its performance is infrequent or seasonal.

(4) Ordinarily, a trade or business is substantially related to the activities for which an organization is granted exemption if the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. In the usual case the nature and size of the trade or business must be compared with the nature and extent of the activities for which the organization is granted exemption in order to determine whether the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. For example, the operation of a wheat farm is substantially related to the exempt activity of an agricultural college if the wheat farm isoperated as a part of the educational program of the college, and is not operated on a scale disproportionately large when compared with the educational program of the college. Similarly, a university radio station or press is considered a related trade or business if operated primarily as an integral part of the educational program of the university, but is considered an unrelated trade or business if operated in substantially the same manner as a commercial radio station

or publishing house. A trade or business not otherwise related does not become substantially related to an organization's exempt purpose merely because incidental use is made of the trade or business in order to further the exempt purpose. For example, the manufacture and sale of a product by an exempt college would not become substantially related merely because students as part of their educational program perform clerical or bookkeeping functions in the business. In some cases, the business may be substantially related because it is a necessary part of the exempt activity. For example, in the case of an organization described in section 501(c)(3) and engaged in the rehabilitation of handicapped persons, the business of selling articles made by such persons as a part of their rehabilitation training would not be considered an unrelated business since such business is a necessary part of the rehabilitation program.

(5) If an organization receives a payment pursuant to a contract or agreement under which such organization is to perform research which constitutes an unrelated trade or business, the entire amount of such payment is income from an unrelated trade or business. See, however, section 512(b), (7), (8), and (9), relating to the exclusion from unrelated business taxable income of income derived from research for the United States, or any State, and of income derived from research performed for any person by a college, university, hospital, or organization operated primarily for the purpose of carrying on fundamental research the results of which are freely available to the general public.

(b) *Exceptions*. Section 513(a) specifically states that the term *unrelated trade or business* does not include:

(1) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) Any trade or business carried on by an organization described in section 501(c)(3) or by a governmental college or university described in section 511(a)(2)(B), primarily for the convenience of its members, students, patients, officers, or employees; or

(3) Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions

An example of the operation of the first of the exceptions mentioned above would be an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on such business is performed for the organization by volunteers without compensation. An example of the second exception would be a laundry operated by a college for the purpose of laundering dormitory linens and the clothing of students. The third exception applies to so-called *thrift shops* operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, etc., to be sold to the general public with the proceeds going to the exempt organization.

(c) *Special rules respecting publishing businesses*. For a special rule with respect to publishing businesses carried on by an organization, see section 513(c) of the Code prior to its amendment by section 121(c) of the Tax Reform Act of 1969 (83 Stat. 542).

(d) *Effective date*. Except as provided in paragraph (g) of § 1.513–1, this section is applicable with respect to taxable years beginning before December 13, 1967.

(Sec. 513 as amended by sec. 4, Act of July 14, 1960 (P.L. 86–667, 74 Stat. 536); secs. 121 (b)(4) and (c), Tax Reform Act of 1969 (83 Stat. 536, 542))

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6525, 26 FR 190, Jan. 11, 1961; T.D. 6939, 32 FR 17657, Dec. 12, 1967; T.D. 7392, 40 FR 58643, Dec. 18, 1975; 40 FR 60053, Dec. 31, 1975]

§ 1.513–3 Qualified convention and trade show activity.

(a) *Introduction*—(1) *In general*. Section 513(d) and § 1.513–3(b) provide that convention and trade show activities carried on by a qualifying organization in connection with a qualified convention or trade show will not be treated as unrelated trade or business. Consequently, income from qualified convention and trade show activities, derived by a qualifying organization that

sponsors the qualified convention or trade show, will not be subject to the tax imposed by section 511. Section 1.513–3(c) defines qualifying organizations and qualified conventions or trade shows. Section 1.513–3(d) concerns the treatment of income derived from certain activities, including rental of exhibition space at a qualified convention or trade show where sales activity is permitted, and the treatment of supplier exhibits at qualified conventions and trade shows.

(2) *Effective date*. This section is effective for taxable years beginning after October 4, 1976.

(b) *Qualified activities not unrelated*. A convention or trade show activity, as defined in section 513(d)(3)(A) and §1.513–3(c)(4), will not be considered unrelated trade or business if it is conducted by a qualifying organization described in section 513(d)(3)(C) and §1.513–3(c)(1), in conjunction with a qualified convention or trade show, as defined in section 513(d)(3)(B) and §1.513–3(c)(2), sponsored by the qualifying organization. Such an activity is a qualified convention or trade show activity. A convention or trade show activity which is conducted by an organization described in section 501(c) (5) or (6), but which otherwise is not so qualified under this section, will be considered unrelated trade or business.

(c) *Definitions*—(1) *Qualifying organization*. Under section 513(d)(3)(C), a qualifying organization is one which:

(i) Is described in either section 501(c) (5) or (6), and

(ii) Regularly conducts as one of its substantial exempt purposes a qualified convention or trade show.

(2) *Qualified convention or trade show*. For purposes of this section, the term *qualified convention or trade show* means a show that meets the following requirements:

(i) It is conducted by a qualifying organization described in section 513(d)(3)(C);

(ii) At least one purpose of the sponsoring organization in conducting the show is the education of its members, or the promotion and stimulation of interest in, and demand for, the products or services of the industry (or segment thereof) of the members of the qualifying organization; and

(iii) The show is designed to achieve that purpose through the character of a significant portion of the exhibits or the character of conferences and seminars held at a convention or meeting.

(3) *Show*. For purposes of this section, the term *show* includes an international, national, state, regional, or local convention, annual meeting or show.

(4) *Convention and trade show activity*. For purposes of this section, convention and trade show activity means any activity of a kind traditionally carried on at shows. It includes, but is not limited to—

(i) Activities designed to attract to the show members of the sponsoring organization, members of an industry in general, and members of the public, to view industry products or services and to stimulate interest in, and demand for such products or services;

(ii) Activities designed to educate persons in the industry about new products or services or about new rules and regulations affecting the industry; and

(iii) Incidental activities, such as furnishing refreshments, of a kind traditionally carried on at such shows.

(d) *Certain activities*—(1) *Rental of exhibition space*. The rental of display space to exhibitors (including exhibitors who are suppliers) at a qualified trade show or at a qualified convention and trade show will not be considered unrelated trade or business even though the exhibitors who rent the space are permitted to sell or solicit orders.

(2) *Suppliers defined*. For purposes of subparagraph (1), a supplier's exhibit is one in which the exhibitor displays goods or services that are supplied to, rather than by, the members of the qualifying organization in the conduct of such members' own trades or businesses.

(e) *Example*. The provisions of this section may be illustrated by the following examples:

Example 1. X, an organization described in section 501(c)(6), was formed to promote the construction industry. Its membership is made up of manufacturers of heavy construction machinery many of whom own, rent, or lease one or more digital computers produced by various computer manufacturers. X is a qualifying organization under section

513(d)(3)(C) that regularly holds an annual meeting. At this meeting a national industry sales campaign and methods of consumer financing for heavy construction machinery are discussed. In addition, new construction machinery developed for use in the industry is on display with representatives of the various manufacturers present to promote their machinery. Both members and nonmembers attend this portion of the conference. In addition, manufacturers of computers are present to educate X's members. While this aspect of the conference is a supplier exhibit (as defined in paragraph (d) of this section), income earned from such activity by X will not constitute unrelated business taxable income to X because the activity is conducted as part of a qualified trade show described in § 1.513–3(c).

Example 2. Assume the same facts as in Example 1, but the only goods or services displayed are those of suppliers, the computer manufacturers. Selling and order taking are permitted. No member exhibits are maintained. Standing alone, this supplier exhibit (as defined in paragraph (d)(2) of this section) would constitute a supplier show and not a qualified convention or trade show. In this situation, however, the rental of exhibition space to suppliers is not unrelated trade or business. It is conducted by a qualifying organization in conjunction with a qualified convention or trade show. The show (the annual meeting) is a qualified convention or trade show because one of its purposes is the promotion and stimulation of interest in, and demand for, the products or services of the industry through the character of the annual meeting.

Example 3. Y is an organization described in section 501(c)(6). The organization conducts an annual show at which its members exhibit their products and services in order to promote public interest in the line of business. Potential customers are invited to the show, and sales and order taking are permitted. The organization secures the exhibition facility, undertakes the planning and direction of the show, and maintains exhibits designed to promote the line of business in general. The show is a qualified convention or trade show described in paragraph (c)(2) of this section. The provision of exhibition space to individual members is a qualified trade show activity, and is not unrelated trade or business.

Example 4. Z is an organization described in section 501(c)(6) that sponsors an annual show. As the sole activity at the show, suppliers to the members of Z exhibit their products and services for the purpose of stimulating the sale of their products. Selling and order taking are permitted. The show is a supplier show and does not meet the definition of a qualified convention show as it does not satisfy any of the three alternative bases for qualification. First, the show does not stimulate interest in the members' products through the character of product exhibits as the only products exhibited are those of suppliers rather than members. Second, the show does not stimulate interest in members' products through conferences or seminars as no such conferences are held at the show. Third, the show does not meet the definition of a qualified show on the basis of educational activities as the exhibition of suppliers' products is designed primarily to stimulate interest in, and sale of, suppliers' products. Thus, the organization's provision of exhibition space is not a qualified convention or trade show activity. Income derived from rentals of exhibition space to suppliers will be unrelated business taxable income under section 512.

[T.D. 7896, 48 FR 23817, May 27, 1983]

§ 1.513–4 Certain sponsorship not unrelated trade or business.

(a) *In general.* Under section 513(i), the receipt of qualified sponsorship payments by an exempt organization which is subject to the tax imposed by section 511 does not constitute receipt of income from an unrelated trade or business.

(b) *Exception.* The provisions of this section do not apply with respect to payments made in connection with qualified convention and trade show activities. For rules governing qualified convention and trade show activity, see § 1.513–3. The provisions of this section also do not apply to income derived from the sale of advertising or acknowledgments in exempt organization periodicals. For this purpose, the term *periodical* means regularly scheduled and printed material published by or on behalf of the exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the exempt organization. For this purpose, printed material includes material that is published electronically. For rules governing the sale of advertising in exempt organization periodicals, see § 1.512(a)–1(f).

(c) *Qualified sponsorship payment*—(1) *Definition.* The term *qualified sponsorship payment* means any payment by any person engaged in a trade or business with respect to which there is no arrangement or expectation that the person will receive any substantial return benefit. In determining whether a

payment is a qualified sponsorship payment, it is irrelevant whether the sponsored activity is related or unrelated to the recipient organization's exempt purpose. It is also irrelevant whether the sponsored activity is temporary or permanent. For purposes of this section, payment means the payment of money, transfer of property, or performance of services.

(2) *Substantial return benefit*—(i) *In general*. For purposes of this section, a *substantial return benefit* means any benefit other than a use or acknowledgment described in paragraph (c)(2)(iv) of this section, or disregarded benefits described in paragraph (c)(2)(ii) of this section.

(ii) *Certain benefits disregarded*. For purposes of paragraph (c)(2)(i) of this section, benefits are disregarded if the aggregate fair market value of all the benefits provided to the payor or persons designated by the payor in connection with the payment during the organization's taxable year is not more than 2% of the amount of the payment. If the aggregate fair market value of the benefits exceeds 2% of the amount of the payment, then (except as provided in paragraph (c)(2)(iv) of this section) the entire fair market value of such benefits, not merely the excess amount, is a substantial return benefit. Fair market value is determined as provided in paragraph (d)(1) of this section.

(iii) *Benefits defined*. For purposes of this section, benefits provided to the payor or persons designated by the payor may include:

(A) Advertising as defined in paragraph (c)(2)(v) of this section.

(B) Exclusive provider arrangements as defined in paragraph (c)(2)(vi)(B) of this section.

(C) Goods, facilities, services or other privileges.

(D) Exclusive or nonexclusive rights to use an intangible asset (e.g., trademark, patent, logo, or designation) of the exempt organization.

(iv) *Use or acknowledgment*. For purposes of this section, a substantial return benefit does not include the use or acknowledgment of the name or logo (or product lines) of the payor's trade or business in connection with the activities of the exempt organization. Use or acknowledgment does not include advertising as described in paragraph (c)(2)(v) of this section, but may include the following: exclusive sponsorship arrangements; logos and slogans that do not contain qualitative or comparative descriptions of the payor's products, services, facilities or company; a list of the payor's locations, telephone numbers, or Internet address; value-neutral descriptions, including displays or visual depictions, of the payor's product-line or services; and the payor's brand or trade names and product or service listings. Logos or slogans that are an established part of a payor's identity are not considered to contain qualitative or comparative descriptions. Mere display or distribution, whether for free or remuneration, of a payor's product by the payor or the exempt organization to the general public at the sponsored activity is not considered an inducement to purchase, sell or use the payor's product for purposes of this section and, thus, will not affect the determination of whether a payment is a qualified sponsorship payment.

(v) *Advertising*. For purposes of this section, the term *advertising* means any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product. Advertising includes messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product. A single message that contains both advertising and an acknowledgment is advertising. This section does not apply to activities conducted by a payor on its own. For example, if a payor purchases broadcast time from a television station to advertise its product during commercial breaks in a sponsored program, the exempt organization's activities are not thereby converted to advertising.

(vi) *Exclusivity arrangements*—(A) *Exclusive sponsor*. An arrangement that acknowledges the payor as the exclusive sponsor of an exempt organization's activity, or the exclusive sponsor

representing a particular trade, business or industry, generally does not, by itself, result in a substantial return benefit. For example, if in exchange for a payment, an organization announces that its event is sponsored exclusively by the payor (and does not provide any advertising or other substantial return benefit to the payor), the payor has not received a substantial return benefit.

(B) *Exclusive provider*. An arrangement that limits the sale, distribution, availability, or use of competing products, services, or facilities in connection with an exempt organization's activity generally results in a substantial return benefit. For example, if in exchange for a payment, the exempt organization agrees to allow only the payor's products to be sold in connection with an activity, the payor has received a substantial return benefit.

(d) *Allocation of payment*—(1) *In general*. If there is an arrangement or expectation that the payor will receive a substantial return benefit with respect to any payment, then only the portion, if any, of the payment that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment. However, if the exempt organization does not establish that the payment exceeds the fair market value of any substantial return benefit, then no portion of the payment constitutes a qualified sponsorship payment.

(i) *Treatment of payments other than qualified sponsorship payments*. The unrelated business income tax (UBIT) treatment of any payment (or portion thereof) that is not a qualified sponsorship payment is determined by application of sections 512, 513 and 514. For example, payments related to an exempt organization's providing facilities, services, or other privileges to the payor or persons designated by the payor, advertising, exclusive provider arrangements described in paragraph (c)(2)(vi)(B) of this section, a license to use intangible assets of the exempt organization, or other substantial return benefits, are evaluated separately in determining whether the exempt organization realizes unrelated business taxable income.

(ii) *Fair market value*. The fair market value of any substantial return benefit provided as part of a sponsorship arrangement is the price at which the benefit would be provided between a willing recipient and a willing provider of the benefit, neither being under any compulsion to enter into the arrangement and both having reasonable knowledge of relevant facts, and without regard to any other aspect of the sponsorship arrangement.

(iii) *Valuation date*. In general, the fair market value of the substantial return benefit is determined when the benefit is provided. However, if the parties enter into a binding, written sponsorship contract, the fair market value of any substantial return benefit provided pursuant to that contract is determined on the date the parties enter into the sponsorship contract. If the parties make a material change to a sponsorship contract, it is treated as a new sponsorship contract as of the date the material change is effective. A material change includes an extension or renewal of the contract, or a more than incidental change to any amount payable (or other consideration) pursuant to the contract.

(iv) *Examples*. The following examples illustrate the provisions of this section:

Example 1. On June 30, 2001, a national corporation and Z, a charitable organization, enter into a five-year binding, written contract effective for years 2002 through 2007. The contract provides that the corporation will make an annual payment of $5,000 to Z, and in return the corporation will receive no benefit other than advertising. On June 30, 2001, the fair market value of the advertising to be provided to the corporation in each year of the agreement is $75, which is less than the disregarded benefit amount provided for in paragraph (c)(2)(ii) of this section (2% of $5,000 is $100). In 2002, pursuant to the sponsorship contract, the corporation makes a payment to Z of $5,000, and receives the specified benefit (advertising). As of January 1, 2002, the fair market value of the advertising to be provided by Z each year has increased to $110. However, for purposes of this section, the fair market value of the advertising benefit is determined on June 30, 2001, the date the parties entered into the sponsorship contract. Therefore, the entire $5,000 payment received in 2002 is a qualified sponsorship payment.

Example 2. The facts are the same as *Example 1*, except that the contract provides for an initial payment by the corporation to Z of $5,000 in 2002, followed by annual payments of $1,000 during each of years 2003–2007. In

2003, pursuant to the sponsorship contract, the corporation makes a payment to Z of $1,000, and receives the specified advertising benefit. In 2003, the fair market value of the benefit provided ($75, as determined on June 30, 2001) exceeds 2% of the total payment received (2% of $1,000 is $20). Therefore, only $925 of the $1,000 payment received in 2003 is a qualified sponsorship payment.

(2) *Anti-abuse provision*. To the extent necessary to prevent avoidance of the rule stated in paragraphs (d)(1) and (c)(2) of this section, where the exempt organization fails to make a reasonable and good faith valuation of any substantial return benefit, the Commissioner (or the Commissioner's delegate) may determine the portion of a payment allocable to such substantial return benefit and may treat two or more related payments as a single payment.

(e) *Special rules*—(1) *Written agreements*. The existence of a written sponsorship agreement does not, in itself, cause a payment to fail to be a qualified sponsorship payment. The terms of the agreement, not its existence or degree of detail, are relevant to the determination of whether a payment is a qualified sponsorship payment. Similarly, the terms of the agreement and not the title or responsibilities of the individuals negotiating the agreement determine whether a payment (or any portion thereof) made pursuant to the agreement is a qualified sponsorship payment.

(2) *Contingent payments*. The term *qualified sponsorship payment* does not include any payment the amount of which is contingent, by contract or otherwise, upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to the sponsored activity. The fact that a payment is contingent upon sponsored events or activities actually being conducted does not, by itself, cause the payment to fail to be a qualified sponsorship payment.

(3) *Determining public support*. Qualified sponsorship payments in the form of money or property (but not services) are treated as contributions received by the exempt organization for purposes of determining public support to the organization under section 170(b)(1)(A)(vi) or 509(a)(2). See §§ 1.509(a)–3(f)(1) and 1.170A–9(e)(6)(i). The fact that a payment is a qualified sponsorship payment that is treated as a contribution to the payee organization does not determine whether the payment is deductible by the payor under section 162 or 170.

(f) *Examples*. The provisions of this section are illustrated by the following examples. The tax treatment of any payment (or portion of a payment) that does not constitute a qualified sponsorship payment is governed by general UBIT principles. In these examples, the recipients of the payments at issue are section 501(c) organizations. The expectations or arrangements of the parties are those specifically indicated in the example. The examples are as follows:

Example 1. M, a local charity, organizes a marathon and walkathon at which it serves to participants drinks and other refreshments provided free of charge by a national corporation. The corporation also gives M prizes to be awarded to winners of the event. M recognizes the assistance of the corporation by listing the corporation's name in promotional fliers, in newspaper advertisements of the event and on T-shirts worn by participants. M changes the name of its event to include the name of the corporation. M's activities constitute acknowledgment of the sponsorship. The drinks, refreshments and prizes provided by the corporation are a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 2. N, an art museum, organizes an exhibition and receives a large payment from a corporation to help fund the exhibition. N recognizes the corporation's support by using the corporate name and established logo in materials publicizing the exhibition, which include banners, posters, brochures and public service announcements. N also hosts a dinner for the corporation's executives. The fair market value of the dinner exceeds 2% of the total payment. N's use of the corporate name and logo in connection with the exhibition constitutes acknowledgment of the sponsorship. However, because the fair market value of the dinner exceeds 2% of the total payment, the dinner is a substantial return benefit. Only that portion of the payment, if any, that N can demonstrate exceeds the fair market value of the dinner is a qualified sponsorship payment.

Example 3. O coordinates sports tournaments for local charities. An auto manufacturer agrees to underwrite the expenses of the tournaments. O recognizes the auto manufacturer by including the manufacturer's name and established logo in the title of each tournament as well as on signs, scoreboards and other printed material. The auto

manufacturer receives complimentary admission passes and pro-am playing spots for each tournament that have a combined fair market value in excess of 2% of the total payment. Additionally, O displays the latest models of the manufacturer's premier luxury cars at each tournament. O's use of the manufacturer's name and logo and display of cars in the tournament area constitute acknowledgment of the sponsorship. However, the admission passes and pro-am playing spots are a substantial return benefit. Only that portion of the payment, if any, that O can demonstrate exceeds the fair market value of the admission passes and pro-am playing spots is a qualified sponsorship payment.

Example 4. P conducts an annual college football bowl game. P sells to commercial broadcasters the right to broadcast the bowl game on television and radio. A major corporation agrees to be the exclusive sponsor of the bowl game. The detailed contract between P and the corporation provides that in exchange for a $1,000,000 payment, the name of the bowl game will include the name of the corporation. In addition, the contract provides that the corporation's name and established logo will appear on player's helmets and uniforms, on the scoreboard and stadium signs, on the playing field, on cups used to serve drinks at the game, and on all related printed material distributed in connection with the game. P also agrees to give the corporation a block of game passes for its employees and to provide advertising in the bowl game program book. The fair market value of the passes is $6,000, and the fair market value of the program advertising is $10,000. The agreement is contingent upon the game being broadcast on television and radio, but the amount of the payment is not contingent upon the number of people attending the game or the television ratings. The contract provides that television cameras will focus on the corporation's name and logo on the field at certain intervals during the game. P's use of the corporation's name and logo in connection with the bowl game constitutes acknowledgment of the sponsorship. The exclusive sponsorship arrangement is not a substantial return benefit. Because the fair market value of the game passes and program advertising ($16,000) does not exceed 2% of the total payment (2% of $1,000,000 is $20,000), these benefits are disregarded and the entire payment is a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 5. Q organizes an amateur sports team. A major pizza chain gives uniforms to players on Q's team, and also pays some of the team's operational expenses. The uniforms bear the name and established logo of the pizza chain. During the final tournament series, Q distributes free of charge souvenir flags bearing Q's name to employees of the pizza chain who come out to support the team. The flags are valued at less than 2% of the combined fair market value of the uniforms and operational expenses paid. Q's use of the name and logo of the pizza chain in connection with the tournament constitutes acknowledgment of the sponsorship. Because the fair market value of the flags does not exceed 2% of the total payment, the entire amount of the funding and supplied uniforms are a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 6. R is a liberal arts college. A soft drink manufacturer enters into a binding, written contract with R that provides for a large payment to be made to the college's English department in exchange for R agreeing to name a writing competition after the soft drink manufacturer. The contract also provides that R will allow the soft drink manufacturer to be the exclusive provider of all soft drink sales on campus. The fair market value of the exclusive provider component of the contract exceeds 2% of the total payment. R's use of the manufacturer's name in the writing competition constitutes acknowledgment of the sponsorship. However, the exclusive provider arrangement is a substantial return benefit. Only that portion of the payment, if any, that R can demonstrate exceeds the fair market value of the exclusive provider arrangement is a qualified sponsorship payment.

Example 7. S is a noncommercial broadcast station that airs a program funded by a local music store. In exchange for the funding, S broadcasts the following message: ''This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call today at 555–1234. This station is proud to have the Music Shop as a sponsor.'' Because this single broadcast message contains both advertising and an acknowledgment, the entire message is advertising. The fair market value of the advertising exceeds 2% of the total payment. Thus, the advertising is a substantial return benefit. Unless S establishes that the amount of the payment exceeds the fair market value of the advertising, none of the payment is a qualified sponsorship payment.

Example 8. T, a symphony orchestra, performs a series of concerts. A program guide that contains notes on guest conductors and other information concerning the evening's program is distributed by T at each concert. The Music Shop makes a $1,000 payment to T in support of the concert series. As a supporter of the event, the Music Shop receives complimentary concert tickets with a fair market value of $85, and is recognized in the program guide and on a poster in the lobby of the concert hall. The lobby poster states that, ''The T concert is sponsored by the Music Shop, located at 123 Main Street, telephone number 555–1234.'' The program guide

contains the same information and also states, ''Visit the Music Shop today for the finest selection of music CDs and cassette tapes.'' The fair market value of the advertisement in the program guide is $15. T's use of the Music Shop's name, address and telephone number in the lobby poster constitutes acknowledgment of the sponsorship. However, the combined fair market value of the advertisement in the program guide and complimentary tickets is $100 ($15 + $85), which exceeds 2% of the total payment (2% of $1,000 is $20). The fair market value of the advertising and complimentary tickets, therefore, constitutes a substantial return benefit and only that portion of the payment, or $900, that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment.

Example 9. U, a national charity dedicated to promoting health, organizes a campaign to inform the public about potential cures to fight a serious disease. As part of the campaign, U sends representatives to community health fairs around the country to answer questions about the disease and inform the public about recent developments in the search for a cure. A pharmaceutical company makes a payment to U to fund U's booth at a health fair. U places a sign in the booth displaying the pharmaceutical company's name and slogan, ''Better Research, Better Health,'' which is an established part of the company's identity. In addition, U grants the pharmaceutical company a license to use U's logo in marketing its products to health care providers around the country. The fair market value of the license exceeds 2% of the total payment received from the company. U's display of the pharmaceutical company's name and slogan constitutes acknowledgment of the sponsorship. However, the license granted to the pharmaceutical company to use U's logo is a substantial return benefit. Only that portion of the payment, if any, that U can demonstrate exceeds the fair market value of the license granted to the pharmaceutical company is a qualified sponsorship payment.

Example 10. V, a trade association, publishes a monthly scientific magazine for its members containing information about current issues and developments in the field. A textbook publisher makes a large payment to V to have its name displayed on the inside cover of the magazine each month. Because the monthly magazine is a periodical within the meaning of paragraph (b) of this section, the section 513(i) safe harbor does not apply. See § 1.512(a)–1(f).

Example 11. W, a symphony orchestra, maintains a Web site containing pertinent information and its performance schedule. The Music Shop makes a payment to W to fund a concert series, and W posts a list of its sponsors on its Web site, including the Music Shop's name and Internet address. W's Web site does not promote the Music Shop or advertise its merchandise. The Music Shop's Internet address appears as a hyperlink from W's Web site to the Music Shop's Web site. W's posting of the Music Shop's name and Internet address on its Web site constitutes acknowledgment of the sponsorship. The entire payment is a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 12. X, a health-based charity, sponsors a year-long initiative to educate the public about a particular medical condition. A large pharmaceutical company manufactures a drug that is used in treating the medical condition, and provides funding for the initiative that helps X produce educational materials for distribution and post information on X's Web site. X's Web site contains a hyperlink to the pharmaceutical company's Web site. On the pharmaceutical company's Web site, the statement appears, ''X endorses the use of our drug, and suggests that you ask your doctor for a prescription if you have this medical condition.'' X reviewed the endorsement before it was posted on the pharmaceutical company's Web site and gave permission for the endorsement to appear. The endorsement is advertising. The fair market value of the advertising exceeds 2% of the total payment received from the pharmaceutical company. Therefore, only the portion of the payment, if any, that X can demonstrate exceeds the fair market value of the advertising on the pharmaceutical company's Web site is a qualified sponsorship payment.

[T.D. 8991, 67 FR 20438, Apr. 25, 2002]

§ 1.513–5 Certain bingo games not unrelated trade or business.

(a) *In general.* Under section 513(f), and subject to the limitations in paragraph (C) of this section, in the case of an organization subject to the tax imposed by section 511, the term *unrelated trade or business* does not include any trade or business that consists of conducting bingo games (as defined in paragraph (d) of this section).

(b) *Exception.* The provisions of this section shall not apply with respect to any bingo game otherwise excluded from the term *unrelated trade or business* by reason of section 513(a)(1) and § 1.513–1(e)(1) (relating to trades or businesses in which substantially all the work is performed without compensation).

(c) *Limitations*—(1) *Bingo games must be legal.* Paragraph (a) of this section shall not apply with respect to any

bingo game conducted in violation of State or local law.

(2) *No commercial competition*. Paragraph (a) of this section shall not apply with respect to any bingo game conducted in a jurisdiction in which bingo games are ordinarily carried out on a commercial basis. Bingo games are *ordinarily carried out on a commercial basis* within a jursidiction if they are regularly carried on (within the meaning of § 1.513–1(c)) by for-profit organizations in any part of that jurisidiction. Normally, the entire State will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis. However, if State law permits local jurisdictions to determine whether bingo games may be conducted by for-profit organizations, or if State law limits or confines the conduct of bingo games by for-profit organizations to specific local jurisdictions, then the local jurisdiction will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis.

(3) *Examples*. The application of this paragraph is illustrated by the examples that follow. In each example, it is assumed that the bingo games referred to are operated by individuals who are compensated for their services. Accordingly, none of the bingo games would be excluded from the term *unrelated trade or business* under section 513 (a)(1).

Example 1. Church Z, a tax-exempt organization, conducts weekly bingo games in State O. State and local laws in State O expressly provide that bingo games may be conducted by tax-exempt organizations. Bingo games are not conducted in State O by any for-profit businesses. Since Z's bingo games are not conducted in violation of State or local law and are not the type of activity ordinarily carried out on a commercial basis in State O, Z's bingo games do not constitute unrelated trade or business.

Example 2. Rescue Squad X, a tax-exempt organization, conducts weekly bingo games in State M. State M has a statutory provision that prohibits all forms of gambling including bingo games. However, that law generally is not enforced by State officials against local charitable organizations such as X that conduct bingo games to raise funds. Since bingo games are illegal under State law, X's bingo games constitute unrelated trade or business regardless of the degree to which the State law is enforced.

Example 3. Veteran's organizations Y and X, both tax-exempt organizations, are organized under the laws of State N. State N has a statutory provision that permits bingo games to be conducted by tax-exempt organizations. In addition, State N permits bingo games to be conducted by for-profit organizations in city S, a resort community located in county R. Several for-profit organizations conduct nightly bingo games in city S. Y conducts weekly bingo games in city S. X conducts weekly bingo games in county R. Since State law confines the conduct of bingo games by for-profit organizations to city S, and since bingo games are regularly carried on there by those organizations, Y's bingo games conducted in city S constitute unrelated trade or business. However, X's bingo games conducted in county R outside of city S do not constitute unrelated trade or business.

(d) *Bingo game defined*. A bingo game is a game of chance played with cards that are generally printed with five rows of five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a preselected pattern such as a horizontal, vertical, or diagonal line, or all four corners. The first participant to form the preselected pattern wins the game. As used in this section, the term *bingo game* means any game of bingo of the type described above in which wagers are placed, winners are determined, and prizes or other property is distributed in the presence of all persons placing wagers in that game. The term *bingo game* does not refer to any game of chance (including, but not limited to, keno games, dice games, card games, and lotteries) other than the type of game described in this paragraph.

(e) *Effective date*. Section 513(f) and this section apply to taxable years beginning after December 31, 1969.

[T.D. 7699, 45 FR 33970, May 21, 1980]

§ 1.513–6 Certain hospital services not unrelated trade or business.

(a) *In general*. Under section 513(e), the furnishing of a service listed in section 501(e)(1)(A) by a hospital to one or more other hospitals will not constitute unrelated trade or business if—

(1) The service is provided solely to hospitals that have facilities to serve not more than 100 inpatients,

(2) The service would, if performed by the recipient hospital, constitute an activity consistent with that hospital's exempt purposes, and

(3) The service is provided at a fee not in excess of actual cost, including straight line depreciation and a reasonable rate of return on the capital goods used to provide the service. For purposes of this section, a rate of return on capital goods will be considered *reasonable* provided that it does not exceed, on an annual basis, the percentage described below which is based on the average of the rates of interest on special issues of public debt obligations issued to the Federal Hospital Insurance Trust Fund for each of the months included in the taxable year of the hospital duringwhich the captial goods are used in providing the service. Determinations as to the cost of services and the applicable rate of return should be made as prescribed by 42 U.S.C. 1395x(v)(1) (A) and (B) and the regulations thereunder (permitting a health care facility to be reimbursed under the Medicare program for the *reasonable cost of (its) services*, including, in the case of certain proprietary facilities, a *reasonable return on equity capital*). For taxable years beginning on or before May 14, 1986, the rate of return shall be one and one-half times the average of the rates of interest on public debt obligations described above which were in effect on or before April 20, 1983.

(b) *Hospital defined*. As used in this section the word *hospital* means a hospital described in section 170(b)(1)(A)(iii).

(c) *Example*. The provisions of this section are illustrated by the following example:

Example. A large metropolitan hospital provides various services to other hospitals. The hospital furnishes a purchasing service to hosptials N and O, a data processing service to hospitals R and S, and a food service to hospitals X and Y. All the hospitals are described in section 170(b)(1)(A)(iii). All the hospitals have facilities to serve not more than 100 inpatients except hospital N. The services are furnished at cost to all hospitals except that hospital R is charged a fee in excess of cost for its use of the data processing service. The purchasing service constitutes unrelated trade or business because it is not provided solely to hospitals having facilities to serve not more than 100 inpatients.

The data processing service constitutes unrelated trade or business because it is provided at a fee in excess of cost. The food service satisfies all three requirements of paragraph (a) of this section and does not constitute unrelated trade or business.

(d) *Effective date*. Section 513(e) and this section apply to taxable years beginning after December 31, 1953.

[T.D. 8075, 51 FR 5322, Feb. 13, 1986; 51 FR 8490, Mar. 12, 1986]

§ 1.513–7 Travel and tour activities of tax exempt organizations.

(a) Travel tour activities that constitute a trade or business, as defined in § 1.513–1(b), and that are not substantially related to the purposes for which exemption has been granted to the organization constitute an unrelated trade or business with respect to that organization. Whether travel tour activities conducted by an organization are substantially related to the organization's exempt purpose is determined by looking at all relevant facts and circumstances, including, but not limited to, how a travel tour is developed, promoted and operated. Section 513(c) and § 1.513–1(b) also apply to travel tour activity. Application of the rules of section 513(c) and § 1.513–1(b) may result in different treatment for individual tours within an organization's travel tour program.

(b) *Examples*. The provisions of this section are illustrated by the following examples. In all of these examples, the travel tours are priced to produce a profit for the exempt organization. The examples are as follows:

Example 1. O, a university alumni association, is exempt from federal income tax under section 501(a) as an educational organization described in section 501(c)(3). As part of its activities, O operates a travel tour program. The program is open to all current members of O and their guests. O works with travel agencies to schedule approximately 10 tours annually to various destinations around the world. Members of O pay $x to the organizing travel agency to participate in a tour. The travel agency pays O a per person fee for each participant. Although the literature advertising the tours encourages O's members to continue their lifelong learning by joining the tours, and a faculty member of O's related university frequently joins

the tour as a guest of the alumni association, none of the tours includes any scheduled instruction or curriculum related to the destinations being visited. The travel tours made available to O's members do not contribute importantly to the accomplishment of O's educational purpose. Rather, O's program is designed to generate revenues for O by regularly offering its members travel services. Accordingly, O's tour program is an unrelated trade or business within the meaning of section 513(a).

Example 2. N is an organization formed for the purpose of educating individuals about the geography and culture of the United States. It is exempt from federal income tax under section 501(a) as an educational and cultural organization described in section 501(c)(3). N engages in a number of activities to accomplish its purposes, including offering courses and publishing periodicals and books. As one of its activities, N conducts study tours to national parks and other locations within the UnitedStates. The study tours are conducted by teachers and other personnel certified by the Board of Education of the State of P. The tours are directed toward students enrolled in degree programs at educational institutions in P, as reflected in the promotional materials, but are open to all who agree to participate in the required study program. Each tour's study program consists of instruction on subjects related to the location being visited on the tour. During the tour, five or six hours per day are devoted to organized study, preparation of reports, lectures, instruction and recitation by the students. Each tour group brings along a library of material related to the subject being studied on the tour. Examinations are given at the end of each tour and the P StateBoard of Education awards academic credit for tour participation. Because the tours offered by N include a substantial amount of required study, lectures, report preparation, examinations and qualify for academic credit, the tours are substantially related to N's educational purpose. Accordingly, N's tour program is not an unrelated trade or business within the meaning of section 513(a).

Example 3. R is a section 501(c)(4) social welfare organization devoted to advocacy on a particular issue. On a regular basis throughout the year, R organizes travel tours for its members to Washington, DC. While in Washington, the members follow a schedule according to which they spend substantially all of their time during normal business hours over several days attending meetings with legislators and government officials and receiving briefings on policy developments related to the issue that is R's focus. Members do have some time on their own in the evenings to engage in recreational or social activities of their own choosing. Bringing members to Washington to participate in advocacy on behalf of the organization and learn about developments relating to the organization's principal focus is substantially related to R's social welfare purpose. Therefore, R's operation of the travel tours does not constitute an unrelated trade or business within the meaning of section 513(a).

Example 4. S is a membership organization formed to foster cultural unity and to educate X Americans about X, their country of origin. It is exempt from federal income tax under section 501(a) and is described in section 501(c)(3) as an educational and cultural organization. Membership in S is open to all Americans interested in the X heritage. As part of its activities, S sponsors a program of travel tours to X. The tours are divided into two categories. Category A tours are trips to X that are designed to immerse participants in the X history, culture and language. Substantially all of the daily itinerary includes scheduled instruction on the X language, history and cultural heritage, and visits to destinations selected because of their historical or cultural significance or because of instructional resources they offer. Category B tours are also trips to X, but rather than offering scheduled instruction, participants are given the option of taking guided tours of various X locations included in their itinerary. Other than the optional guided tours, Category B tours offer no instruction or curriculum. Destinations of principally recreational interest, rather than historical or cultural interest, are regularly included on Category B tour itineraries. Based on the facts and circumstances, sponsoring Category A tours is an activity substantially related to S's exempt purposes, and does not constitute an unrelated trade or business within the meaning of section 513(a). However, sponsoring Category B tours does not contribute importantly to S's accomplishment of its exempt purposes and, thus, constitutes an unrelated trade or business within the meaning of section 513(a).

Example 5. T is a scientific organization engaged in environmental research. T is exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3). T is engaged in a long-term study of how agricultural pesticide and fertilizer use affects the populations of various bird species. T collects data at several bases located in an important agricultural region of country U. The minutes of a meeting of T's Board of Directors state that, after study, the Board has determined that non-scientists can reliably perform needed data collection in the field, under supervision of T's biologists. The Board minutes reflect that the Board approved offering one-week trips to T's bases in U, where participants will assist T's biologists in collecting data for the study. Tour participants collect data during the same hours as T's biologists. Normally,

data collection occurs during the early morning and evening hours, although the work schedule varies by season. Each base has rustic accommodations and few amenities, but country U is renowned for its beautiful scenery and abundant wildlife. T promotes the trips in its newsletter and on its Internet site and through various conservation organizations. The promotional materials describe the work schedule and emphasize the valuable contribution made by trip participants to T's research activities. Based on the facts and circumstances, sponsoring trips to T's bases in country U is an activity substantially related to T's exempt purpose, and, thus, does not constitute an unrelated trade or business within the meaning of section 513(a).

Example 6. V is an educational organization devoted to the study of ancient history and cultures and is exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3). In connection with its educational activities, V conducts archaeological expeditions around the world, including in the Y region of country Z. In cooperation with the National Museum of Z, V recently presented an exhibit on ancient civilizations of the Y region of Z, including artifacts from the collection of the Z National Museum. V instituted a program of travel tours to V's archaeological sites located in the Y region. The tours were initially proposed by V staff members as a means of educating the public about ongoing field research conducted by V. V engaged a travel agency to handle logistics such as accommodations and transportation arrangements. In preparation for the tours, V developed educational materials relating to each archaeological site to be visited on the tour, describing in detail the layout of the site, the methods used by V's researchers in exploring the site, the discoveries made at the site, and their historical significance. V also arranged special guided tours of its exhibit on the Y region for individuals registered for the travel tours. Two archaeologists from V (both of whom had participated in prior archaeological expeditions in the Y region) accompanied the tours. These experts led guided tours of each site and explained the significance of the sites to tour participants. At several of the sites, tour participants also met with a working team of archaeologists from V and the National Museum of Z, who shared their experiences. V prepared promotional materials describing the educational nature of the tours, including the daily trips to V's archaeological sites and the educational background of the tour leaders, and providing a recommended reading list. The promotional materials do not refer to any particular recreational or sightseeing activities. Based on the facts and circumstances, sponsoring trips to the Y region is an activity substantially related to V's exempt purposes. The scheduled activities, which include tours of archaeological sites led by experts, are part of a coordinated educational program designed to educate tour participants about the ancient history of the Y region of Z and V's ongoing field research. Therefore, V's tour program does not constitute an unrelated trade or business within the meaning of section 513(a).

Example 7. W is an educational organization devoted to the study of the performing arts and is exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3). In connection with its educational activities, W presents public performances of musical and theatrical works. Individuals become members of W by making an annual contribution to W of $q. Each year, W offers members an opportunity to travel as a group to one or more major cities in the United States or abroad. In each city, tour participants are provided tickets to attend a public performance of a play, concert or dance program each evening. W also arranges a sightseeing tour of each city and provides evening receptions for tour participants. W views its tour program as an important means to develop and strengthen bonds between W and its members, and to increase their financial and volunteer support of W. W engaged a travel agency to handle logistics such as accommodations and transportation arrangements. No educational materials are prepared by W or provided to tour participants in connection with the tours. Apart from attendance at the evening cultural events, the tours offer no scheduled instruction, organized study or group discussion. Although several members of W's administrative staff accompany each tour group, their role is to facilitate member interaction. The staff members have no special expertise in the performing arts and play no educational role in the tours. W prepared promotional materials describing the sightseeing opportunities on the tours and emphasizing the opportunity for members to socialize informally and interact with one another and with W staff members, while pursuing shared interests. Although W's tour program may foster goodwill among W members, it does not contribute importantly to W's educational purposes. W's tour program is primarily social and recreational in nature. The scheduled activities, which include sightseeing and attendance at various cultural events, are not part of a coordinated educational program. Therefore, W's tour program is an unrelated trade or business within the meaning of section 513(a).

[T.D. 8874, 65 FR 5773, Feb. 7, 2000; 65 FR 16143, Mar. 27, 2000]

§ 1.514(a)–1 Unrelated debt-financed income and deductions.

(a) *Income includible in gross income:*

(1) *Percentage of income taken into account*—(i) *In general.* For taxable years beginning after December 31, 1969, there shall be included with respect to each debt-financed property (as defined in section 514 and §1.514(b)–1) as an item of gross income derived from an unrelated trade or business the amount of unrelated debt-financed income (as defined in subdivision (ii) of this subparagraph). See paragraph (a)(5) of §1.514(c)–1 for special rules regarding indebtedness incurred before June 28, 1966, applicable for taxable years beginning before January 1, 1972, and for special rules applicable to churches or conventions or associations of churches.

(ii) *Unrelated debt-financed income.* The *unrelated debt-financed income* with respect to each debt-financed property is an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as:

(*a*) The average acquisition indebtedness (as defined in subparagraph (3) of this paragraph) with respect to the property is of

(*b*) The average adjusted basis of such property (as defined in subparagraph (2) of this paragraph).

(iii) *Debt/basis percentage.* The percentage determined under subdivision (ii) of this subparagraph is hereinafter referred to as the *debt/basis percentage.*

(iv) *Example.* Subdivisions (i), (ii), and (iii) of this subparagraph are illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. X, an exempt trade association, owns an office building which in 1971 produces $10,000 of gross rental income. The average adjusted basis of the building for 1971 is $100,000, and the average acquisition indebtedness with respect to the building for 1971 is $50,000. Accordingly, the debt/basis percentage for 1971 is 50 percent (the ratio of $50,000 to $100,000). Therefore, the unrelated debt-financed income with respect to the building for 1971 is $5,000 (50 percent of $10,000).

(v) *Gain from sale or other disposition.* If debt-financed property is sold or otherwise disposed of, there shall be included in computing unrelated business taxable income an amount with respect to such gain (or loss) which is the same percentage (but not in excess of 100 percent) of the total gain (or loss) derived from such sale or other disposition as:

(*a*) The highest acquisition indebtedness with respect to such property during the 12-month period, preceding the date of disposition, is of

(*b*) The average adjusted basis of such property.

The tax on the amount of gain (or loss) included in unrelated business taxable income pursuant to the preceding sentence shall be determined in accordance with the rules set forth in subchapter P, chapter 1 of the Code (relating to capital gains and losses). See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

(2) *Average adjusted basis*—(i) *In general.* The *average adjusted basis* of debt-financed property is the average amount of the adjusted basis of such property during that portion of the taxable year it is held by the organization. This amount is the average of:

(*a*) The adjusted basis of such property as of the first day during the taxable year that the organization holds the property, and

(*b*) The adjusted basis of such property as of the last day during the taxable year that the organization holds the property

See section 1011 and the regulations thereunder for determination of the adjusted basis of property.

(ii) *Adjustments for prior taxable years.* For purposes of subdivision (i) of this subparagraph, the determination of the average adjusted basis of debt-financed property is not affected by the fact that the organization was exempt from taxation for prior taxable years. Proper adjustment must be made under section 1011 for the entire period since the acquisition of the property. For example, adjustment must be made for depreciation for all prior taxable years whether or not the organization was exempt from taxation for any such years. Similarly, the fact that only a portion of the depreciation allowance may be taken into account in computing the percentage of deductions allowable under section 514(a)(2) does not affect the amount of the adjustment

for depreciation which is used in determining average adjusted basis.

(iii) *Cross reference.* For the determination of the basis of debt-financed property acquired in a complete or partial liquidation of a corporation in exchange for its stock, see § 1.514(d)–1.

(iv) *Example.* This subparagraph may be illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. On July 10, 1970, X, an exempt educational organization, purchased an office building for $510,000, using $300,000 of borrowed funds. During 1970 the only adjustment to basis is $20,000 for depreciation. As of December 31, 1970, the adjusted basis of the building is $490,000 and the indebtedness is still $300,000. X files its return on a calendar year basis. Under these circumstances, the debt/basis percentage for 1970 is 60 percent, calculated in the following manner:

	Basis
As of July 10, 1970 (acquisition date)	$510,000
As of December 31, 1970	490,000
Total	1,000,000

Average Adjusted basis:

$$\$1,000,000 \div 2 = \$500,000$$

Debt/basis percentage:

Average acquisition indebtedness ($300,000) / Average adjusted basis ($500,000) = 60 percent

For an illustration of the determination of the debt/basis percentage as changes in the acquisition indebtedness occur, see example 1 of subparagraph (3)(iii) of this paragraph.

(3) *Average acquisition indebtedness*—(i) *In general.* The *average acquisition indebtedness* with respect to debt-financed property is the average amount of the outstanding principal indebtedness during that portion of the taxable year the property is held by the organization.

(ii) *Computation.* The average acquisition indebtedness is computed by determining the amount of the outstanding principal indebtedness on the first day in each calendar month during the taxable year that the organization holds the property, adding these amounts together, and then dividing this sum by the total number of months during the taxable year that the organization held such property. A fractional part of a month shall be treated as a full month in computing average acquisition indebtedness.

(iii) *Examples.* The application of this subparagraph may be illustrated by the following examples. For purposes of these examples it is assumed that the property is debt-financed property.

Example 1. Assume the facts as stated in the example in subparagraph (2)(iv) of this paragraph, except that beginning July 20, 1970, the organization makes payments of $21,000 a month ($20,000 of which is attributable to principal and $1,000 to interest). In this situation, the average acquisition indebtedness for 1970 is $250,000. Thus, the debt/basis percentage for 1970 is 50 percent, calculated in the following manner:

	Indebtedness on the first day in each calendar month that the property is held
Month:	
July	$300,000
August	280,000
September	260,000
October	240,000
November	220,000
December	200,000
Total	1,500,000

Average acquisition indebtedness:
$1,500,000 ÷ 6 months = $250,000

Debt/basis percentage:
Average acquisition indebtedness ($250,000) / Average adjusted basis ($500,000) = 50 percent

Example 2. Y, an exempt organization, owns stock in a corporation which it does not control. At the beginning of the year, Y has an outstanding principal indebtedness with respect to such stock of $12,000. Such indebtedness is paid off at the rate of $2,000 per month beginning January 30, so that it is retired at the end of 6 months. The average acquisition indebtedness for the taxable year is $3,500, calculated in the following manner:

	Indebtedness on the first day in each calendar month that the property is held
Month:	
January	$12,000
February	10,000
March	8,000
April	6,000
May	4,000
June	2,000
July thru December	0
Total	42,000

Average acquisition indebtedness:

$$\$42,000 \div 6 \text{ months} = \$3,500$$

(4) *Indeterminate price*—(i) *In general.* If an exempt organization acquires (or improves) property for an indeterminate price, the initial acquisition indebtedness and the unadjusted basis shall be determined in accordance with subdivisions (ii) and (iii) of this paragraph, unless the organization has obtained the consent of the Commissioner to use another method to compute such amounts.

(ii) *Unadjusted basis.* For purposes of this subparagraph, the unadjusted basis of property (or of an improvement) is the fair market value of the property (or improvement) on the date of acquisition (or the date of completion of the improvement). The average adjusted basis of such property shall be determined in accordance with paragraph (a)(2) of this section.

(iii) *Initial acquisition indebtedness.* For purposes of this subparagraph, the initial acquisition indebtedness is the fair market value of the property (or improvement) on the date of acquisition (or the date of completion of the improvement) less any down payment or other initial payment applied to the principal indebtedness. The average acquisition indebtednessith respect to such property shall be computed in accordance with paragraph (a)(3) of this section.

(iv) *Example.* The application of this subparagraph may be illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. On January 1, 1971, X, an exempt trade association, acquires an office building for a down payment of $310,000 and an agreement to pay 10 percent of the income generated by the building for 10 years. Neither the sales price nor the amount which X is obligated to pay in the future is certain. The fair market value of the building on the date of acquisition is $600,000. The depreciation allowance for 1971 is $40,000. Unless X obtains the consent of the Commissioner to use another method, the unadjusted basis of the property is $600,000 (the fair market value of the property on the date of acquisition), and the initial acquisition indebtedness is $290,000 (fair market value of $600,000 less initial payment of $310,000). Under these circumstances, the average adjusted basis of the property for 1971 is $580,000, calculated as follows:

[Initial fair market value + (initial fair market value less depreciation)] ÷ 2 = [$600,000 + ($600,000 − $40,000)] ÷ 2 = $580,000.

If no payment other than the initial payment is made in 1971, the average acquisition indebtedness for 1971 is $290,000. Thus, the debt/basis percentage for 1971 is 50 percent, calculated as follows:

Average acquisition indebtedness ÷ average adjusted basis = $290,000 ÷ $580,000 = 50 percent

(b) *Deductions*—(1) *Percentage of deductions taken into account.* Except as provided in subparagraphs (4) and (5) of this paragraph, there shall be allowed as a deduction with respect to each debt-financed property an amount determined by applying the debt/basis percentage to the sum of the deductions allowable under subparagraph (2) of this paragraph.

(2) *Deductions allowable.* The deductions allowable are those items allowed as deductions by chapter 1 of the Code which are directly connected with the debt-financed property or the income therefrom (including the dividends received deductions allowed by sections 243, 244, and 245), except that:

(i) The allowable deductions are subject to the modifications provided by section 512(b) on computation of the unrelated business taxable income, and

(ii) If the debt-financed property is of a character which is subject to the allowance for depreciation provided in section 167, such allowance shall be computed only by use of the straight-line method of depreciation.

(3) *Directly connected with.* To be *directly connected with* debt-financed property or the income therefrom, an item of deduction must have proximate and primary relationship to such property or the income therefrom. Expenses, depreciation, and similar items attributable solely to such property are proximately and primarily related to such property or the income therefrom, and therefore qualify for deduction, to the extent they meet the requirements of subparagraph (2) of this paragraph. Thus, for example, if the straight-line depreciation allowance for an office building is $10,000 a year, an organization would be allowed a deduction for depreciation of $10,000 if the entire building were debt-financed property. However, if only one-half of

the building were treated as debt-financed property, then the depreciation allowed as a deduction would be $5,000. (See example 2 of § 1.514(b)–1(b)(1)(iii).)

(4) *Capital losses*—(i) *In general.* If the sale or exchange of debt-financed property results in a capital loss, the amount of such loss taken into account in the taxable year in which the loss arises shall be computed in accordance with paragraph (a)(1)(v) of this section. If, however, any portion of such capital loss not taken into account in such year may be carried back or carried over to another taxable year, the debt/basis percentage is not applied to determine what portion of such capital loss may be taken as a deduction in the year to which such capital loss is carried.

(ii) *Example.* This subparagraph is illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. X, an exempt educational organization, owns securities which are capital assets and which it has held for more than 6 months. In 1972 X sells the securities at a loss of $20,000. The debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the securities is 40 percent. Thus, X has sustained a capital loss of $8,000 (40 percent of $20,000) with respect to the sale of the securities. For 1972 and the preceding three taxable years X has no other capital transactions. Under these circumstances, the $8,000 of capital loss may be carried over to the succeeding 5 taxable years without further application of the debt/basis percentage.

(5) *Net operating loss*—(i) *In general.* If, after applying the debt/basis percentage to the income derived from debt-financed property and the deductions directly connected with such income, such deductions exceed such income, the organization has sustained a net operating loss for the taxable year. This amount may be carried back or carried over to other taxable years in accordance with section 512(b)(6). However, the debt/ basis percentage shall not be applied in such other years to determine the amounts that may be taken as a deduction in those years.

(ii) *Example.* This subparagraph may be illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. During 1974, Y, an exempt organization, receives $20,000 of rent from a building which it owns. Y has no other unrelated business taxable income for 1974. For 1974 the deductions directly connected with this building are property taxes of $5,000, interest of $5,000 on the acquisition indebtedness, and salary of $15,000 to the manager of the building. The debt/basis percentage for 1974 with respect to the building is 50 percent. Under these circumstances, Y shall take into account in computing its unrelated business taxable income for 1974, $10,000 of income (50 percent of $20,000) and $12,500 (50 percent of $25,000) of the deductions directly connected with such income. Thus, for 1974 Y has sustained a net operating loss of $2,500 ($10,000 of income less $12,500 of deductions) which may be carried back or carried over to other taxable years without further application of the debt/basis percentage.

[T.D. 7229, 37 FR 28143, Dec. 21, 1972]

§ 1.514(a)–2 Business lease rents and deductions for taxable years beginning before January 1, 1970.

(a) *Effective date.* This section applies to taxable years beginning before January 1, 1970.

(b) *In general*—(1) *Rents includible in gross income.* There shall be included with respect to each business lease, as an item of gross income derived from an unrelated trade or business, an amount which is the same percentage (but not in excess of 100 percent) of the total rents derived during the taxable year under such lease as:

(i) The amount of the business lease indebtedness at the close of the taxable year of the lessor tax-exempt organization, with respect to the premises covered by such lease, is of

(ii) The adjusted basis of such premises at the close of such taxable year

For definition of business lease as a lease for a term of more than 5 years, and for rules for determining the computation of such 5-year term in certain specific situations, see § 1.514(f)–1. For definition of business lease indebtedness and allocation of business lease indebtedness where only a portion of the property is subject to a business lease, see § 1.514(g)–1.

(2) *Determination of basis.* For purposes of the unrelated business income tax the basis (unadjusted) of property

is determined under section 1012, and the adjusted basis of property is determined under section 1011. The determination of the adjusted basis of property is not affected by the fact that the organization was exempt from tax for prior taxable years. Proper adjustment must be made under section 1011 for the entire period since the acquisition of the property. Thus adjustment must be made for depreciation for all taxable years whether or not the organization was exempt from tax for any of such years. Similarly, for taxable years during which the organization is subject to the tax on unrelated business taxable income the fact that only a portion of the deduction for depreciation is taken into account under paragraph (c)(1) of this section does not affect the amount of the adjustment for depreciation.

(3) *Examples*. The application of this paragraph may be illustrated by the following examples, in each of which it is assumed that the taxpayer makes its returns under section 511 on the basis of the calendar year, and that the lease is not substantially related to the purpose for which the organization is granted exemption from tax.

Example 1. Assume that a tax-exempt educational organization purchased property in 1952 for $600,000, using borrowed funds, and leased the building for a period of 20 years. Assume further that the adjusted basis of such building at the close of 1954 is $500,000 and that, at the close of 1954, $200,000 of the indebtedness incurred to acquire the property remains outstanding. Since the amount of the outstanding indebtedness is two-fifths of the adjusted basis of the building at the close of 1954, two-fifths of the gross rental received from the building during 1954 shall be included as an item of gross income in computing unrelated business taxable income. If, at the close of a subsequent taxable year, the outstanding indebtedness is $100,000 and the adjusted basis of the building is $400,000, one-fourth of the gross rental for such taxable year shall be included as an item of gross income in computing unrelated business taxable income for such taxable year.

Example 2. Assume that a tax-exempt organization owns a four-story building, that in 1954 it borrows $100,000 which it uses to improve the whole building, and that it thereafter in 1954 rents the first and second floors of the building under six-year leases at rentals of $4,000 a year. The third and fourth floors of the building are leased on a yearly basis during 1954. Assume, also, that the adjusted basis of the real property at the end of 1954 (after reflecting the expenditures for improving the building) is $200,000, allocable equally to each of the four stories. Under these facts, only one-half of the real property is subject to a business lease since only one-half is rented under a lease for more than 5 years. See §1.514(f)–1. The percentage of the rent under such lease which is taken into account is determined by the ratio which the allocable part of the business lease indebtedness bears to the allocable part of the adjusted basis of the real property, that is, the ratio which one-half of the $100,000 of business lease indebtedness outstanding at the close of 1954, or $50,000, bears to one-half of the adjusted basis of the business lease premises at the close of 1954, or $100,000. The percentage of rent which is business lease income for 1954 is, therefore, one-half (the ratio of $50,000 to $100,000) of $8,000, or $4,000, and this amount of $4,000 is considered an item of gross income derived from an unrelated trade or business.

(c) *Deductions*—(1) *Deductions allowable against gross income*. The same percentage is used in determining both the portion of the rent and the portion of the deductions taken into account with respect to the business lease in computing unrelated business taxable income. Such percentage is applicable only to the sum of the following deductions allowable under section 161:

(i) Taxes and other expenses paid or accrued during the taxable year upon or with respect to the real property subject to the business lease;

(ii) Interest paid or accrued during the taxable year on the business lease indebtedness;

(iii) A reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) of the real property subject to such lease.

Where only a portion of the real property is subject to the business lease, there shall be taken into account only those amounts of the above-listed deductions which are properly allocable to the premises covered by such lease.

(2) *Excess deductions*. The deductions allowable under subparagraph (1) of this paragraph with respect to a business lease are not limited by the amount included in gross income with respect to the rent from such lease. Any excess of such deductions over such gross income shall be applied against other items of gross income in

computing unrelated business taxable income taxable under section 511(a).

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

Example. Assume the same facts as those in example 1 in paragraph (b)(3) of this section. Assume, also that for 1954 the organization pays taxes of $4,000 on the property, interest of $6,000 on its business lease indebtedness, and that the depreciation allowable for 1954 under section 167 is $10,000. Under the facts set forth in such example 1 and in this example, the deductions to be taken into account for 1954 in computing unrelated business taxable income would be two-fifths of the total of the deductions of $20,000, that is $8,000.

[T.D. 7229, 37 FR 28145, Dec. 21, 1972]

§ 1.514(b)–1 Definition of debt-financed property.

(a) *In general*. For purposes of section 514 and the regulations thereunder, the term *debt-financed property* means any property which is held to produce income (e.g., rental real estate, tangible personal property, and corporate stock), and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property) at any time during the taxable year. The term *income* is not limited to recurring income but applies as well to gains from the disposition of property. Consequently, when any property held to produce income by an organization which is not used in a manner described in section 514(b)(1) (A), (B), (C), or (D) is disposed of at a gain during the taxable year, and there was an acquisition indebtedness outstanding with respect to such property at any time during the 12-month period preceding the date of disposition (even though such period covers more than 1 taxable year), such property is *debt-financed property*. For example, assume that on June 1, 1972, an organization is given mortgaged, unimproved property which it does not use in a manner described in section 514(b)(1) (A), (B), (C), or (D) and that the organization assumes payment ofthe mortgage on such property. On July 15, 1972, the organization sells such property for a gain. Such property is *debt-financed property* and such gain is taxable as unrelated debt-financed income. See section 514(c) and § 1.514(c)–1 for rules relating to when there is acquisition indebtedness with respect to property. See paragraph (a) of § 1.514(a)–1 for rules determining the amount of income or gain from debt-financed property which is treated as unrelated debt-financed income.

(b) *Exceptions*—(1) *Property related to certain exempt purposes*. (i) To the extent that the use of any property is substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting its basis for exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function designated in section 501(c)(3)) such property shall not be treated as *debt-financed property*. See § 1.513–1 for principles applicable in determining whether there is a substantial relationship to the exempt purpose of the organization.

(ii) If substantially all of any property is used in a manner described in subdivision (i) of this subparagraph, such property shall not be treated as *debt-financed property*. In general the preceding sentence shall apply if 85 percent or more of the use of such property is devoted to the organization's exempt purpose. The extent to which property is used for a particular purpose shall be determined on the basis of all the facts and circumstances. These may include (where appropriate):

(*a*) A comparison of the portion of time such property is used for exempt purposes with the total time such property is used,

(*b*) A comparison of the portion of such property that is used for exempt purposes with the portion of such property that is used for all purposes, or

(*c*) Both the comparisons described in (*a*) and (*b*) of this subdivision.

(iii) This subparagraph may be illustrated by the following examples. For purposes of these examples it is assumed that the indebtedness is acquisition indebtedness.

Example 1. W, an exempt organization, owns a computer with respect to which there

is an outstanding principal indebtedness and which is used by W in the performance of its exempt purpose. W sells time for the use of the computer to M corporation on occasions when the computer is not in full-time use by W. W uses the computer in furtherance of its exempt purpose more than 85 percent of the time it is in use and M uses the computer less than 15 percent of the total operating time the computer is in use. In this situation, substantially all the use of the computer is related to the performance of W's exempt purpose. Therefore, no portion of the computer is treated as debt-financed property.

Example 2. X, an exempt college, owns a four story office building which has been purchased with borrowed funds. In 1971, the lower two stories of the building are used to house computers which are used by X for administrative purposes. The top two stories are rented to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The gross income derived by X from the building is $6,000, all of which is attributable to the rents paid by tenants. There are $2,000 of expenses, allocable equally to each use of the building. The average adjusted basis of the building for1971 is $100,000, and the outstanding principal indebtedness throughout 1971 is $60,000. Thus, the average acquisition indebtedness for 1971 is $60,000. In accordance with subdivision (i) of this subparagraph, only the upper half of the building is debt-financed property. Consequently, only the rental income and the deductions directly connected with such income are to be taken into account in computing unrelated business taxable income. The portion of such amounts to be taken into account is determined by multiplying the $6,000 of rental income and $1,000 of deductions directly connected with such rental income by the debt/basis percentage. The debt/basis percentage is the ratio which the allocable part of the average acquisition indebtedness is of the allocable part of the average adjusted basis of the property, that is, the ratio which $30,000 (one-half of $60,000) bears to $50,000 (one-half of $100,000). Thus, the debt/basis percentage for 1971 is 60 percent (the ratio of $30,000 to $50,000). Under these circumstances, X shall include net rental income of $3,000 in its unrelated business taxable income for 1971, computed as follows:

Total rental income	$6,000
Deductions directly connected with rental income	$1,000
Debt/basis percentage ($30,000/$50,000)	60%
Rental income treated as gross income from an unrelated trade or business (60 percent of $6,000)	$3,600
Less the allowable portion of deductions directly connected with such income (60 percent of $1,000)	$600
Net rental income included by X in computing its unrelated business taxable income pursuant to section 514	$3,000

Example 3. Assume the facts as stated in example 2 except that on December 31, 1971, X sells the building and realizes a long-term capital gain of $10,000. This is X's only capital transaction for 1971. An allocable portion of this gain is subject to tax. This amount is determined by multiplying the gain related to the nonexempt use, $5,000 (one-half of $10,000), by the ratio which the debtedness for the 12-month period preceding the date of sale, $30,000 (one-half of $60,000), is of the allocable part of the average adjusted basis, $50,000 (one-half of $100,000). Thus, the debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the building is 60 percent (the ratio of $30,000 to $50,000). Consequently, $3,000 (60 percent of $5,000) is a net section 1201 gain (capital gain net income for taxable years beginning after December 31, 1976). The portion of such gain which is taxable shall be determined in accordance with rules contained in subchapter P, chapter 1 of the Code (relating to capital gains and losses). See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

(2) *Property used in an unrelated trade or business*—(i) *In general.* To the extent that the gross income from any property is treated as income from the conduct of an unrelated trade or business, such property shall not be treated as *debt-financed property*. However, any gain on the disposition of such property which is not included in the income of an unrelated trade or business by reason of section 512(b)(5) is includible as gross income derived *from or on account of debt-financed property* under paragraph (a)(1) of § 1.514(a)–1.

(ii) *Amounts specifically taxable under other provisions of the Code.* Section 514 does not apply to amounts which are otherwise included in the computation of unrelated business taxable income, such as rents from personal property includible pursuant to section 512(b)(13) or rents and interest from controlled organizations includible pursuant to section 512(b)(3). See paragraph (1)(5) of § 1.512(b)–1 for the rules determining the manner in which amounts are taken into account where such amounts may be included in the computation of unrelated business taxable income by operation of more than one provision of the Code.

(3) *Examples*. Subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the indebtedness is acquisition indebtedness.

Example 1. X, an exempt scientific organization, owns a 10-story office building. During 1972, four stories are occupied by X's administrative offices, and the remaining six stories are rented to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). On December 31, 1972, the building is sold and X realizes a long-term capital gain of $100,000. This is X's only capital transaction for 1972. The debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the building is 30 percent. Since 40 percent of the building was used for X's exempt purpose, only 60 percent of the building is debt-financed property. Thus, only $60,000 of the gain (60 percent of $100,000) is subject to this section. Consequently, the amount of gain treated as unrelated debt-financed income is $18,000 ($60,000 multiplied by the debt/basis percentage of 30 percent). The portion of such $18,000 which is taxable shall be determined in accordance with the rules contained in subchapter P, chapter 1 of the Code. See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

Example 2. Y, an exempt organization, owns two properties, a restaurant and an office building. In 1972, all the space in the office building, except for the portion utilized by Y to house the administrative offices of the restaurant, is rented to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The average adjusted basis of the office building for 1972 is $2 million. The outstanding principal indebtedness throughout 1972 is $1 million. Thus, the highest acquisition indebtedness in the calendar year of 1972 is $1 million. It is determined that 30 percent of the space in the office building is used for the administrative functions engaged in by the employees of the organization with respect to the restaurant. Since the income attributable to the restaurant is attributable to the conduct of an unrelated trade or business, only 70 percent of the building is treated as debt-financed property for purposes of determining the portion of the rental income which is unrelated debt-financed income. On December 31, 1972, the office building is sold and Y realizes a long-term capital gain of $250,000. This is Y's only capital transaction for 1972. In accordance with subparagraph (2)(i) of this paragraph, all the gain derived from this sale is taken into account in computing the amount of such gain subject to tax. The portion of such gain which is taxable is determined by multiplying the $250,000 gain by the debt/basis percentage. The debt/basis percentage is the ratio which the highest acquisition indebtedness for the 12-month period preceding the date of sale, $1 million, is of the averageadjusted basis, $2 million. Thus, the debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the building is 50 percent (the ratio of $1 million to $2 million). Consequently, $125,000 (50 percent of $250,000) is a net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976). The amount of such gain which is taxable shall be determined in accordance with the rules contained in subchapter P, chapter 1 of the Code. See also section 511(d) and the regulations thereunder.

Example 3. (a) Z, an exempt university, owns all the stock of M, a nonexempt corporation. During 1971 M leases from Z University a factory unrelated to Z's exempt purpose and a dormitory for the students of Z, for a total annual rent of $100,000: $80,000 for the factory and $20,000 for the dormitory. During 1971, M has $500,000 of taxable income, disregarding the rent paid to Z: $150,000 from the dormitory and $350,000 from the factory. The factory is subject to a mortgage of $150,000. Its average adjusted basis for 1971 is determined to be $300,000. Z's deductions for 1971 with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. In accordance with subdivision (ii) of this subparagraph, section 514 applies only to that portion of the rent which is excluded from the computation of unrelated business taxable income by operation of section 512(b)(3) and not included in such computation pursuant to section 512(b)(13). Since all the rent received by Z is derived from real property, section 512(b)(3) would exclude all such rent from computation of Z's unrelated business taxable income. However, 70 percent of the rent paid to Z with respect to the factory and 70 percent of the deductions directly connected with such rent shall be taken into account by Z in determining its unrelated business taxable income pursuant to section 512(b)(15), computed as follows:

M's taxable income (disregarding rent paid to Z)	$500,000
Less taxable income from dormitory	$150,000
Excess taxable income	$350,000
Ratio ($350,000/$500,000)	7/10
Total rent paid to Z	$100,000
Total deductions ($4,000 + $16,000)	$20,000
Rental income treated under section 512(b)(15) as gross income from an unrelated trade or business (7/10 of $100,000)	$70,000
Less deductions directly connected with such income (7/10 of $20,000)	$14,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 512(b)(15)	$56,000

(b) Since only that portion of the rent derived from the factory and the deductions directly connected with such rent not taken into account pursuant to section 512(b)(15) may be included in computing unrelated business taxable income by operation of section 514, only $10,000 ($80,000 minus $70,000) of rent and $2,000 ($16,000 minus $14,000) of deductions are so taken into account. The portion of such amounts to be taken into account is determined by multiplying the $10,000 of income and $2,000 of deductions by the debt/basis percentage. The debt/basis percentage is the ratio which the average acquisition indebtedness ($150,000) is of the average adjusted basis of the property ($300,000). Thus, the debt/basis percentage for 1971 is 50 percent (the ratio of $150,000 to $300,000). Under these circumstances, Z shall include net rental income of $4,000 in its unrelated business taxable income for 1971, computed as follows:

Total rents	$10,000
Deductions directly connected with such rents	$2,000
Debt/basis percentage ($150,000/$300,000)	50%
Rental income treated as gross income from an unrelated trade or business (50 percent of $10,000)	$5,000
Less the allowable portion of deductions directly connected with such income (50 percent of $2,000)	$1,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 514	$4,000

(4) *Property related to research activities*. To the extent that the gross income from any property is derived from research activities excluded from the tax on unrelated business income by paragraph (7), (8), or (9) of section 512(b), such property shall not be treated as *debt-financed property*.

(5) *Property used in thrift shops*, etc. To the extent that property is used in any trade or business which is excepted from the definition of *unrelated trade or business* by paragraph (1), (2), or (3) of section 513(a), such property shall not be treated as *debt-financed property*.

(6) *Use by a related organization*. For purposes of subparagraph (1), (4), or (5) of this paragraph, use of property by a related exempt organization (as defined in paragraph (c)(2)(ii) of this section) for a purpose described in such subparagraphs shall be taken into account in order to determine the extent to which such property is used for a purpose described in such subparagraphs.

(c) *Special rules*—(1) *Medical clinic*. Property is not debt-financed property if it is real property subject to a lease to a medical clinic, and the lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by the lessor of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. For example, assume that an exempt hospital leases all of its clinic space to an unincorporated association of physicians and surgeons who, by the provisions of the lease, agree to provide all of the hospital's out-patient medical and surgical services and to train all of the hospital's residents and interns. In this situation, the rents received by the hospital from this clinic are not to be treated as unrelated debt-financed income.

(2) *Related exempt uses*—(i) *In general*. Property owned by an exempt organization and used by a related exempt organization or by an exempt organization related to such related exempt organization shall not be treated as *debt-financed property* to the extent such property is used by either organization in furtherance of the purpose constituting the basis for its exemption under section 501. Furthermore, property shall not be treated as *debt-financed property* to the extent such property is used by a related exempt organization for a purpose described in paragraph (b)(4) or (5) of this section.

(ii) *Related organizations*. For purposes of subdivision (i) of this subparagraph, an exempt organization is related to another exempt organization only if:

(*a*) One organization is an exempt holding company described in section 501(c)(2) and the other organization receives the profits derived by such exempt holding company,

(*b*) One organization has control of the other organization within the meaning of paragraph (1)(4) of § 1.512(b)-1,

(*c*) More than 50 percent of the members of one organization are members of the other organization, or

(*d*) Each organization is a local organization which is directly affiliated with a common state, national, or international organization which is also exempt.

(iii) *Examples*. This subparagraph may be illustrated by the following examples. For purposes of these examples it is assumed that the indebtedness is acquisition indebtedness.

Example 1. M, an exempt trade association described in section 501(c)(6), leases 70 percent of the space of an office building for furtherance of its exempt purpose. The title to such building is held by N, an exempt holding company described in section 501(c)(2), which acquired title to the building with borrowed funds. The other 30 percent of the space in this office building is leased to L, a nonstock exempt trade association described in section 501(c)(6). L uses such office space in furtherance of its exemptpurpose. The members of L's Board of Trustees serves for fixed terms and M's Board of Directors has the power to select all such members. N pays over to M all the profits it derives from the leasing of space in this building to M and L. Accordingly, M is *related* to N (as such term is defined in subdivision (ii)(*a*) of this subparagraph) and L is *related* to M (as such term is defined in subdivision (ii)(*b*) of this subparagraph). Under these circumstances, since all the available space in the building is leased to either an exempt organization related to the exempt organization holding title to the building or an exempt organization related to such related exempt organization, no portion of the building is treated as debt-financed property.

Example 2. W, an exempt labor union described in section 501(c)(5), owns a 10-story office building which has been purchased with borrowed funds. Five floors of the building are used by W in furtherance of its exempt purpose. Four of the other floors are rented to X which is an exempt voluntary employees' beneficiary association described in section 501(c)(9), operated for the benefit of W's members. X uses such office space in furtherance of its exempt purpose. Seventy percent of the members of W are also members of X. Accordingly, X is *related* to W (as such term is defined in subdivision (ii)(*c*) of this subparagraph). The remaining floor of the building is rented to the general public for purposes not described in section 514(b)(1)(A), (B), (C), or (D). Under thesecircumstances, no portion of this building is treated as debt-financed property since more than 85 percent of the office space available in this building is used either by W or X, an exempt organization related to W, in furtherance of their respective exempt purpose. See paragraph (b)(1) of this section for rules relating to the use of property substantially related to an exempt purpose. See paragraph (b)(6) of this section for rules relating to uses by related exempt organizations.

Example 3. Assume the same facts as in example 2, except that W and X are each exempt local labor unions described in section 501(c)(5) having no common membership and are each affiliated with N, an exempt international labor union described in section 501(c)(5). Under these circumstances, no portion of this building is treated as debt-financed property since more than 85 percent of the office space available in this building is used either by W or X, an exempt organization related to W, in furtherance of their respective exempt purpose.

Example 4. Assume the same facts as in example 3, except that W and X are directly affiliated with different exempt international labor unions and that W and X are not otherwise affiliated with, or members of, a common exempt organization, other than an association of international labor unions. Under these circumstances, the portions of this building which are rented to X and to the general public are treated as debt-financed property since X is not related to W and W uses less than 85 percent of the building for its exempt purpose.

(3) *Life income contracts*. (i) Property shall not be treated as *debt-financed property* when:

(*a*) An individual transfers property to a trust or a fund subject to a contract providing that the income is to be paid to him or other individuals or both for a period of time not to exceed the life of such individual or individuals in a transaction in which the payments to the individual or individuals do not constitute the proceeds of a sale or exchange of the property so transferred, and

(*b*) The remainder interest is payable to an exempt organization described in section 501(c)(3).

(ii) Subdivision (i) of this subparagraph is illustrated by the following example.

Example. On January 1, 1967, A transfers property to X, an exempt organization described in section 501(c)(3), which immediately places the property in a fund. On January 1, 1971, A transfers additional property to X, which property is also placed in the fund. In exchange for each transfer, A receives income participation fund certificates which entitle him to a proportionate part of the fund's income for his life and for the life of another individual. None of the payments made by X are treated by the recipients as the proceeds of a sale or exchange of the property transferred. In this situation, none of the property received by X from A is treated as debt-financed property.

(d) *Property acquired for prospective exempt use*—(1) *Neighborhood land*—(i) *In general*. If an organization acquires real property for the principal purpose of using the land in the exercise or performance of its exempt purpose, commencing within 10 years of the time of acquisition, such property will not be treated as debt-financed property, so long as (*a*) such property is in the neighborhood of other property owned by the organization which is used in the performance of its exempt purpose, and (*b*) the organization does not abandon its intent to use the land in such a manner within the 10-year period. The rule expressed in this subdivision is hereinafter referred to as the *neighborhood land rule*.

(ii) *Neighborhood* defined. Property shall be considered in the *neighborhood* of property owned and used by the organization in the performance of its exempt purpose if the acquired property is contiguous with the exempt purpose property or would be contiguous with such property except for the interposition of a road, street, railroad, stream, or similar property. If the acquired property is not contiguous with exempt function property, it may still be in the *neighborhood* of such property, but only if it is within 1 mile of such property and the facts and circumstances of the particular situation make the acquisition of contiguous property unreasonable. Some of the criteria to consider in determining this question include the availability of land and the intended future use of the land. For example, a university attempts to purchase land contiguous to its present campus but cannot do so because the owners either refuse to sell or ask unreasonable prices. The nearest land of sufficient size and utility is a block away from the campus. The university purchases such land. Under these circumstances, the contiguity requirement is unreasonable and the land purchased would be considered *neighborhood land*.

(iii) *Exception*. The neighborhood land rule shall not apply to any property after the expiration of 10 years from the date of acquisition. Further, the neighborhood land rule shall apply after the first 5 years of the 10-year period only if the organization establishes to the satisfaction of the Commissioner that future use of the acquired land in furtherance of the organization's exempt purpose before the expiration of the 10-year period is reasonably certain. In order to satisfy the Commissioner, the organization does not necessarily have to show binding contracts. However, it must at least have a definite plan detailing a specific improvement and a completion date, and some affirmative action toward the fulfillment of such a plan. This information shall be forwarded to the Commissioner of Internal Revenue, Washington, DC 20224, for a ruling at least 90 days before the end of the fifth year after acquisition of the land.

(2) *Actual use*. If the neighborhood land rule is inapplicable because:

(i) The acquired land is not in the neighborhood of other property used by the organization in performance of its exempt purpose, or

(ii) The organization (for the period after the first 5 years of the 10-year period) is unable to establish to the satisfaction of the Commissioner that the use of the acquired land for its exempt purposes within the 10-year period is reasonably certain

but the land is actually used by the organization in furtherance of its exempt purpose within the 10-year period, such property (subject to the provisions of subparagraph (4) of this paragraph) shall not be treated as debt-financed property for any period prior to such conversion.

(3) *Limitations*—(i) *Demolition or removal required*. (*a*) Subparagraphs (1) and (2) of this paragraph shall apply with respect to any structure on the land when acquired by the organization, or to the land occupied by the structure, only so long as the intended future use of the land in furtherance of the organization's exempt purpose requires that the structure be demolished or removed in order to use the land in such a manner. Thus, during the first 5 years after acquisition (and for subsequent years if there is a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph) improved property is not debt-financed so long as the organization does not abandon its intent to demolish the existing structures and use the land in furtherance of

its exempt purpose. Furthermore, if there is an actual demolition of such structures, the use made of the land need not be the one originally intended. Therefore, the actual use requirement of this subdivision may be satisfied by using the land in any manner which furthers the exempt purpose of the organization.

(*b*) Subdivision (i)(*a*) of this subparagraph may be illustrated by the following examples. For purposes of the following examples it is assumed that but for the application of the neighborhood land rule such property would be debt-financed property.

Example 1. An exempt university acquires a contiguous tract of land on which there is an apartment building. The university intends to demolish the apartment building and build classrooms and does not abandon this intent during the first 4 years after acquisition. In the fifth year after acquisition it abandons the intent to demolish and sells the apartment building. Under these circumstances, such property is not debt-financed property for the first 4 years after acquisition even though there was no eventual demolition or use made of such land in furtherance of the university's exempt purpose. However, such property is debt-financed property as of the time in the fifth year that the intent to demolish the building is abandoned and any gain on the sale of property is subject to section 514.

Example 2. Assume the facts as stated in Example 1 except that the university did not abandon its intent to demolish the existing building and construct a classroom building until the eighth year after acquisition when it sells the property. Assume further that the university did not receive a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph. Under these circumstances, the building is debt- financed property for the sixth, seventh, and eighth years. It is not, however, treated as debt-financed property for the first 5 years after acquisition.

Example 3. Assume the facts as stated in Example 2 except that the university received a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph. Under these circumstances, the building is not debt-financed property for the first 7 years after acquisition. It only becomes debt-financed property as of the time in the eighth year when the university abandoned its intent to demolish the existing structure.

Example 4. (1) Assume that a university acquires a contiguous tract of land containing an office building for the principal purpose of demolishing the office building and building a modern dormitory. Five years later the dormitory has not been constructed, and the university has failed to satisfy the Commissioner that the office building will be demolished and the land will be used in furtherance of its exempt purpose (and consequently has failed to obtain a favorable ruling under subparagraph (1)(iii) of this paragraph). In the ninth taxable year after acquisition the university converts the office building into an administration building. Under these circumstances, during the sixth, seventh, and eighth years after acquisition, the office building is treated as debt-financed property because the office building was not demolished or removed. Therefore, the income derived from such property during these years shall be subject to the tax on unrelated business income.

(*2*) Assume that instead of converting the office building to an administration building, the university demolishes the office building in the ninth taxable year after acquisition and then constructs a new administration building. Under these circumstances, the land would not be considered debt-financed property for any period following the acquisition, and the university would be entitled to a refund of taxes paid on the income derived from such property for the sixth through eighth taxable years after the acquisition in accordance with subparagraph (4) of this paragraph.

(ii) *Subsequent construction.* Subparagraphs (1) and (2) of this paragraph do not apply to structures erected on the land after the acquisition of the land.

(iii) *Property subject to business lease.* Subparagraphs (1) and (2) of this paragraph do not apply to property subject to a lease which is a business lease (as defined in § 1.514(f)–1) whether the organization acquired the property subject to the lease or whether it executed the lease subsequent to acquisition. If only a portion of the real property is subject to a lease, paragraph (c) of § 1.514(f)–1 applies in determining whether such lease is a business lease.

(4) *Refund of taxes.* (i) If an organization has not satisfied the actual use condition of subparagraph (2) of this paragraph or paragraph (e)(3) of this section before the date prescribed by law (including extensions) for filing the return for the taxable year, the tax for such year shall be computed without regard to the application of such actual use condition. However, if:

(*a*) A credit or refund of any overpayment of taxes is allowable for a prior taxable year as a result of the satisfaction of such actual use condition, and

(*b*) Such credit or refund is prevented by the operation of any law or rule of law (other than chapter 74, relating to closing agreements and compromises)

such credit or refund may nevertheless be allowed or made, if a claim is filed within 1 year after the close of the taxable year in which such actual use condition is satisfied. For a special rule with respect to the payment of interest at the rate of 4 percent per annum, see section 514(b)(3)(D), prior to its amendment by section 7(b) of the Act of January 3, 1975 (Pub. L. 93–625, 88 Stat. 2115).

(ii) This subparagraph may be illustrated by the following example. For purposes of this example it is assumed that but for the neighborhood land rule such property would be debt-financed property.

Example. Y, a calendar year exempt organization, acquires real property in January 1970, which is contiguous with other property used by Y in furtherance of its exempt purpose. However, Y does not satisfy the Commissioner by January 1975, that the existing structure will be demolished and the land will be used in furtherance of its exempt purpose. In accordance with this subparagraph, from 1975 until the property is converted to an exempt use, the income derived from such property shall be subject to the tax on unrelated business income. During July 1979, Y demolishes the existing structure on the land and begins using the land in furtherance of its exempt purpose. At this time Y may file claims for refund for the open years 1976 through 1978. Further, in accordance with this subparagraph, Y may also file a claim for refund for 1975, even though a claim for such taxable year may be barred by the statute of limitations, provided such claim is filed before the close of 1980.

(e) *Churches*—(1) *In general*. If a church or association or convention of churches acquires real property, for the principal purpose of using the land in the exercise or performance of its exempt purpose, commencing within 15 years of the time of acquisition, such property shall not be treated as debt-financed property so long as the organization does not abandon its intent to use the land in such a manner within the 15-year period.

(2) *Exception*. This paragraph shall not apply to any property after the expiration of the 15-year period. Further, this paragraph shall apply after the first 5 years of the 15-year period only if the church or association or convention of churches establishes to the satisfaction of the Commissioner that use of the acquired land in furtherance of the organization's exempt purpose before the expiration of the 15-year period is reasonably certain. For purposes of the preceding sentence, the rules contained in paragraph (d)(1)(iii) of this section with respect to satisfying the Commissioner that the exempt organization intends to use the land within the prescribed time in furtherance of its exempt purpose shall apply.

(3) *Actual use*. If the church or association or convention of churches for the period after the first 5 years of the 15-year period is unable to establish to the satisfaction of the Commissioner that the use of the acquired land for its exempt purpose within the 15-year period is reasonably certain, but such land is in fact converted to an exempt use within the 15-year period, the land (subject to the provisions of paragraph (d)(4) of this section) shall not be treated as debt-financed property for any period prior to such conversion.

(4) *Limitations*. The limitations stated in paragraph (d)(3)(i) and (ii) of this section shall similarly apply to the rules contained in this paragraph.

[T.D. 7229, 37 FR 28146, Dec. 21, 1972; 39 FR 6607, Feb. 21, 1974, as amended by T.D. 7384, 40 FR 49322, Oct. 22, 1975; T.D. 7632, 44 FR 42681, July 20, 1979; T.D. 7728, 45 FR 72651, Nov. 3, 1980]

§ 1.514(c)–1 Acquisition indebtedness.

(a) *In general*—(1) *Definition of acquisition indebtedness*. For purposes of section 514 and the regulations thereunder, the term *acquisition indebtedness* means, with respect to any debt-financed property, the outstanding amount of:

(i) The principal indebtedness incurred by the organization in acquiring or improving such property.

(ii) The principal indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(iii) The principal indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement

Whether the incurrence of an indebtedness is reasonably foreseeable depends upon the facts and circumstances of each situation. The fact that an organization did not actually foresee the need for the incurrence of an indebtedness prior to the acquisition or improvement does not necessarily mean that the subsequent incurrence of indebtedness was not reasonably foreseeable.

(2) *Examples*. The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. X, an exempt organization, pledges some of its investment securities with a bank for a loan and uses the proceeds of such loan to purchase an office building which it leases to the public for purposes other than those described in section 514(b)(1) (A), (B), (C), or (D). The outstanding principal indebtedness with respect to the loan constitutes acquisition indebtedness incurred prior to the acquisition which would not have been incurred but for such acquisition.

Example 2. Y, an exempt scientific organization, mortgages its laboratory to replace working capital used in remodeling an office building which Y rents to an insurance company for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The indebtedness is *acquisition indebtedness* since such indebtedness, though incurred subsequent to the improvement of the office building, would not have been incurred but for such improvement, and the indebtedness was reasonably foreseeable when, to make such improvement, Y reduced its working capital below the amount necessary to continue current operations.

Example 3. (a) U, an exempt private preparatory school, as its sole educational facility owns a classroom building which no longer meets the needs of U's students. In 1971, U sells this building for $3 million to Y, a corporation which it does not control. U receives $1 million as a down payment from Y and takes back a purchase money mortgage of $2 million which bears interest at 10 percent per annum. At the time U became the mortgagee of the $2 million purchase money mortgage, U realized that it would have to construct a new classroom building and knew that it would have to incur an indebtedness in the construction of the new classroom building. In 1972, U builds a new classroom building for a cost of $4 million. In connection with the construction of this building, U borrows $2.5 million from X Bank pursuant to a deed of trust bearing interest at 6 percent perannum. Under these circumstances, $2 million of the $2.5 million borrowed to finance construction of the new classroom building would not have been borrowed but for the retention of the $2 million purchase money mortgage. Since such indebtedness was reasonably foreseeable, $2 million of the $2.5 million borrowed to finance the construction of the new classroom building is acquisition indebtedness with respect to the purchase money mortgage and the purchase money mortgage is debt-financed property.

(*b*) In 1972, U receives $200,000 in interest from Y (10 percent of $2 million) and makes a $150,000 interest payment to X (6 percent of $2.5 million). In addition, assume that for 1972 the debt/basis percentage is 100 percent ($2 million/$2 million). Accordingly, all the interest and all the deductions directly connected with such interest income are to be taken into account in computing unrelated business taxable income. Thus, $200,000 of interest income and $120,000 ($150,000 × $2 million/$2.5 million) of deductions directly connected with such interest income are taken into account. Under these circumstances, U shall include net interest income of $80,000 ($200,000 of income less $120,000 of deductions directly connected with such income) in its unrelated business taxable income for 1972.

Example 4. In 1972 X, an exempt organization, forms a partnership with A and B. The partnership agreement provides that all three partners shall share equally in the profits of the partnership, shall each invest $3 million, and that X shall be a limited partner. X invests $1 million of its own funds in the partnership and $2 million of borrowed funds. The partnership purchases as its sole asset an office building which is leased to the general public for purposes other than those described in section 514(b)(1) (A), (B), (C), or (D). The office building cost the partnership $24 million of which $15 million is borrowed from Y bank. This loan is secured by a mortgage on the entire office building. By agreement with Y bank, X is held not to be personally liable for payment of such mortgage. By reason of section 702(b) the character of any item realized by the partnership and included in the partner's distributive share shall be determined as if the partner realized such item directly from the source from which it was realized by the partnership and in the same manner. Therefore, a portion of X's income from the building is debt-financed income. Under these circumstances,

since both the $2 million indebtedness incurred by X in acquiring its partnership interest and $5 million, the allocable portion of the partnership'sindebtedness incurred with respect to acquiring the office building which is attributable to X in computing the debt/basis percentage (one-third of $15 million), were incurred in acquiring income-producing property, X has acquisition indebtedness of $7 million ($2 million plus $5 million). Similarly, the allocable portion of the partnership's adjusted basis in the office building which is attributable to X in computing the debt-basis percentage is $8 million (one-third of $24 million). Assuming no payment with respect to either indebtedness and no adjustments to basis in 1972, X's average acquisition indebtedness is $7 million and X's average adjusted basis is $8 million for such year. Therefore, X's debt/basis percentage with respect to its share of the partnership income for 1972 is 87.5 percent ($7 million/$8 million).

(3) *Changes in use of property.* Since property used in a manner described in section 514(b)(1) (A), (B), (C), or (D) is not considered debt-financed property, indebtedness with respect to such property is not acquisition indebtedness. However, if an organization converts such property to a use which is not described in section 514(b)(1) (A), (B), (C), or (D) and such property is otherwise treated as debt-financed property, the outstanding principal indebtedness with respect to such property will thereafter be treated as *acquisition indebtedness*. For example, assume that in 1971 a university borrows funds to acquire an apartment building as housing for married students. In 1974 the university rents the apartment building to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The outstanding principal indebtedness is *acquisition indebtedness* as of the time in 1974 when the building is first rented to the public.

(4) *Continued indebtedness.* If:

(i) An organization sells or exchanges property, subject to an indebtedness (incurred in a manner described in subparagraph (1) of this paragraph),

(ii) Acquires another property without retiring the indebtedness, and

(iii) The newly acquired property is otherwise treated as debt-financed property

the outstanding principal indebtedness with respect to the acquired property is *acquisition indebtedness*, even though the original property was not debt-financed property. For example, to house its administrative offices, an exempt organization purchases a building with $600,000 of its own funds and $400,000 of borrowed funds secured by a pledge of its securities. It later sells the building for $1,000,000 without redeeming the pledge. It uses these proceeds to purchase an apartment building which it rents to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The indebtedness of $400,000 is *acquisition indebtedness* with respect to the apartment building even though the office building was not debt-financed property.

(5) *Indebtedness incurred before June 28, 1966.* For taxable years beginning before January 1, 1972, *acquisition indebtedness* does not include any indebtedness incurred before June 28, 1966, unless such indebtedness was incurred on rental real property subject to a business lease and such indebtedness constituted business lease indebtedness. Furthermore, in the case of a church or convention or association of churches, the preceding sentence applies without regard to whether the indebtedness incurred before June 28, 1966, constituted business lease indebtedness.

(b) *Property acquired subject to lien*—(1) *Mortgages.* Except as provided in subparagraphs (3) and (4) of this paragraph, whenever property is acquired subject to a mortgage, the amount of the outstanding principal indebtedness secured by such mortgage is treated as *acquisition indebtedness* with respect to such property even though the organization did not assume or agree to pay such indebtedness. The preceding sentence applies whether property is acquired by purchase, gift, devise, bequest, or any other means. Thus, for example, assume that an exempt organization pays $50,000 for real property valued at $150,000 and subject to a $100,000 mortgage. The $100,000 of outstanding principal indebtedness is *acquisition indebtedness* just as though the organization had borrowed $100,000 to buy the property.

(2) *Other liens.* For purposes of this paragraph, liens similar to mortgages shall be treated as mortgages. A lien is similar to a mortgage if title to property is encumbered by the lien for the

benefit of a creditor. However, in the case where State law provides that a tax lien attaches to property prior to the time when such lien becomes due and payable, such lien shall not be treated as similar to a mortgage until after it has become due and payable and the organization has had an opportunity to pay such lien in accordance with State law. Liens similar to mortgages include (but are not limited to):

(i) Deeds of trust,

(ii) Conditional sales contracts,

(iii) Chattel mortgages,

(iv) Security interests under the Uniform Commercial Code,

(v) Pledges,

(vi) Agreements to hold title in escrow, and

(vii) Tax liens (other than those described in the third sentence of this subparagraph).

(3) *Certain encumbered property acquired by gift, bequest or devise*—(i) *Bequest or devise.* Where property subject to a mortgage is acquired by an organization by bequest or devise, the outstanding principal indebtedness secured by such mortgage is not to be treated as *acquisition indebtedness* during the 10-year period following the date of acquisition. For purposes of the preceding sentence, the date of acquisition is the date the organization receives the property.

(ii) *Gifts.* If an organization acquires property by gift subject to a mortgage, the outstanding principal indebtedness secured by such mortgage shall not be treated as *acquisition indebtedness* during the 10-year period following the date of such gift, so long as:

(*a*) The mortgage was placed on the property more than 5 years before the date of the gift, and

(*b*) The property was held by the donor for more than 5 years before the date of the gift

For purposes of the preceding sentence, the date of the gift is the date the organization receives the property.

(iii) *Limitation.* Subdivisions (i) and (ii) of this subparagraph shall not apply if:

(*a*) The organization assumes and agrees to pay all or any part of the indebtedness secured by the mortgage, or

(*b*) The organization makes any payment for the equity owned by the decedent or the donor in the property (other than a payment pursuant to an annuity excluded from the definition of *acquisition indebtedness* by paragraph (e) of this section)

Whether an organization has assumed and agreed to pay all or any part of an indebtedness in order to acquire the property shall be determined by the facts and circumstances of each situation.

(iv) *Examples.* The application of this subparagraph may be illustrated by the following examples:

Example 1. A dies on January 1, 1971. His will devises an office building subject to a mortgage to U, an exempt organization described in section 501(c)(3). U does not at any time assume the mortgage. For the period 1971 through 1980, the outstanding principal indebtedness secured by the mortgage is not acquisition indebtedness. However, after December 31, 1980, the outstanding principal indebtedness secured by the mortgage is acquisition indebtedness if the building is otherwise treated as debt-financed property.

Example 2. Assume the facts as stated in example 1 except that on January 1, 1975, U assumes the mortgage. After January 1, 1975, the outstanding principal indebtedness secured by the mortgage is acquisition indebtedness if the building is otherwise treated as debt-financed property.

(4) *Bargain sale before October 9, 1969.* Where property subject to a mortgage is acquired by an organization before October 9, 1969, the outstanding principal indebtedness secured by such mortgage is not to be treated as *acquisition indebtedness* during the 10-year period following the date of acquisition if:

(i) The mortgage was placed on the property more than 5 years before the purchase, and

(ii) The organization paid the seller a total amount no greater than the amount of the seller's cost (including attorney's fees) directly related to the transfer of such property to the organization, but in any event no more than 10 percent of the value of the seller's equity in the property transferred.

(c) *Extension of obligations*—(1) *In general.* An extension, renewal, or refinancing of an obligation evidencing a preexisting indebtedness is considered

as a continuation of the old indebtedness to the extent the outstanding principal amount thereof is not increased. Where the principal amount of the modified obligation exceeds the outstanding principal amount of the preexisting indebtedness, the excess shall be treated as a separate indebtedness for purposes of section 514 and the regulations thereunder. For example, if the interest rate on an obligation incurred prior to June 28, 1966, by an exempt university is modified subsequent to such date, the modified obligation shall be deemed to have been incurred prior to June 28, 1966. Thus, such an indebtedness will not be treated as acquisition indebtedness for taxable years beginning before January 1, 1972, unless the original indebtedness was business lease indebtedness (as defined in §1.514(g)–1).

(2) *Extension or renewal.* In general, any modification or substitution of the terms of an obligation by the organization shall be an extension or renewal of the original obligation, rather than the creation of a new indebtedness to the extent that the outstanding principal amount of the indebtedness is not increased. The following are examples of acts which result in the extension or renewal of an obligation:

(i) Substitution of liens to secure the obligation;

(ii) Substitution of obligees, whether or not with the consent of the organization;

(iii) Renewal, extension or acceleration of the payment terms of the obligation; and

(iv) Addition, deletion, or substitution of sureties or other primary or secondary obligors.

(3) *Allocation.* In cases where the outstanding principal amount of the modified obligation exceeds the outstanding principal amount of the unmodified obligation and only a portion of such refinanced indebtedness is to be treated as acquisition indebtedness, payments on the amount of the refinanced indebtedness shall be apportioned prorata between the amount of the preexisting indebtedness and the excess amount. For example, assume that an organization has an outstanding principal indebtedness of $500,000 which is treated as acquisition indebtedness. It borrows another $100,000, which is not acquisition indebtedness, from the same lending institution and gives the lender a $600,000 note for its total obligation. In this situation, a payment of $60,000 on the amount of the total obligation would reduce the acquisition indebtedness by $50,000 and the excess indebtedness by $10,000.

(d) *Indebtedness incurred in performing exempt purpose. Acquisition indebtedness* does not include the incurrence of an indebtedness inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption. Thus, *acquisition indebtedness* does not include the indebtedness incurred by an exempt credit union in accepting deposits from its members or the obligation incurred by an exempt organization in accepting payments from its members to provide such members with insurance, retirement or other similar benefits.

(e) *Annuities*—(1) *Requirements.* The obligation to make payment of an annuity is not *acquisition indebtedness* if the annuity meets all the following requirements:

(i) It must be the sole consideration (other than a mortgage to which paragraph (b)(3) of this section applies) issued in exchange for the property acquired;

(ii) At the time of the exchange, the present value of the annuity (determined in accordance with subparagraph (2) of this paragraph) must be less than 90 percent of the value of the prior owner's equity in the property received in the exchange;

(iii) The annuity must be payable over the life of one individual in being at the time the annuity is issued, or over the lives of two individuals in being at such time; and

(iv) The annuity must be payable under a contract which:

(*a*) Does not guarantee a minimum number of payments or specify a maximum number of payments, and

(*b*) Does not provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or any other property.

(2) *Valuation.* For purposes of this paragraph, the value of an annuity at the time of exchange shall be computed

in accordance with section 1011(b), §1.1011–2(e)(1)(iii)(*b*)(2), and section 3 of Rev. Rul. 62–216, C.B. 1962–2, 30.

(3) *Examples*. The application of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the property transferred is used for purposes other than those described in section 514(b)(1) (A), (B), (C), or (D).

Example 1. On January 1, 1971, X, an exempt organization, receives property valued at $100,000 from donor A, a male aged 60. In return X promises to pay A $6,000 a year for the rest of A's life, with neither a minimum nor maximum number of payments specified. The annuity is payble on December 31, of each year. The amounts paid under the annuity are not dependent on the income derived from the property transferred to X. The present value of this annuity is $81,156, determined in accordance with Table A of Rev. Rul. 62–216. Since the value of the annuity is less than 90 percent of A's equity in the property transferred and the annuity meets all the other requirements of subparagraph (1) of this paragraph, the obligation to make annuity payments is not acquisition indebtedness.

Example 2. On January 1, 1971, B transfers an office building to Y, an exempt university, subject to a mortgage. In return Y agrees to pay B $5,000 a year for the rest of his life, with neither a minimum nor maximum number of payments specified. The amounts paid under the annuity are not dependent on the income derived from the property transferred to Y. It is determined that the actual value of the annuity is less than 90 percent of the value of B's equity in the property transferred. Y does not assume the mortgage. For the taxable years 1971 through 1980, the outstanding principal indebtedness secured by the mortgage is not treated as acquisition indebtedness. Further, Y's obligation to make annuity payments to B never constitutes acquisition indebtedness.

(f) *Certain Federal financing. Acquisition indebtedness* does not include an obligation to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons to the extent that it is insured by the Federal Housing Administration. Thus, for example, to the extent that an obligation is insured by the Federal Housing Administration under section 221(d)(3) (12 U.S.C. 1715(I)(d)(3)) or section 236 (12 U.S.C. 1715z–1) of title II of the National Housing Act, as amended, the obligation is not *acquisition indebtedness*.

(g) *Certain obligations of charitable remainder trusts*. For purposes of section 664(c) and §1.664–1(c), a charitable remainder trust (as defined in §1.664–1(a)(1)(iii)(*a*) does not incur *acquisition indebtedness* when the sole consideration it is required to pay in exchange for unencumbered property is an *annuity amount* or a *unitrust amount* (as defined in §1.664–1(a)(1)(iii)(*b*) and (*c*)).

[T.D. 7229, 37 FR 28151, Dec. 21, 1972; 38 FR 21918, Aug. 14, 1973; T.D. 7698, 45 FR 33973, May 21, 1980]

§1.514(c)–2 Permitted allocations under section 514(c)(9)(E).

(a) *Table of contents*. This paragraph contains a listing of the major headings of this §1.514(c)–2.

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(b) *Application of section 514(c)(9)(E), relating to debt-financed real property held by partnerships*—(1) *In general.* This §1.514(c)–2 provides rules governing the application of section 514(c)(9)(E). To comply with section 514(c)(9)(E), the following two requirements must be met:

(i) *The fractions rule.* The allocation of items to a partner that is a qualified organization cannot result in that partner having a percentage share of overall partnership income for any partnership taxable year greater than that partner's fractions rule percentage (as defined in paragraph (c)(2) of this section).

(ii) *Substantial economic effect.* Each partnership allocation must have substantial economic effect. However, allocations that cannot have economic effect must be deemed to be in accordance with the partners' interests in the partnership pursuant to §1.704–1(b)(4), or (if §1.704–1(b)(4) does not provide a method for deeming the allocations to be in accordance with the partners' interests in the partnership) must otherwise comply with the requirements of §1.704–1(b)(4). Allocations attributable to nonrecourse liabilities or partner nonrecourse debt must comply with the requirements of §1.704–2(e) or §1.704–2(i).

(2) *Manner in which fractions rule is applied*—(i) *In general.* A partnership must satisfy the fractions rule both on a prospective basis and on an actual basis for each taxable year of the partnership, commencing with the first taxable year of the partnership in which the partnership holds debt-financed real property and has a qualified organization as a partner. Generally, a partnership does not qualify for the unrelated business income tax exception provided by section 514(c)(9)(A) for any taxable year of its existence unless it satisfies the fractions rule for every year the fractions rule applies. However, if an actual allocation described in paragraph (e)(4), (h), (j)(2), or (m)(1)(ii) of this section (regarding certain allocations that are disregarded or not taken into account for purposes of the fractions rule until an actual allocation is made) causes the partnership to violate the fractions rule, the partnership ordinarily is treated as violating the fractions rule only for the taxable year of the actual allocation and subsequent taxable years. For purposes of applying the fractions rule, the term *partnership agreement* is defined in accordance with §1.704–1(b)(2)(ii)(*h*), and informal understandings are considered part of the partnership agreement in appropriate circumstances. See paragraph (k) of this section for rules relating to changes in the partners' interests and *de minimis* exceptions to the fractions rule.

(ii) *Subsequent changes.* A subsequent change to a partnership agreement that causes the partnership to violate

the fractions rule ordinarily causes the partnership's income to fail the exception provided by section 514(c)(9)(A) only for the taxable year of the change and subsequent taxable years.

(c) *General definitions*—(1) *Overall partnership income and loss.* Overall partnership income is the amount by which the aggregate items of partnership income and gain for the taxable year exceed the aggregate items of partnership loss and deduction for the year. Overall partnership loss is the amount by which the aggregate items of partnership loss and deduction for the taxable year exceed the aggregate items of partnership income and gain for the year.

(i) *Items taken into account in determining overall partnership income and loss.* Except as otherwise provided in this section, the partnership items that are included in computing overall partnership income or loss are those items of income, gain, loss, and deduction (including expenditures described in section 705(a)(2)(B)) that increase or decrease the partners' capital accounts under §1.704–1(b)(2)(iv). Tax items allocable pursuant to section 704(c) or §1.704–1(b)(2)(iv)(*f*)(*4*) are not included in computing overall partnership income or loss. Nonetheless, allocations pursuant to section 704(c) or §1.704–1(b)(2)(iv)(*f*)(*4*) may be relevant in determining that this section is being applied in a manner that is inconsistent with the fractions rule. See paragraph (k)(4) of this section.

(ii) *Guaranteed payments to qualified organizations.* Except to the extent otherwise provided in paragraph (d) of this section—

(A) A guaranteed payment to a qualified organization is not treated as an item of partnership loss or deduction in computing overall partnership income or loss; and

(B) Income that a qualified organization may receive or accrue with respect to a guaranteed payment is treated as an allocable share of overall partnership income or loss for purposes of the fractions rule.

(2) *Fractions rule percentage.* A qualified organization's fractions rule percentage is that partner's percentage share of overall partnership loss for the partnership taxable year for which that partner's percentage share of overall partnership loss will be the smallest.

(3) *Definitions of certain terms by cross reference to partnership regulations. Minimum gain chargeback, nonrecourse deduction, nonrecourse liability, partner nonrecourse debt, partner nonrecourse debt minimum gain, partner nonrecourse debt minimum gain chargeback, partner nonrecourse deduction,* and *partnership minimum gain* have the meanings provided in §1.704–2.

(4) *Example.* The following example illustrates the provisions of this paragraph (c).

Example. Computation of overall partnership income and loss for a taxable year. (i) Taxable corporation TP and qualified organization QO form a partnership to own and operate encumbered real property. Under the partnership agreement, all items of income, gain, loss, deduction, and credit are allocated 50 percent to TP and 50 percent to QO. Neither partner is entitled to a preferred return. However, the partnership agreement provides for a $900 guaranteed payment for services to QO in each of the partnership's first two taxable years. No part of the guaranteed payments qualify as a reasonable guaranteed payment under paragraph (d) of this section.

(ii) The partnership violates the fractions rule. Due to the existence of the guaranteed payment, QO's percentage share of any overall partnership income in the first two years will exceed QO's fractions rule percentage. For example, the partnership might have bottom-line net income of $5,100 in its first taxable year that is comprised of $10,000 of rental income, $4,000 of salary expense, and the $900 guaranteed payment to QO. The guaranteed payment would not be treated as an item of deduction in computing overall partnership income or loss because it does not qualify as a reasonable guaranteed payment. See paragraph (c)(1)(ii)(A) of this section. Accordingly, overall partnership income for the year would be $6,000, which would consist of $10,000 of rental income less $4,000 of salary expense. See paragraph (c)(1)(i) of this section. The $900 QO would include in income with respect to the guaranteed payment would be treated as an allocable share of the $6,000 of overall partnership income. See paragraph (c)(1)(ii)(B) of this section. Therefore, QO's allocable share of the overall partnership income for the year would be $3,450, whichwould be comprised of the $900 of income pertaining to QO's guaranteed payment, plus QO's $2,550 allocable share of the partnership's net income for the year (50 percent of $5,100). QO's $3,450 allocable share of overall partnership income would equal 58 percent of the $6,000 of

overall partnership income and would exceed QO's fractions rule percentage, which is less than 50 percent. (If there were no guaranteed payment, QO's fractions rule percentage would be 50 percent. However, the existence of the guaranteed payment to QO that is not disregarded for purposes of the fractions rule pursuant to paragraph (d) of this section means that QO's fractions rule percentage is less than 50 percent.)

(d) *Exclusion of reasonable preferred returns and guaranteed payments*—(1) *Overview*. This paragraph (d) sets forth requirements for disregarding reasonable preferred returns for capital and reasonable guaranteed payments for capital or services for purposes of the fractions rule. To qualify, the preferred return or guaranteed payment must be set forth in a binding, written partnership agreement.

(2) *Preferred returns*. Items of income (including gross income) and gain that may be allocated to a partner with respect to a current or cumulative reasonable preferred return for capital (including allocations of minimum gain attributable to nonrecourse liability (or partner nonrecourse debt) proceeds distributed to the partner as a reasonable preferred return) are disregarded in computing overall partnership income or loss for purposes of the fractions rule. Similarly, if a partnership agreement effects a reasonable preferred return with an allocation of what would otherwise be overall partnership income, those items comprising that allocation are disregarded in computing overall partnership income for purposes of the fractions rule.

(3) *Guaranteed payments*. A current or cumulative reasonable guaranteed payment to a qualified organization for capital or services is treated as an item of deduction in computing overall partnership income or loss, and the income that the qualified organization may receive or accrue from the current or cumulative reasonable guaranteed payment is not treated as an allocable share of overall partnership income or loss. The treatment of a guaranteed payment as reasonable for purposes of section 514(c)(9)(E) does not affect its possible characterization as unrelated business taxable income under other provisions of the Internal Revenue Code.

(4) *Reasonable amount*—(i) *In general*. A guaranteed payment for services is reasonable only to the extent the amount of the payment is reasonable under §1.162–7 (relating to the deduction of compensation for personal services). A preferred return or guaranteed payment for capital is reasonable only to the extent it is computed, with respect to unreturned capital, at a rate that is commercially reasonable based on the relevant facts and circumstances.

(ii) *Safe harbor*. For purposes of this paragraph (d)(4), a rate is deemed to be commercially reasonable if it is no greater than four percentage points more than, or if it is no greater than 150 percent of, the highest long-term applicable federal rate (AFR) within the meaning of section 1274(d), for the month the partner's right to a preferred return or guaranteed payment is first established or for any month in the partnership taxable year for which the return or payment on capital is computed. A rate in excess of the rates described in the preceding sentence may be commercially reasonable, based on the relevant facts and circumstances.

(5) *Unreturned capital*—(i) *In general*. Unreturned capital is computed on a weighted-average basis and equals the excess of—

(A) The amount of money and the fair market value of property contributed by the partner to the partnership (net of liabilities assumed, or taken subject to, by the partnership); over

(B) The amount of money and the fair market value of property (net of liabilities assumed, or taken subject to, by the partner) distributed by the partnership to the partner as a return of capital.

(ii) *Return of capital*. In determining whether a distribution constitutes a return of capital, all relevant facts and circumstances are taken into account. However, the designation of distributions in a written partnership agreement generally will be respected in determining whether a distribution constitutes a return of capital, so long as the designation is economically reasonable.

(6) *Timing rules*—(i) *Limitation on allocations of income with respect to reasonable preferred returns for capital.* Items of income and gain (or part of what would otherwise be overall partnership income) that may be allocated to a partner in a taxable year with respect to a reasonable preferred return for capital are disregarded for purposes of the fractions rule only to the extent the allocable amount will not exceed—

(A) The aggregate of the amount that has been distributed to the partner as a reasonable preferred return for the taxable year of the allocation and prior taxable years, on or before the due date (not including extensions) for filing the partnership's return for the taxable year of the allocation; minus

(B) The aggregate amount of corresponding income and gain (and what would otherwise be overall partnership income) allocated to the partner in all prior years.

(ii) *Reasonable guaranteed payments may be deducted only when paid in cash.* If a partnership that avails itself of paragraph (d)(3) of this section would otherwise be required (by virtue of its method of accounting) to deduct a reasonable guaranteed payment to a qualified organization earlier than the taxable year in which it is paid in cash, the partnership must delay the deduction of the guaranteed payment until the taxable year it is paid in cash. For purposes of this paragraph (d)(6)(ii), a guaranteed payment that is paid in cash on or before the due date (not including extensions) for filing the partnership's return for a taxable year may be treated as paid in that prior taxable year.

(7) *Examples.* The following examples illustrate the provisions of this paragraph (d).

Facts. Qualified organization QO and taxable corporation TP form a partnership. QO contributes $9,000 to the partnership and TP contributes $1,000. The partnership borrows $50,000 from a third party lender and purchases an office building for $55,000. At all relevant times the safe harbor rate described in paragraph (d)(4)(ii) of this section equals 10 percent.

Example 1. Allocations made with respect to preferred returns. (i) The partnership agreement provides that in each taxable year the partnership's *distributable cash* is first to be distributed to QO as a 10 percent preferred return on its unreturned capital. To the extent the partnership has insufficient cash to pay QO its preferred return in any taxable year, the preferred return is compounded (at 10 percent) and is to be paid in future years to the extent the partnership has distributable cash. The partnership agreement first allocates gross income and gain 100 percent to QO, to the extent cash has been distributed to QO as a preferred return. All remaining profit or loss is allocated 50 percent to QO and 50 percent to TP.

(ii) The partnership satisfies the fractions rule. Items of income and gain that may be specially allocated to QO with respect to its preferred return are disregarded in computing overall partnership income or loss for purposes of the fractions rule because the requirements of paragraph (d) of this section are satisfied. After disregarding those allocations, QO's fractions rule percentage is 50 percent (see paragraph (c)(2) of this section), and under the partnership agreement QO may not be allocated more than 50 percent of overall partnership income in any taxable year.

(iii) The facts are the same as in paragraph (i) of this *Example 1*, except that QO's preferred return is computed on unreturned capital at a rate that exceeds a commercially reasonable rate. The partnership violates the fractions rule. The income and gain that may be specially allocated to QO with respect to the preferred return is not disregarded in computing overall partnership income or loss to the extent it exceeds a commercially reasonable rate. See paragraph (d) of this section. As a result, QO's fractions rule percentage is less than 50 percent (see paragraph (c)(2) of this section), and allocations of income and gain to QO with respect to its preferred return could result in QO being allocated more than 50 percent of the overall partnership income in a taxable year.

Example 2. Guaranteed payments and the computation of overall partnership income or loss. (i) The partnership agreement allocates all bottom-line partnership income and loss 50 percent to QO and 50 percent to TP throughout the life of the partnership. The partnership agreement provides that QO is entitled each year to a 10 percent guaranteed payment on unreturned capital. To the extent the partnership is unable to make a guaranteed payment in any taxable year, the unpaid amount is compounded at 10 percent and is to be paid in future years.

(ii) Assuming the requirements of paragraph (d)(6)(ii) of this section are met, the partnership satisfies the fractions rule. The guaranteed payment is disregarded for purposes of the fractions rule because it is computed with respect to unreturned capital at the safe harbor rate described in paragraph

(d)(4)(ii) of this section. Therefore, the guaranteed payment is treated as an item of deduction in computing overall partnership income or loss, and the corresponding income that QO may receive or accrue with respect to the guaranteed payment is not treated as an allocable share of overall partnership income or loss. See paragraph (d)(3) of this section. Accordingly, QO's fractions rule percentage is 50 percent (see paragraph (c)(2) of this section), and under the partnership agreement QO may not be allocated more than 50 percent of overall partnership income in any taxable year.

(e) *Chargebacks and offsets*—(1) *In general.* The following allocations are disregarded in computing overall partnership income or loss for purposes of the fractions rule—

(i) Allocations of what would otherwise be overall partnership income that may be made to chargeback (i.e., reverse) prior disproportionately large allocations of overall partnership loss (or part of the overall partnership loss) to a qualified organization, and allocations of what would otherwise be overall partnership loss that may be made to chargeback prior disproportionately small allocations of overall partnership income (or part of the overall partnership income) to a qualified organization;

(ii) Allocations of income or gain that may be made to a partner pursuant to a minimum gain chargeback attributable to prior allocations of nonrecourse deductions to the partner;

(iii) Allocations of income or gain that may be made to a partner pursuant to a minimum gain chargeback attributable to prior allocations of partner nonrecourse deductions to the partner and allocations of income or gain that may be made to other partners to chargeback compensating allocations of other losses, deductions, or section 705(a)(2)(B) expenditures to the other partners; and

(iv) Allocations of items of income or gain that may be made to a partner pursuant to a qualified income offset, within the meaning of §1.704–1(b)(2)(ii)(*d*).

(v) Allocations made in taxable years beginning on or after January 1, 2002, that are mandated by statute or regulation other than subchapter K of chapter 1 of the Internal Revenue Code and the regulations thereunder.

(2) *Disproportionate allocations*—(i) *In general.* To qualify under paragraph (e)(1)(i) of this section, prior disproportionate allocations may be reversed in full or in part, and in any order, but must be reversed in the same ratio as originally made. A prior allocation is disproportionately large if the qualified organization's percentage share of that allocation exceeds its fractions rule percentage. A prior allocation is disproportionately small if the qualified organization's percentage share of that allocation is less than its fractions rule percentage. However, a prior allocation (or allocations) is not considered disproportionate unless the balance of the overall partnership income or loss for the taxable year of the allocation is allocated in a manner that would independently satisfy the fractions rule.

(ii) *Limitation on chargebacks of partial allocations.* Except in the case of a chargeback allocation pursuant to paragraph (e)(4) of this section, and except as otherwise provided by the Internal Revenue Service by revenue ruling, revenue procedure, or, on a case-by-case basis, by letter ruling, paragraph (e)(1)(i) of this section applies to a chargeback of an allocation of part of the overall partnership income or loss only if that part consists of a pro rata portion of each item of partnership income, gain, loss, and deduction (other than nonrecourse deductions, as well as partner nonrecourse deductions and compensating allocations) that is included in computing overall partnership income or loss.

(3) *Minimum gain chargebacks attributable to nonrecourse deductions.* Commencing with the first taxable year of the partnership in which a minimum gain chargeback (or partner nonrecourse debt minimum gain chargeback) occurs, a chargeback to a partner is attributable to nonrecourse deductions (or separately, on a debt-by-debt basis, to partner nonrecourse deductions) in the same proportion that the partner's percentage share of the partnership minimum gain (or separately, on a debt-by-debt basis, the partner nonrecourse debt minimum gain) at the end of the immediately preceding taxable year is attributable to nonrecourse deductions (or partner

nonrecoursedeductions). The partnership must determine the extent to which a partner's percentage share of the partnership minimum gain (or partner nonrecourse debt minimum gain) is attributable to deductions in a reasonable and consistent manner. For example, in those cases in which none of the exceptions contained in § 1.704–2(f) (2) through (5) are relevant, a partner's percentage share of the partnership minimum gain generally is attributable to nonrecourse deductions in the same ratio that—

(i) The aggregate amount of the nonrecourse deductions previously allocated to the partner but not charged back in prior taxable years; bears to

(ii) The sum of the amount described in paragraph (e)(3)(i) of this section, plus the aggregate amount of distributions previously made to the partner of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain but not charged back in prior taxable years.

(4) *Minimum gain chargebacks attributable to distribution of nonrecourse debt proceeds*—(i) *Chargebacks disregarded until allocations made.* Allocations of items of income and gain that may be made pursuant to a provision in the partnership agreement that charges back minimum gain attributable to the distribution of proceeds of a nonrecourse liability (or a partner nonrecourse debt) are taken into account for purposes of the fractions rule only to the extent an allocation is made. (See paragraph (d)(2) of this section, pursuant to which there is permanently excluded chargeback allocations of minimum gain that are attributable to proceeds distributed as a reasonable preferred return.)

(ii) *Certain minimum gain chargebacks related to returns of capital.* Allocations of items of income or gain that (in accordance with § 1.704–2(f)(1)) may be made to a partner pursuant to a minimum gain chargeback attributable to the distribution of proceeds of a nonrecourse liability are disregarded in computing overall partnership income or loss for purposes of the fractions rule to the extent that the allocations (subject to the requirements of paragraph (e)(2) of this section) also charge back prior disproportionately large allocations of overall partnership loss (or part of the overall partnership loss) to a qualified organization. This exception applies only to the extent the disproportionately large allocation consisted of depreciation from real property (other than items of nonrecourse deduction or partner nonrecourse deduction) that subsequently was used to secure the nonrecourse liability providing the distributed proceeds, and only if those proceeds were distributed as a return of capital and in the same proportion as the disproportionately large allocation.

(5) *Examples.* The following examples illustrate the provisions of this paragraph (e).

Example 1. Chargebacks of disproportionately large allocations of overall partnership loss. (i) Qualified organization QO and taxable corporation TP form a partnership. QO contributes $900 to the partnership and TP contributes $100. The partnership agreement allocates overall partnership loss 50 percent to QO and 50 percent to TP until TP's capital account is reduced to zero; then 100 percent to QO until QO's capital account is reduced to zero; and thereafter 50 percent to QO and 50 percent to TP. *Overall partnership income* is allocated first 100 percent to QO to chargeback overall partnership loss allocated 100 percent to QO, and thereafter 50 percent to QO and 50 percent to TP.

(ii) The partnership satisfies the fractions rule. QO's fractions rule percentage is 50 percent. See paragraph (c)(2) of this section. Therefore, the 100 percent allocation of overall partnership loss to QO is disproportionately large. See paragraph (e)(2)(i) of this section. Accordingly, the 100 percent allocation to QO of what would otherwise be overall partnership income (if it were not disregarded), which charges back the disproportionately large allocation of overall partnership loss, is disregarded in computing overall partnership income and loss for purposes of the fractions rule. The 100 percent allocation is in the same ratio as the disproportionately large loss allocation, and the rest of the allocations for the taxable year of the disproportionately large loss allocation will independently satisfy the fractions rule. See paragraph (e)(2)(i) of this section. After disregarding the chargeback allocation of 100 percent of what would otherwise be overall partnership income, QO will not be allocated a percentage share of overall partnership income in excess of its fractions rule percentage for any taxable year.

Example 2. Chargebacks of disproportionately small allocations of overall partnership income. (i) Qualified organization QO and taxable

corporation TP form a partnership. QO contributes $900 to the partnership and TP contributes $100. The partnership purchases real property with money contributed by its partners and with money borrowed by the partnership on a recourse basis. In any year, the partnership agreement allocates the first $500 of overall partnership income 50 percent to QO and 50 percent to TP; the next $100 of overall partnership income 100 percent to TP (as an incentive for TP to achieve significant profitability in managing the partnership'soperations); and all remaining overall partnership income 50 percent to QO and 50 percent to TP. *Overall partnership loss* is allocated first 100 percent to TP to chargeback overall partnership income allocated 100 percent to TP at any time in the prior three years and not reversed; and thereafter 50 percent to QO and 50 percent to TP.

(ii) The partnership satisfies the fractions rule. QO's fractions rule percentage is 50 percent because qualifying chargebacks are disregarded pursuant to paragraph (e)(1)(i) in computing overall partnership income or loss. See paragraph (c)(2) of this section. The zero percent allocation to QO of what would otherwise be overall partnership loss is a qualifying chargeback that is disregarded because it is in the same ratio as the income allocation it charges back, because the rest of the allocations for the taxable year of that income allocation will independently satisfy the fractions rule (see paragraph (e)(2)(i) of this section), and because it charges back an allocation of zero overall partnership income to QO, which is proportionately smaller (i.e., disproportionately small) than QO's 50 percent fractions rule percentage. After disregarding the chargeback allocation of 100 percent of what would otherwise be overall partnership loss, QO will not be allocated a percentage share of overall partnership income in excess of its fractions rule percentage for any taxable year.

Example 3. Chargebacks of partner nonrecourse deductions and compensating allocations of other items. (i) Qualified organization QO and taxable corporation TP form a partnership to own and operate encumbered real property. QO and TP each contribute $500 to the partnership. In addition, QO makes a $300 nonrecourse loan to the partnership. The partnership agreement contains a partner nonrecourse debt minimum gain chargeback provision and a provision that allocates partner nonrecourse deductions to the partner who bears the economic burden of the deductions in accordance with § 1.704–2. The partnership agreement also provides that to the extent partner nonrecourse deductions are allocated to QO in any taxable year, other compensating items of partnership loss or deduction (and, if appropriate, section 705(a)(2)(B) expenditures) will first be allocated 100 percent to TP. In addition, to the extent items of income or gain are allocated to QO in any taxable year pursuant to a partner nonrecourse debt minimum gain chargeback of deductions, items of partnership income and gain will first be allocated 100 percent to TP. The partnership agreement allocates all other overall partnership income or loss 50 percent to QO and 50 percent to TP.

(ii) The partnership satisfies the fractions rule on a prospective basis. The allocations of the partner nonrecourse deductions and the compensating allocation of other items of loss, deduction, and expenditure that may be made to TP (but which will not be made unless there is an allocation of partner nonrecourse deductions to QO) are not taken into account for purposes of the fractions rule until a taxable year in which an allocation is made. See paragraph (j)(1) of this section. In addition, partner nonrecourse debt minimum gain chargebacks of deductions and allocations of income or gain to other partners that chargeback compensating allocations of other deductions are disregarded in computing overall partnership income or loss for purposes of the fractions rule. See paragraph (e)(1)(iii) of this section. Since all other overall partnership income and loss is allocated 50 percent to QO and 50 percent to TP, QO's fractions rule percentage is 50 percent (see paragraph (c)(2) of this section), and QO will not be allocated a percentage share of overall partnership income in excess of its fractions rule percentage for any taxable year.

(iii) The facts are the same as in paragraph (i) of this *Example 3,* except that the partnership agreement provides that compensating allocations of loss or deduction (and section 705(a)(2)(B) expenditures) to TP will not be charged back until year 10. The partners expect $300 of partner nonrecourse deductions to be allocated to QO in year 1 and $300 of income or gain to be allocated to QO in year 2 pursuant to the partner nonrecourse debt minimum gain chargeback provision.

(iv) The partnership fails to satisfy the fractions rule on a prospective basis under the anti-abuse rule of paragraph (k)(4) of this section. If the partners' expectations prove correct, at the end of year 2, QO will have been allocated $300 of partner nonrecourse deductions and an offsetting $300 of partner nonrecourse debt minimum gain. However, the $300 of compensating deductions and losses that may be allocated to TP will not be charged back until year 10. Thus, during the period beginning at the end of year 2 and ending eight years later, there may be $300 more of unreversed deductions and losses allocated to TP than to QO, which would be inconsistent with the purpose of the fractions rule.

Example 4. Minimum gain chargeback attributable to distributions of nonrecourse debt proceeds. (i) Qualified organization QO and taxable corporation TP form a partnership. QO contributes $900 to the partnership and TP contributes $100. The partnership agreement generally allocates overall partnership income and loss 90 percent to QO and 10 percent to TP. However, the partnership agreement contains a minimum gain chargeback provision, and also provides that in any partnership taxable year in which there is a chargeback of partnership minimum gain to QO attributable to distributions of proceeds of nonrecourse liabilities, all other items comprising overall partnership income or loss will be allocated in a manner such that QO is not allocated more than 90 percent of the overall partnership income for the year.

(ii) The partnership satisfies the fractions rule on a prospective basis. QO's fractions rule percentage is 90 percent. See paragraph (c)(2) of this section. The chargeback that may be made to QO of minimum gain attributable to distributions of nonrecourse liability proceeds is taken into account for purposes of the fractions rule only to the extent an allocation is made. See paragraph (e)(4) of this section. Accordingly, that potential allocation to QO is disregarded in applying the fractions rule on a prospective basis (see paragraph (b)(2) of this section), and QO is treated as not being allocated a percentage share of overall partnership income in excess of its fractions rule percentage in any taxable year. (Similarly, QO is treated as not being allocated items of income or gain in a taxable year when the partnership has an overall partnership loss.)

(iii) In year 3, the partnership borrows $400 on a nonrecourse basis and distributes it to QO as a return of capital. In year 8, the partnership has $400 of gross income and cash flow and $300 of overall partnership income, and the partnership repays the $400 nonrecourse borrowing.

(iv) The partnership violates the fractions rule for year 8 and all future years. Pursuant to the minimum gain chargeback provision, the entire $400 of partnership gross income is allocated to QO. Accordingly, notwithstanding the curative provision in the partnership agreement that would allocate to TP the next $44 (($400 ÷ .9) × 10%) of income and gain included in computing overall partnership income, the partnership has no other items of income and gain to allocate to QO. Because the $400 of gross income actually allocated to QO is taken into account for purposes of the fractions rule in the year an allocation is made (see paragraph (e)(4) of this section), QO's percentage share of overall partnership income in year 8 is greater than 100 percent. Since this exceeds QO's fractions rule percentage (i.e., 90 percent), the partnership violates the fractions rule for year 8 and all subsequent taxable years. See paragraph (b)(2) of this section.

(f) *Exclusion of reasonable partner-specific items of deduction or loss.* Provided that the expenditures are allocated to the partners to whom they are attributable, the following partner-specific expenditures are disregarded in computing overall partnership income or loss for purposes of the fractions rule—

(1) Expenditures for additional record-keeping and accounting incurred in connection with the transfer of a partnership interest (including expenditures incurred in computing basis adjustments under section 743(b));

(2) Additional administrative costs that result from having a foreign partner;

(3) State and local taxes or expenditures relating to those taxes; and

(4) Expenditures designated by the Internal Revenue Service by revenue ruling or revenue procedure, or, on a case-by-case basis, by letter ruling. (See § 601.601(d)(2)(ii)(*b*) of this chapter).

(g) *Exclusion of unlikely losses and deductions.* Unlikely losses or deductions (other than items of nonrecourse deduction) that may be specially allocated to partners that bear the economic burden of those losses or deductions are disregarded in computing overall partnership income or loss for purposes of the fractions rule, so long as a principal purpose of the allocation is not tax avoidance. To be excluded under this paragraph (g), a loss or deduction must have a low likelihood of occurring, taking into account all relevant facts, circumstances, and information available to the partners (including bona fide financial projections). The types of events that may give rise to unlikely losses or deductions, depending on the facts and circumstances, include tort and other third-party litigation that give rise to unforeseen liabilities in excess of reasonable insurance coverage; unanticipated labor strikes; unusual delays in securing required permits or licenses; abnormal weather conditions (considering the season and the job site); significant delays in leasing property due to an unanticipated severe economic downturn in the geographic area; unanticipated cost overruns; and the discovery of environmental conditions

that require remediation. No inference is drawn as to whether a loss or deduction is unlikely from the fact that the partnership agreement includes a provision for allocating that loss or deduction.

(h) *Provisions preventing deficit capital account balances.* A provision in the partnership agreement that allocates items of loss or deduction away from a qualified organization in instances where allocating those items to the qualified organization would cause or increase a deficit balance in its capital account that the qualified organization is not obligated to restore (within the meaning of §1.704–1(b)(2)(ii) (*b*) or (*d*)), is disregarded for purposes of the fractions rule in taxable years of the partnership in which no such allocations are made pursuant to the provision. However, this exception applies only if, at the time the provision becomes part of the partnership agreement, all relevant facts, circumstances, and information (including bona fide financial projections) available to the partners reasonably indicate that it is unlikely that an allocation will be made pursuant to the provision during the life of the partnership.

(i) [Reserved]

(j) *Exception for partner nonrecourse deductions*—(1) *Partner nonrecourse deductions disregarded until actually allocated.* Items of partner nonrecourse deduction that may be allocated to a partner pursuant to §1.704–2, and compensating allocations of other items of loss, deduction, and section 705(a)(2)(B) expenditures that may be allocated to other partners, are not taken into account for purposes of the fractions rule until the taxable years in which they are allocated.

(2) *Disproportionate allocation of partner nonrecourse deductions to a qualified organization.* A violation of the fractions rule will be disregarded if it arises because an allocation of partner nonrecourse deductions to a qualified organization that is not motivated by tax avoidance reduces another qualified organization's fractions rule percentage below what it would have been absent the allocation of the partner nonrecourse deductions.

(k) *Special rules*—(1) *Changes in partnership allocations arising from a change in the partners' interests.* A qualified organization that acquires a partnership interest from another qualified organization is treated as a continuation of the prior qualified organization partner (to the extent of that acquired interest) for purposes of applying the fractions rule. Changes in partnership allocations that result from other transfers or shifts of partnership interests will be closely scrutinized (to determine whether the transfer or shift stems from a prior agreement, understanding, or plan or could otherwise be expected given the structure of the transaction), but generally will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years.

(2) *De minimis interest rule*—(i) *In general.* Section 514(c)(9)(B)(vi) does not apply to a partnership otherwise subject to that section if—

(A) Qualified organizations do not hold, in the aggregate, interests of greater than five percent in the capital or profits of the partnership; and

(B) Taxable partners own substantial interests in the partnership through which they participate in the partnership on substantially the same terms as the qualified organization partners.

(ii) *Example.* Partnership *PRS* has two types of limited partnership interests that participate in partnership profits and losses on different terms. Qualified organizations (QOs) only own one type of limited partnership interest and own no general partnership interests. In the aggregate, the QOs own less than five percent of the capital and profits of *PRS*. Taxable partners also own the same type of limited partnership interest that the QOs own. These limited partnership interests owned by the taxable partners are 30 percent of the capital and profits of *PRS*. Thirty percent is a substantial interest in the partnership. Therefore, *PRS* satisfies paragraph (k)(2) of this section and section 514(c)(9)(B)(vi) does not apply.

(3) *De minimis allocations disregarded.* A qualified organization's fractions rule percentage of the partnership's items of loss and deduction, other than nonrecourse and partner nonrecourse deductions, that are allocated away from the qualified organization and to

other partners in any taxable year are treated as having been allocated to the qualified organization for purposes of the fractions rule if—

(i) The allocation was neither planned nor motivated by tax avoidance; and

(ii) The total amount of those items of partnership loss or deduction is less than both—

(A) One percent of the partnership's aggregate items of gross loss and deduction for the taxable year; and

(B) $50,000.

(4) *Anti-abuse rule.* The purpose of the fractions rule is to prevent tax avoidance by limiting the permanent or temporary transfer of tax benefits from tax-exempt partners to taxable partners, whether by directing income or gain to tax-exempt partners, by directing losses, deductions, or credits to taxable partners, or by some other similar manner. This section may not be applied in a manner that is inconsistent with the purpose of the fractions rule.

(l) [Reserved]

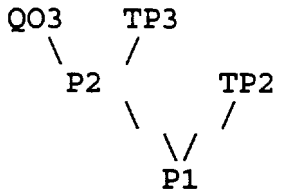
(m) *Tiered partnerships*—(1) *In general.* If a qualified organization holds an indirect interest in real property through one or more tiers of partnerships (a chain), the fractions rule is satisfied only if—

(i) The avoidance of tax is not a principal purpose for using the tiered-ownership structure (investing in separate real properties through separate chains of partnerships so that section 514(c)(9)(E) is, effectively, applied on a property-by-property basis is not, in and of itself, a tax avoidance purpose); and

(ii) The relevant partnerships can demonstrate under any reasonable method that the relevant chains satisfy the requirements of paragraphs (b)(2) through (k) of this section. For purposes of applying § 1.704–2(k) under the independent chain approach described in Example 3 of paragraph (m)(2) of this section, allocations of items of income or gain that may be made pursuant to a provision in the partnership agreement that charges back minimum gain are taken into account for purposes of the fractions rule only to the extent an allocation is made.

(2) *Examples.* The following examples illustrate the provisions of this paragraph (m).

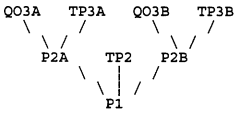
Example 1. Tiered partnerships—collapsing approach. (i) Qualified organization QO3 and taxable individual TP3 form upper-tier partnership P2. The P2 partnership agreement allocates overall partnership income 20 percent to QO3 and 80 percent to TP3. Overall partnership loss is allocated 30 percent to QO3 and 70 percent to TP3. P2 and taxable individual TP2 form lower-tier partnership P1. The P1 partnership agreement allocates overall partnership income 60 percent to P2 and 40 percent to TP2. Overall partnership loss is allocated 40 percent to P2 and 60 percent to TP2. The only asset of P2 (which has no outstanding debt) is its interest in P1. P1 purchases real property with money contributed by its partners and with borrowed money. There is no tax avoidance purpose for the use of the tiered-ownership structure, which is illustrated by the following diagram.



(ii) P2 can demonstrate that the P2/P1 chain satisfies the requirements of paragraphs (b)(2) through (k) of this section by collapsing the tiered-partnership structure. On a collapsed basis, QO3's fractions rule percentage is 12 percent (30 percent of 40 percent). See paragraph (c)(2) of this section. P2 satisfies the fractions rule because QO3 may not be allocated more than 12 percent (20 percent of 60 percent) of overall partnership income in any taxable year.

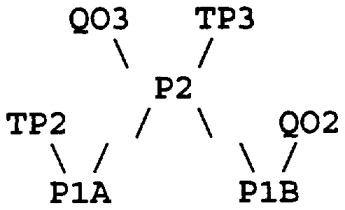
Example 2. Tiered partnerships—entity-by-entity approach. (i) Qualified organization QO3A is a partner with taxable individual TP3A in upper-tier partnership P2A. Qualified organization QO3B is a partner with taxable individual TP3B in upper-tier partnership P2B. P2A, P2B, and taxable individual TP2 are partners in lower-tier partnership P1, which owns encumbered real estate. None of QO3A, QO3B, TP3A, TP3B or TP2 has a direct or indirect ownership interest in each other. P2A has been established for the purpose of investing in numerous real estate properties independently of P2B and its partners. P2B has been established for the purpose of investing in numerous real estate properties independently of P2A and its partners. Neither P2A nor P2B has outstanding debt. There is no tax avoidance purpose for the use

of the tiered-ownership structure, which is illustrated by the following diagram.



(ii) The P2A/P1 chain (Chain A) will satisfy the fractions rule if P1 and P2A can demonstrate in a reasonable manner that they satisfy the requirements of paragraphs (b)(2) through (k) of this section. The P2B/P1 chain (Chain B) will satisfy the fractions rule if P1 and P2B can demonstrate in a reasonable manner that they satisfy the requirements of paragraphs (b)(2) through (k) of this section. To meet its burden, P1 treats P2A and P2B as qualified organizations. Provided that the allocations that may be made by P1 would satisfy the fractions rule if P2A and P2B were direct qualified organization partners in P1, Chain A will satisfy the fractions rule (for the benefit of QO3A) if the allocations that may be made by P2A satisfy the requirements of paragraphs (b)(2) through (k) of this section. Similarly, Chain B will satisfy the fractions rule (for the benefit of QO3B) if the allocations that may be made by P2B satisfy the requirements of paragraphs (b)(2) through (k) of this section. Under these facts, QO3A does not have to know how income and loss may be allocated by P2B, and QO3B does not have to know how income and loss may be allocated by P2A. QO3A's and QO3B's burden would not change even if TP2 were not a partner in P1.

Example 3. Tiered partnerships—independent chain approach. (i) Qualified organization QO3 and taxable corporation TP3 form upper-tier partnership P2. P2 and taxable corporation TP2 form lower-tier partnership P1A. P2 and qualified organization QO2 form lower-tier partnership P1B. P2 has no outstanding debt. P1A and P1B each purchase real property with money contributed by their respective partners and with borrowed money. Each partnership's real property is completely unrelated to the real property owned by the other partnership. P1B's allocations do not satisfy the requirements of paragraphs (b)(2) through (k) of this section because of allocations that may be made to QO2. However, if P2's interest in P1B were completely disregarded, the P2/P1A chain would satisfy the requirements of paragraphs (b)(2) through (k) of this section. There is no tax avoidance purpose for the use of the tiered-ownership structure, which is illustrated by the following diagram.



(ii) P2 satisfies the fractions rule with respect to the P2/P1A chain, but only if the P2 partnership agreement allocates those items allocated to P2 by P1A separately from those items allocated to P2 by P1B. For this purpose, allocations of items of income or gain that may be made pursuant to a provision in the partnership agreement that charges back minimum gain, are taken into account for purposes of the fractions rule only to the extent an allocation is made. See paragraph (m)(1)(ii) of this section. P2 does not satisfy the fractions rule with respect to the P2/P1B chain.

(n) *Effective date*—(1) *In general.* Section 514(c)(9)(E), as amended by sections 2004(h) (1) and (2) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100–647, applies generally with respect to property acquired by partnerships after October 13, 1987, and to partnership interests acquired after October 13, 1987.

(2) *General effective date of the regulations.* Section 1.514(c)–2 (a) through (m) applies with respect to partnership agreements entered into after December 30, 1992, property acquired by partnerships after December 30, 1992, and partnership interests acquired by qualified organizations after December 30, 1992 (other than a partnership interest that at all times after October 13, 1987, and prior to the acquisition was held by a qualified organization). For this purpose, paragraphs (a) through (m) of this section will be treated as satisfied with respect to partnership agreements entered into on or before May 13, 1994, property acquired by partnerships on or before May 13, 1994, and partnership interests acquired by qualified organizations on or before May 13, 1994, if the guidance set forth in (paragraphs (a) through (m) of § 1.514(c)–2 of) PS–56–90, published at 1993–5 I.R.B. 42, February 1, 1993, is satisfied. (See § 601.601(d)(2)(ii)(*b*) of this chapter).

(3) *Periods after June 24, 1990, and prior to December 30, 1992.* To satisfy the requirements of section 514(c)(9)(E) with respect to partnership agreements entered into after June 24, 1990, property acquired by partnerships after June 24, 1990, and partnership interests acquired by qualified organizations after June 24, 1990, (other than a partnership interest that at all times after October 13, 1987, and prior to the acquisition was held by a qualified organization) to which paragraph (n)(2) of this section does not apply, paragraphs (a) through (m) of this section must be satisfied as of the first day that section 514(c)(9)(E) applies with respect to the partnership, property, or acquired interest. For this purpose, paragraphs (a) through (m) of this section will be treated as satisfied if the guidance in sections I through VI of Notice 90–41, 90–1 C.B. 350, (see § 601.601(d)(2)(ii)(*b*) of this chapter) has been followed.

(4) *Periods prior to the issuance of Notice 90–41.* With respect to partnerships commencing after October 13, 1987, property acquired by partnerships after October 13, 1987, and partnership interests acquired by qualified organizations after October 13, 1987, to which neither paragraph (n)(2) nor (n)(3) of this section applies, the Internal Revenue Service will not challenge an interpretation of section 514(c)(9)(E) that is reasonable in light of the underlying purposes of section 514(c)(9)(E) (as reflected in its legislative history) and that is consistently applied as of the first day that section 514(c)(9)(E) applies with respect to the partnership, property, or acquired interest. A reasonable interpretation includes an interpretation that substantially follows the guidance in either sections I through VI of Notice 90–41, (see § 601.601(d)(2)(ii)(*b*) of this chapter) or paragraphs (a) through (m) of this section.

(5) Material modifications to partnership agreements. A material modification will cause a partnership agreement to be treated as a new partnership agreement in appropriate circumstances for purposes of this paragraph (n).

[T.D. 8539, 59 FR 24928, May 13, 1994, as amended by T.D. 9047, 68 FR 12825, Mar. 18, 2003]

§ 1.514(d)–1 Basis of debt-financed property acquired in corporate liquidation.

(a) If debt-financed property is acquired by an exempt organization in a complete or partial liquidation of a corporation in exchange for its stock, the organization's basis in such property shall be the same as it would be in the hands of the transferor corporation, increased by the amount of gain recognized to the transferor corporation upon such distribution and by the amount of any gain which is includible, on account of such distribution, in the gross income of the organization as unrelated debt-financed income.

(b) The application of this section may be illustrated by the following example:

Example. On July 1, 1970, T, an exempt trust, exchanges $15,000 of borrowed funds for 50 percent of the shares of M Corporation's stock. M uses $35,000 of borrowed funds in acquiring depreciable assets which are not used at any time for purposes described in section 514(b)(1) (A), (B), (C), or (D). On July 1, 1978, and for the 12-month period preceding this date, T's acquisition indebtedness with respect to M's stock has been $3,000. On this date, there is a complete liquidation of M Corporation to which section 331(a)(1) applies. In the liquidation T receives a distribution in kind of depreciable assets and assumes $7,000 of M's indebtedness which remains unpaid with respect to the depreciable assets. On this date, M's adjusted basis of these depreciable assets is $9,000, and such assets have a fair market value of $47,000. M recognizes gain of $6,000 with respect to this liquidation pursuant to sections 1245 and 1250. T realizes a gain of $25,000 (the difference between the excess of fair market value of the property received over the indebtedness assumed, $40,000 ($47,000–$7,000) and T's basis in M's stock, $15,000). A portion of this gain is to be treated as unrelated debt-financed income. This amount is determined by multiplying T's gain of $25,000 by the debt/basis percentage. The debt/basis percentage is 20 percent, the ratio which the average acquisition indebtedness ($3,000) is of the average adjusted basis ($15,000). Thus, $5,000 (20 percent of $25,000) is unrelated debt-financed income. This amount and the gain recognized pursuant to sections 1245 and 1250 are added to M's basis to determine T's basis in the property received. Consequently, T's basis in the property received from M Corporation is $20,000, determined as follows:

M Corporation's adjusted basis	$9,000
Gain recognized by M Corporation on the distribution	6,000

Unrelated debt-financed income recognized by T with respect to the distribution	5,000
T's transferred basis	20,000

[T.D. 7229, 37 FR 28153, Dec. 21, 1972]

§ 1.514(e)–1 Allocation rules.

Where only a portion of property is debt-financed property, proper allocation of the basis, indebtedness, income, and deductions with respect to such property must be made to determine the amount of income or gain derived from such property which is to be treated as unrelated debt-financed income. See examples 2 and 3 of paragraph (b)(1)(iii) of § 1.514(b)–1 and examples 1, (2), and (3) of paragraph (b)(3)(iii) of § 1.514(b)–1 for illustrations of proper allocation.

[T.D. 7229, 37 FR 28153, Dec. 21, 1972]

§ 1.514(f)–1 Definition of business lease.

(a) *In general*. The term *business lease* means any lease, with certain exceptions discussed in paragraph (c) of this section, for a term of more than 5 years of real property by an organization subject to section 511 (or by a partnership of which it is a member) if at the close of the organization's taxable year there is a business lease indebtedness as defined in section 514(g) and § 1.514(g)–1 with respect to such property. For the purpose of this section the term *real property* and the term *premises* include personal property of the lessor tax-exempt organization leased by it to a lessee of its real estate if the lease of such personal property is made under, or in connection with, the lease of such real estate. For amounts of business lease rents and deductions to be included in computing unrelated business taxable income for taxable years beginning before January 1, 1970, see § 1.514(a)–2.

(b) *Special rules*. (1) In computing the term of the lease, the period for which a lease may be renewed or extended by reason of an option contained therein shall be considered as part of the term. For example, a 3-year lease with an option for renewal for another such period is considered a lease for a term of 6 years. Another example is the case of a 1-year lease with option of renewal for another such term, where the parties at the end of each year renew the arrangement. In this case, during the fifth year (but not during the first 4 years), the lease falls within the 5-year rule, since the lease then involves 5 years and there is an option for the sixth year. In determining the term of the lease, an option for renewal of the lease is taken into account whether or not the exercise of the option depends upon conditions or contingencies.

(2) If the property is acquired subject to a lease, the term of such lease shall be considered to begin on the date of such acquisition. For example, if an exempt organization purchases, in whole or in part with borrowed funds, real property subject to a 10-year lease which has 3 years left to run, and such lease contains no right of renewal or extension, the lease shall be considered a 3-year lease and hence does not meet the definition of a business lease in section 514(f) and paragraph (a) of this section. However, if this lease contains an option to renew for a period of 3 years or more, it is a business lease.

(3) Under the provisions of section 514(f)(2)(B) a lease is considered as continuing for more than 5 years if the same lessee has occupied the premises for a total period of more than 5 years, whether the occupancy is under one or more leases, renewals, extensions, or continuations. Continued occupancy shall be considered to be by the same lessee if the occupants during the period are so related that losses in respect of sales or exchanges of property between them would be disallowed under section 267(a). Such period shall be considered as commencing not earlier than the date of the acquisition of the property by the tax-exempt organization or trust. This rule is applicable only in the sixth and succeeding years of such occupancy by the same lessee. See, however, paragraph (c)(3) of this section.

(c) *Exceptions*. (1) A lease shall not be considered a business lease if such lease is entered into primarily for a purpose which is substantially related (aside from the need of such organization for income or funds, or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting

the basis for its exemption. For example, where a tax-exempt hospital leases real property owned by it to an association of doctors for use as a clinic, the rents derived under such lease would not be included in computing unrelated business taxable income if the clinic is substantially related to the carrying on of hospital functions. See § 1.513–1 for principles applicable in determining whether there is a substantial relationship to the exempt purpose of an organization.

(2) A lease is not a business lease if the lease is of premises in a building primarily designed for occupancy and occupied by the tax-exempt organization.

(3) If a lease for more than 5 years to a tenant is for only a portion of the real property, and space in the real property is rented during the taxable year under a lease for not more than 5 years to any other tenant of the tax-exempt organization, all leases of the real property for more than 5 years shall be considered as business leases during the taxable year only if:

(i) The rents derived from the real property during the taxable year under leases for more than 5 years represent 50 percent or more of the total rents derived during the taxable year from the real property; or the area of the premises occupied under leases for more than 5 years represents, at any time during the taxable year, 50 percent or more of the total area of the real property rented at such time; or

(ii) The rent derived from the real property during the taxable year from any tenant under a lease for more than 5 years, or from a group of tenants (under such leases) who are either members of an affiliated group (as defined in section 1504) or are partners, represents more than 10 percent of the total rents derived during the taxable year from such property; or the area of the premises occupied by any one such tenant, or by any such group of tenants, represents at any time during the taxable year more than 10 percent of the total area of the real property rented at such time

In determining whether 50 percent or more of the total rents are derived from leases for more than 5 years, or whether 50 percent or more of the total area is occupied under leases for more than 5 years:

(iii) An occupancy which is considered to be a lease of more than 5 years solely by reason of the provisions of paragraph (b)(3) of this subparagraph shall not be treated as such a lease for purposes of subdivision (i) of this subparagraph, and

(iv) An occupancy which is considered to be a lease of more than 5 years solely by reason of the provisions of paragraph (b)(3) of this section shall be treated as such a lease for purposes of subdivision (ii) of this subparagraph, and

(v) If during the last half of the term of a lease a new lease is made to take effect after the expiration of such lease, the unexpired portion of the first lease will not be added to the second lease to determine whether such second lease is a lease for more than 5 years for purposes of subdivision (i) of this subparagraph.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. In 1954 an educational organization, which is on the calendar year basis, begins the erection of an 11-story apartment building using funds borrowed for that purpose, and immediately leases for a 10-year term the first floor to a real estate development company to sublet for stores and shops. As fast as the new apartments are completed, they are rented on an annual basis. At the end of 1959 all except the 10th and 11th floors are rented. Those two floors are completed during 1960 and rented. Assume that for 1954 and each subsequent taxable year through 1959, and for the taxable year 1963, the gross rental for the first floor represents more than 10 percent of the total gross rents derived during the taxable year from the building. Under this set of facts the 10-year lease of the first floor would be considered to be a business lease for all except the taxable years 1961, 1962, and 1964.

[T.D. 7229, 37 FR 28154, Dec. 21, 1972]

§ 1.514(g)–1 Business lease indebtedness.

(a) *Definition*. The term *business lease indebtedness* means, with respect to any real property leased by a tax-exempt organization for a term of more than 5 years, the unpaid amount of:

(1) The indebtedness incurred by the lessor tax-exempt organization in acquiring or improving such property;

(2) The indebtedness incurred by the lessor tax-exempt organization prior to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(3) The indebtedness incurred by the lessor tax-exempt organization subsequent to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of the indebtedness was reasonably foreseeable at the time of such acquisition or improvement

See paragraph (i) of this section with respect to subsidiary corporations.

(b) *Examples*. The rules of section 514(g) respecting business leases also cover certain cases where the leased property itself is not subject to an indebtedness. For example, they apply to cases such as the following:

Example 1. A university pledges some of its investment securities with a bank for a loan and uses the proceeds of such loan to purchase (either directly or through a subsidiary corporation) a building, which building is subject to a lease that then has more than 5 years to run. This would be an example of a business lease indebtedness incurred prior to the acquisition of the property which would not have been incurred but for such acquisition.

Example 2. If the building itself in example 1 in this paragraph is later mortgaged to raise funds to release the pledged securities, the lease would continue to be a business lease.

Example 3. If a scientific organization mortgages its laboratory building to replace working capital used in remodeling another one of its buildings or a building held by its subsidiary corporation, which other building is free of indebtedness and is subject to a lease that then has more than 5 years to run, the lease would be a business lease inasmuch as the indebtedness though incurred subsequent to the improvement of such property would not have been incurred but for such improvement, and the incurrence of the indebtedness was reasonably foreseeable when, to make such improvement, the organization reduced its working capital below the amount necessary to continue current operations.

(c) *Property acquired subject to lien*. Where real property is acquired subject to a mortgage or similar lien, whether the acquisition be by gift, bequest, devise, or purchase, the amount of the indebtedness secured by such mortgage or lien is a business lease indebtedness (unless paragraph (d)(1) of this section applies) even though the lessor does not assume or agree to pay the indebtedness. For example, a university pays $100,000 for real estate valued at $300,000 and subject to a $200,000 mortgage. For the purpose of the tax on unrelated business taxable income, the result is the same as if $200,000 of borrowed funds had been used to buy the property.

(d) *Certain property acquired by gifts, etc*. (1) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a mortgage or other similar lien, the amount of such mortgage or other similar lien shall not be considered as an indebtedness of the lessor tax-exempt organization incurred in acquiring such property. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(2) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a lease requiring improvements in such property upon the happening of stated contingencies, indebtedness incurred in improving such property in accordance with the terms of such lease shall not be considered as indebtedness described in section 514(g) and in this section. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(e) *Certain corporations described in section 501(c)(2)*. In the case of a title holding corporation described in section 501(c)(2), all of the stock of which was acquired before July 1, 1950, by an organization described in section 501(c)(3), (5), or (6) (and more than one-third of such stock was acquired by such organization by gift or bequest), any indebtedness incurred by such corporation before July 1, 1950, and any indebtedness incurred by such corporation on or after such date in improving real property in accordance with the terms of a lease entered into before such date, shall not be considered an indebtedness described in section 514(g) and in this

section with respect to either such section 501(c)(2) corporation or such section 501(c) (3), (5), or (6) organization.

(f) *Certain trusts described in section 401(a).* In the case of a trust described in section 401(a), or in the case of a corporation described in section 501(c)(2) all of the stock of which was acquired before March 1, 1954, by such a trust, any indebtedness incurred by such trust or such corporation before such date, in connection with real property which is leased before such date, and any indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease, shall not be considered as an indebtedness described in section 514(g) and in this section.

(g) *Business lease on portion of property.* Where only a portion of the real property is subject to a business lease, proper allocation of the indebtedness applicable to the whole property must be made to the premises covered by the lease. See example 2 of paragraph (b)(3) of § 1.514(a)–2.

(h) *Special rule applicable to trusts described in section 401(a).* If an employees' trust described in section 401(a) lends any money to another such employees' trust of the same employer, for the purpose of acquiring or improving real property, such loan will not be treated as an indebtedness of the borrowing trust except to the extent that the loaning trust:

(1) Incurs any indebtedness in order to make such loan;

(2) Incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan; or

(3) Incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

(i) *Subsidiary corporations.* The provisions of section 514(f), (g), and (h) are applicable whether or not a subsidiary corporation of the type described in section 501(c)(2) is availed of in making the business lease. For example, assume a parent organization borrows funds to purchase realty and sets up a separate section 501(c)(2) corporation as a subsidiary to hold the property. Such subsidiary corporation leases the property for a period of more than 5 years, collects the rents and pays over all of the income, less expenses, to the parent organization, the parent organization being liable for the indebtedness. Under these assumed facts, the lease by section 501(c)(2) subsidiary corporation would be a business lease with respect to such subsidiary corporation, and the rental income would be subject to the tax, whether or not the subsidiary itself assumes the indebtedness and whether or not the property is subject to the indebtedness.

(j) *Certain trusts described in section 501(c)(17).* (1) In the case of a supplemental unemployment benefit trust described in section 501(c)(17), or in the case of a corporation described in section 501(c)(2) all of the stock of which was acquired before January 1, 1960, by such a trust, any indebtedness incurred by such trust or such corporation before such date, in connection with real property which is leased before such date, and any indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease, shall not be considered as an indebtedness described in section 514(g) and in this section.

(2) If a supplemental unemployment benefit trust described in section 501(c)(17) lends any money to another such supplemental unemployment benefit trust forming part of the same plan, for the purpose of acquiring or improving real property, such loan will not be treated as an indebtedness of the borrowing trust except to the extent that the loaning trust:

(i) Incurs any indebtedness in order to make such loan;

(ii) Incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan; or

(iii) Incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

[T.D. 7229, 37 FR 28155, Dec. 21, 1972]

FARMERS' COOPERATIVES

§ 1.521–1 Farmers' cooperative marketing and purchasing associations; requirements for exemption under section 521.

(a)(1) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, livestock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of either the quantity or the value of the products furnished by them, are exempt from income tax except as otherwise provided in section 522, or part I, subchapter T chapter 1 of the Code, and the regulations thereunder. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of either the quantity or the value of milk or of butterfat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in anyother way than on such a proportionate basis, the association does not meet the requirements of the Code and is not exempt. In other words, nonmember patrons must be treated the same as members insofar as the distribution of patronage dividends is concerned. Thus, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Code that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of either the quantity or the value of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Code does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Code patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association instead of paying patronage dividends to nonmember producers incash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are made applicable toward the purchase price of a share of stock or of a membership in the association. See, however, paragraph (c)(1) of § 1.1388–1 for the meaning of *payment in money* for purposes of qualifying a written notice of allocation.

(2) An association which has capital stock will not for such reason be denied exemption (i) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and (ii) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restrictedas far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed

on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends.

(3) The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installation of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 521.

(b) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, livestock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term *supplies and equipment* as used in section 521 includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of paragraph (a) of this section relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for such reason be denied exemption, provided the value of the purchases for nonmembers does not exceed the value of the supplies and equipment purchased for members, and provided the value of the purchases made for nonmembers who are not producers does not exceed 15 percent of the value of all its purchases.

(c) In order to be exempt under either paragraph (a) or (b) of this section an association must establish that it has no taxable income for its own account other than that reflected in a reserve or surplus authorized in paragraph (a) of this section. An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Code. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under section 521 and this section. An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 521.

(d) Cooperative organizations engaged in occupations dissimilar from those of farmers, fruit growers, and the like, are not exempt.

(e) An organization is not exempt from taxation under this section merely because it claims that it complies with the requirements prescribed therein. In order to establish its exemption every organization claiming exemption under section 521 is required to file a Form 1028. The Form 1028, executed in accordance with the instructions on the form or issued therewith, should be filed with the district director for the internal revenue district in which is located the principal place of business or principal office of the organization. However, an organization which has been granted exemption under the provisions of the Internal Revenue Code of 1939 or prior law may rely on that ruling, unless affected by substantive changes in the Internal Revenue Code of 1954 or any changes in the character, purposes, or methods of operation of the organization, and it is not necessary in such case for the organization to request a new determination as to its exempt status.

(f) A cooperative association will not be denied exemption merely because it makes payments solely in nonqualified written notices of allocation to those patrons who do not consent as provided in section 1388 and § 1.1388–1, but makes payments of 20 percent in cash and the remainder in qualified written notices

of allocation to those patrons who do so consent. Nor will such an association be denied exemption merely because, in the case of patrons who have so consented, payments of less than $5 are made solely in nonqualified written notices of allocation while payments of $5 or more are made in the form of 20 percent in cash and the remainder in qualified written notices of allocation. In addition, a cooperative association will not be denied exemption if it pays a smaller amount of interest or dividends on nonqualified written notices of allocation held by persons who have not consented as provided in section 1388 and § 1.1388–1 (or on per-unit retain certificates issued to patrons who are not qualifying patrons with respect thereto within the meaning of § 1.61–5(d)(2)) than it pays on qualified written notices of allocation held by persons who have so consented (or on per-unit retain certificates issued to patrons who are qualifying patrons with respect thereto) provided that the amount of the interest or dividend reduction isreasonable in relation to the fact that the association receives no tax benefit with respect to such nonqualified written notices of allocation (or such certificates issued to nonqualifying patrons) until redeemed. However, such an association will be denied exemption if it otherwise treats patrons who have not consented (or are not qualifying patrons) differently from patrons who have consented (or are qualifying patrons), either with regard to the original payment or allocation or with regard to the redemption of written notices of allocation or per-unit retain certificates. For example, if such an association pays patronage dividends in the form of written notices of allocation accompanied by qualified checks, and provides that any patron who does not cash his check within a specified time will forfeit the portion of the patronage dividend represented by such check, then the cooperative association will be denied exemption under this section as it does not treat all patrons alike.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6643, 28 FR 3162, Apr. 2, 1963; T.D. 6855, 30 FR 13135, Oct. 15, 1965]

§ 1.522–1 Tax treatment of farmers' cooperative marketing and purchasing associations exempt under section 521.

(a) *In general.* (1) Section 522 is applicable to farmers', fruit growers', or like associations organized and operated on a cooperative basis in the manner prescribed in section 521. Although such an association is subject to both normal tax and surtax, as in the case of corporations generally, certain special rules for the computation of taxable income are provided in section 522(b) and § 1.522–2. For the purpose of any law which refers to organizations exempt from income taxes such an association shall, however, be considered as an organization exempt under section 501. Thus, the provisions of section 243, providing a credit for dividends received from a domestic corporation subject to taxation, are not applicable to dividends received from a cooperative association subject to section 522. The provisions of section 1501, relating to consolidated returns, are likewise not applicable.

(2) Rules governing the manner in which amounts allocated as patronage dividends, refunds, or rebates are to be taken into account in computing the taxable income of such an association are set forth in § 1.522–3. For the tax treatment, as to patrons, of amounts received during the taxable year as patronage dividends, rebates, or refunds, see section 61 and § 1.61–5.

(b) *Meaning of terms.* For purposes of §§ 1.522–1 to 1.522–3, inclusive, §§ 1.6044–1 and 1.61–5, the following terms shall have the meaning ascribed below:

(1) *Cooperative association.* The term *cooperative association* includes any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons, except that the term does not include any cooperative or nonprofit corporation (including any cooperative or nonprofit corporation engaged in rural electrification) exempt from taxation under section 501(a) and described in section 501(c) (12) or (15) or any corporation subject to a tax imposed by subchapter L, chapter 1 of the Code (relating to insurance companies).

(2) *Patron*. The term *patron* includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

(3) *Allocation*. The term *allocation* includes distributions made by a cooperative association to a patron in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, similar documents, or in any other manner whereby there is disclosed to a patron the dollar amount apportioned on the books of the association for the account of such patron. Thus, a mere credit to the account of a patron on the books of the cooperative association, without disclosure to the patron, is not an allocation.

(4) *Patronage dividends, rebates, and refunds*. The term *patronage dividend, rebate, or refund* includes any amount allocated by a cooperative association, to the account of a patron on the basis of the business done with or for such patron. The following are not patronage dividends, rebates, or refunds:

(i) Amounts distributed in redemption of capital stock, or in redemption or satisfaction of certificates of indebtedness, revolving fund certificates, retain certificates, letters of advice, or other similar documents;

(ii) Amounts allocated (whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the amount of such dividend, refund, or rebate) by the association for products of members or other patrons to the extent such amounts are fixed without reference to the earnings of the cooperative association. For this purpose, the term *earnings* includes the excess of amounts retained (or assessed) by the association to cover expenses or other items over the amount of such expenses or other items.

(c) *Examples*. The application of paragraph (b) of this section may be illustrated by the following examples:

Example 1. Cooperative A, a marketing association operating on a pooling basis, receives the products of patron W on January 5, 1954. On the same day Cooperative A advances to W 45 cents per unit for the products so delivered and allocates to him a *retain certificate* having a face value calculated at the rate of 5 cents per unit. During the operatiion of the pool, and before substantially all the products in the pool are disposed of, Cooperative A advances to W an additional 40 cents per unit, the amount being determined by reference to the market price of the products sold and the anticipated price of the unsold products. At the close of the pool on November 10, 1954, Cooperative A determines the excess of its receipts over the sum of its expenses and its previous advances to patrons, and allocates to W an additional 3 cents per unit and shares of the capital stock of A having an aggregate of face value calculated at the rate of 2 cents per unit.

The amount of patronage dividends, rebates, or refunds allocated to W during 1954 amount to 5 cents per unit, consisting of the aggregate of the following per-unit allocations: The amount of cash distribution (3 cents), and the face value of the capital stock of A (2 cents), which are fixed with reference to the earnings of A. The amount of the two distributions in cash (85 cents) and the face amount of the *retain certificate* (5 cents), which are fixed without reference to the earnings of A, do not constitute patronage dividends, rebates, or refunds.

Example 2. Cooperative B, a marketing association operating on a pooling basis, receives the products of patron X on March 5, 1954. On the same day Cooperative B pays to X $1.00 per unit for such products, this amount being determined by reference to the market price of the product when received, and issues to him a participation certificate having no face value but which entitles X on the close of the pool to the proceeds derived from the sale of his products less the previous payment of $1.00 and the expenses and other charges attributable to such products. On March 5, 1957, Cooperative B, having sold the products in the pool, having deducted the previous payments for such products, and having determined the expenses and other charges of the pool, redeems the participation certificate of X in cash for 10 cents per unit. The allocation made to X during 1957, amounting to 10 cents per unit, is a patronage dividend, rebate, or refund. Neither the payment to X in 1954 of $1.00 nor the issuance to him of the participation certificate in that year constitutes a patronage dividend, rebate, or refund within the meaning of this section.

Example 3. Cooperative C, a purchasing association, obtains supplies for patron Y on May 1, 1954, and receives in return therefor $100. On February 1, 1955, Cooperative C, having determined the excess of its receipts over

its costs and expenses, allocates to Y a cash distribution of $1.00 and a revolving fund certificate of a face amount of $1.00. The amount of patronage dividends, rebates, or refunds allocated to Y for 1955 is $2.00, the aggregate of the cash distribution of $1.00, and the face amount, $1.00, of the revolving fund certificate.

Example 4. Cooperative D, a service association, sells the products of members on a fee basis. It receives the products of patron Z under an agreement not to pool his products with those of other members, to sell his products, and to deliver to him the proceeds of the sale. Patron Z makes payments to Cooperative D during 1954 aggregating $75 for service rendered him by Cooperative D during that year. On May 15, 1955, Cooperative D, having determined the excess of its receipts over its costs and expenses, allocates to Z a cash distribution of $2.00. Such amount is a patronage dividend, rebate, or refund allocated by Cooperative D during 1955.

(d) *Returns of exempt cooperative associations.* For requirements of annual returns by exempt cooperative associations, see sections 6012 and 6072(d) and paragraph (f) of § 1.6012–2.

§ 1.522–2 Manner of taxation of cooperative associations subject to section 522.

(a) *In general.* Farmers', fruit growers', or like associations, organized and operated in compliance with the requirements of section 521 and § 1.521–1 shall be subject to the taxes imposed by section 11 or section 1201, except that there shall be allowed as deductions from gross income, in addition to the other deductions allowable under chapter 1 of the Code, certain special deductions provided in section 522(b)(1)(A) and paragraph (c) of this section, and section 522(b)(1)(B) and paragraph (d) of this section. Amounts allocated as patronage dividends, refunds, or rebates, whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated, with respect to patronage for the taxable year or for preceding taxable years, shall be taken into account in the manner provided in section 522 and in § 1.522–3.

(b) *Cooperative association exempt from tax before January 1, 1952.* (1) For the purpose of determining the method of accounting under section 446 in the case of a cooperative association which was exempt from tax for taxable years beginning prior to January 1, 1952, the method of accounting, recognized under sections 41, 42, and 43 of the Internal Revenue Code of 1939 and the regulations prescribed thereunder and utilized in the return of such association for its last taxable year to which the Internal Revenue Code of 1939 was applicable, shall be deemed to constitute the method of accounting regularly employed by the cooperative association. Any change from this method may be made only if permission is obtained from the Commissioner to change to another recognized method in accordance with section 446 and the regulations thereunder.

(2) In any case where inventories are an income-producing factor, see sections 471 and 472 and the regulations thereunder. The elective method of inventorying goods provided in section 472 may be adopted by the cooperative association for any taxable year beginning after December 31, 1953, inaccordance with the requirements of section 472 and the regulations thereunder. However, in order to use such method for such a taxable year the cooperative association (unless it has used such method for a taxable year beginning after 1951 and before 1954 pursuant to an election exercised as provided in 26 CFR (1939) 39.22(d)–3 (Regulations 118) must exercise the election provided in section 472 and the regulations thereunder, even if it may have utilized such method for accounting purposes for taxable years beginning before January 1, 1952.

(3) The following rules shall be applicable in computing the net operating loss deduction provided in section 172: No net operating loss carryover shall be allowed from a taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt from tax under section 101(12) of the Internal Revenue Code of 1939. In the case of a taxable year beginning prior to January 1, 1952, for which the association was not exempt under section 101(12) of the Internal Revenue Code of 1939 and of any taxable year beginning after December 31, 1951, the amount of the net operating loss

carryback or carryover from such year shall not be reduced by reference to the income of any taxable year beginning prior to January 1, 1952, for which the association was exempt from tax under section 101(12) of the Internal Revenue Code of 1939. However, any taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt under section 101(12) of the Internal Revenue Code of 1939 shall be taken into account in determining the period for which a net operating loss may be carried back or carried over, as the case may be.

(4) The adjustments to the cost or other basis provided in sections 1011 and 1016 and the regulations thereunder, are applicable for the entire period since the acquisition of the property. Thus, proper adjustment to basis must be made under section 1016 for depreciation, obsolescence, amortization, and depletion for all taxable years beginning prior to January 1, 1952, although the cooperative association was exempt from tax under section 521 or corresponding provisions of prior law for such years. However, no adjustment for percentage or discovery depletion is to be made for any year during which the association was exempt from tax. If a cooperative association has made a proper election in accordance with section 1020 and the regulations prescribed thereunder with respect to a taxable year beginning before 1952 in which the association was not exempt from tax, the adjustment to basis for depreciation for such years shall be limited in accordance with the provisions of section 1016(a)(2).

(5) In the case of tax exempt and partially taxable bonds purchased at a premium and subject to amortization under section 171, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond. (For principles governing the method of computation, see the example in paragraph (b) of §1.1016–9, relating to mutual savings banks, building and loan associations, and cooperative banks.) The basis of a fully taxable bond purchased at a premium shall be adjusted from the date of the election to amortize such premium in accordance with the provisions of section 171 except that no adjustment shall be allowable for such portion of the premium attributable to the period prior to the election.

(6) In the case of a mortgage acquired at a premium where the principal of such mortgage is payable in installments, adjustments to the basis for the premium must be made for all taxable years (whether or not the association was exempt from tax under section 521 during such years) in which installment payments are received. Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such association. For the purpose of this adjustment, the term *premium* includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees or brokerage fees, but such value does not include amounts paid for accrued interest.

(c) *Deduction for dividends paid.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and §1.521–1, amounts paid as dividends during the taxable year upon the capital stock of the cooperative association. For the purpose of the preceding sentence, the term *capital stock* includes common stock (whether voting or nonvoting), preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidence of a proprietary interest in a cooperative association. Such deduction is applicable only to the taxable year in which the dividends are actually or constructively paid to the holder of capital stock or other proprietary interest of the cooperative association. If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mail, in a cover properly stamped and addressed tothe shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by such holder within the taxable year, a presumption arises that the dividend was paid to such holder in

such year. The determination of whether a dividend has been paid to such holder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books. For further rules as to the determination of the right to a deduction for dividends paid, under certain specific circumstances, see section 561 and the regulations thereunder.

(d) *Deduction for amounts allocated from income not derived from patronage.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and § 1.521–1 amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether such amounts are paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. For this purpose, allocations made after the close of the taxable year and on or before the 15th day of the ninth month following the close of the taxable year shall be considered as made on the last day of such taxable year to the extent that such allocations are attributable toincome derived during the taxable year or during years prior to the taxable year. As used in this paragraph, the term *income not derived from patronage* means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, from the sale or exchange of capital assets, constitutes income not derived from patronage. Business done with the United States shall constitute income not derived from patronage. In order that the deduction for income not derived from patronage may be applicable, it is necessary that the amount sought to be deducted be allocated on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. Thus, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during the taxable year, income realized from such gains must be allocated to patrons of such year in proportion to theamount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by the association from the sale or exchange of capital assets held for a period of more than one taxable year income realized from such gains must be allocated, in proportion insofar as is practicable, to the patrons of the taxable years during which the asset was owned by the association, and to the amount of business done by such patrons during such taxable years.

§ 1.522–3 Patronage dividends, rebates, or refunds; treatment as to cooperative associations entitled to tax treatment under section 522.

(a) *General rule.* Patronage dividends, refunds, or rebates, allocated by a cooperative association entitled to tax treatment under section 522 to a patron shall be taken into account in computing the gross income of such association for the taxable year, as an increase in its other cost of goods sold in the case of an association marketing products for patrons, or as a reduction in its gross receipts, in the case of an association purchasing supplies and equipment or performing services for patrons, as the case may be, if:

(1) The allocation is made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated, and

(2) The allocation is made on or before the 15th day of the ninth month following the close of the taxable year in which the amounts allocated were received by the cooperative association

For the purpose of subparagraph (1) of this paragraph, amounts allocated by a cooperative association entitled to tax treatment under section 522 will be deemed allocated in fulfillment and satisfaction of a valid enforceable obligation, if made pursuant to provisions of the bylaws, articles of incorporation,

or other contract, whereby the association is obligated to make such allocation after the retention of *reasonable reserves* and after payment of dividends on capital stock or other proprietary capital interests. Notwithstanding the provisions of subparagraphs (1) and (2) of this paragraph, amounts allocated as patronage dividends, refunds, or rebates during the taxable year, on or before the 15th day of the ninth month following the close of such year, with respect to patronage for years preceding the taxable year, shall be taken into account as an increase in its other cost of goods sold, or as a reduction in gross receipts, for the taxable year, as the case may be, where retention as *reasonable reserves* of the amounts so allocated beyond the year in which earned was proper in accordance with the provisions of section 521 and where the allocation is made to the patron on a patronage basis is proportion insofar as is practicable, to the amount of business done by such patrons during the taxable year or years in which the retained amounts were received by the cooperative association.

(b) *Examples*. This section may be illustrated by the following examples:

Example 1. E, a cooperative association entitled to tax treatment under section 522, organized without capital stock, is engaged in the business of marketing products for its patrons on a non-pool basis. The by-laws of Cooperative E provide that there shall be allocated to patrons as patronage dividends within a reasonable time following the close of the year all of the gross returns from sales, less expenses of operation for the year and amounts retained as *reasonable reserves* necessary to the operation of Cooperative E. At the close of the taxable year, 1954, it is determined that from the gross returns from sales less operating expenses and all taxes for such year, $5,000 is to be retained as *reasonable reserves* for various necessary purposes of Cooperative E. It is assumed that the retention of such amount is proper in accordance with the provisions of section 521. Such $5,000 is apportioned on the books of Cooperative E to patrons of 1954 on a patronage basis, or permanent records are kept from which an apportionment to such patrons can be made. On March 1, 1955, pursuant tothe terms of the by-laws, $200,000, the balance of the gross returns for the taxable year, is allocated to patrons of 1954 on the basis of patronage. $100,000 of such $200,000 is allocated in cash. The remaining $100,000 is allocated in *retain certificates*, bearing no interest and redeemable in the discretion of the Board of Directors of Cooperative E. There may be added to the cost of goods sold by Cooperative E for 1954, $200,000 ($100,000 in cash, $100,000 in retain certificates), the total amount allocated as patronage dividends, rebates, or refunds in fulfillment and satisfaction of the obligation of the by-laws, on March 1, 1955, before the 15th day of the ninth month following the close of 1954. There may not be added to the cost of goods sold by Cooperative E for 1954, $5,000, the amount retained as reserves apportioned on the books, but not allocated as patronage dividends, rebates, or refunds.

Example 2. The facts are the same as example 1, it additionally appearing that at the close of 1955 it is determined by Cooperative E to allocate as cash patronage dividends, rebates, or refunds to patrons of 1954, $5,000, the amount retained as *reasonable reserves* for 1954 in accordance with the provisions of section 521. On March 1, 1956, such amount is allocated. There may be added to the cost of goods sold by Cooperative E for 1955, $5,000, the amount allocated with respect to patronage of a preceding year, 1954, properly maintained as a reserve under section 521.

§ 1.522–4 Taxable years affected.

Section 522 and §§ 1.522–1, 1.522–2, and 1.522–3, are applicable to taxable years beginning before January 1, 1963, and also to amounts paid during taxable years beginning after December 31, 1962, the tax treatment of which is not prescribed in section 1382 and the regulations thereunder.

[T.D. 6643, 28 FR 3163, Apr. 2, 1963]

§ 1.527–1 Political organizations; generally.

Section 527 provides that a political organization is considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes. A political organization is subject to tax only to the extent provided in section 527. In general, a political organization is an organization that is organized and operated primarily for an exempt function as defined in § 1.527–2(c). Section 527 provides that a political organization is taxed on its political organization taxable income (see § 1.527–4) which, in general, does not include the exempt function income (see § 1.527–3) of the political organization. Furthermore, section 527 provides that an exempt organization, other than a political organization, may be subject to

tax under section 527 when it expends an amount for an exempt function, see §1.527–6. The taxation of newsletter funds is provided under section 527(g) and §1.527–7. A special rule for principal campaign committees is provided under section 527(h) and §1.527–9.

[T.D. 8041, 50 FR 30817, July 30, 1985]

§ 1.527–2 Definitions.

For purposes of section 527 and these regulations:

(a) *Political organization*—(1) *In general.* A *political organization* is a party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures for an exempt function activity (as defined in paragraph (c) of this section). Accordingly, a political organization may include 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 a meeting or caucus of a political party. A segregated fund (as defined in paragraph (b) of this section) established and maintained by an individual may qualify as a political organization.

(2) *Organizational test.* A political organization meets the organizational test if its articles of organization provide that the primary purpose of the organization is to carry on one or more exempt functions. A political organization is not required to be formally chartered or established as a corporation, trust, or association. If an organization has no formal articles of organization, consideration is given to statements of the members of the organization at the time the organization is formed that they intend to operate the organization primarily to carry on one or more exempt functions.

(3) *Operational test.* A political organization does not have to engage exclusively in activities that are an exempt function. For example, a political organization may:

(i) Sponsor nonpartisan educational workshops which are not intended to influence or attempt to influence the selection, nomination, election, or appointment of any individual for public office,

(ii) Pay an incumbent's office expenses, or

(iii) Carry on social activities which are unrelated to its exempt function,

provided these are not the organization's primary activities. However, expenditures for purposes described in the preceding sentence are not for an exempt function. See §1.527–2 (c) and (d). Furthermore, it is not necessary that a political organization operate in accordance with normal corporate formalities as ordinarily established in bylaws or under state law.

(b) *Segregated fund*—(1) *General rule.* A *segregated fund* is a fund which is established and maintained by a political organization or an individual separate from the assets of the organization or the personal assets of the individual. The purpose of such a fund must be to receive and segregate exempt function income (and earnings on such income) for use only for an exempt function or for an activity necessary to fulfill an exempt function. Accordingly, the amounts in the fund must be dedicated for use only for an exempt function. Thus, expenditures for the establishment or administration of a political organization or the solicitation of political contributions may be made from the segregated fund, if necessary to fulfill an exempt function. The fund must be clearly identified and established for the pruposes intended. A savings or checking account into which only contributions to the political organization are placed and from which only expenditures for exempt functions are made may be a segregated fund. If an organization that had designated a fund to be a segregated fund for purposes of segregating amounts referred to in section 527(c)(3) (A) through (D), expends more than an insubstantial amount from the segregated fund for activities that are not for an exempt function during a taxable year, the fund will not be treated as a segregated fund for such year. In such a case amounts referred to in section 527(c)(3)(A)–(D),segregated in such fund will not be exempt function income. Further, if more than insubstantial amounts segregated for an

exempt function in prior years are expended for other than an exempt function the facts and circumstances may indicate that the fund was never a segregated fund as defined in this paragraph.

(2) *Record keeping*. The organization or individual maintaining a segregated fund must keep records that are adequate to verify receipts and disbursements of the fund and identify the exempt function activity for which each expenditure is made.

(c) *Exempt function*—(1) *Directly related expenses*. An *exempt function*, as defined in section 527(e)(2), includes all activities that are directly related to and support the process of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to public office or office in a political organization (the selection process). Whether an expenditure is for an exempt function depends upon all the facts and circumstances. Generally, where an organization supports an individual's campaign for public office, the organization's activities and expenditures in futherance of the individual's election or appointment to that office are for an exempt function of the organization. The individual does not have to be an announced candidate for the office. Furthermore, the fact that an individual never becomes a candidate is not crucial in determining whether an organization is engaging in an exempt function. An activity engaged in between elections which is directly related to, and supports, the process of selection, nomination, or election of an individual in the next applicable political campaign is an exempt function activity.

(2) *Indirect expenses*. Expenditures that are not directly related to influencing or attempting to influence the selection process may also be an expenditure for an exempt function by a political organization. These are expenses which are necessary to support the directly related activities of the political organization. Activities which support the directly related activities are those which must be engaged in to allow the political organization to carry out the activity of influencing or attempting to influence the selection process. For example, expenses for overhead and record keeping are necessary to allow the political organization to be established and to engage in political activities. Similarly, expenses incurred in soliciting contributions to the political organization are necessary to support the activities of the political organization.

(3) *Terminating activities*. An exempt function includes an activity which is in furtherance of the process of terminating a political organization's existence. For example, where a political organization is established for a single campaign, payment of campaign debts after the conclusion of the campaign is an exempt function activity.

(4) *Illegal expenditures*. Expenditures which are illegal or are for a judicially determined illegal activity are not considered expenditures in furtherance of an exempt function, even though such expenditures are made in connection with the selection process.

(5) *Examples*. The following examples illustrate the principles of paragraph (c) of this section. The term *exempt function* when used in the following examples means exempt function within the meaning of section 527(e)(2).

(i) *Example 1*. A wants to run for election to public office in State X. A is not a candidate. A travels throughout X in order to rally support for A's intended candidacy. While in X, A attends a convention of an organization for the purpose of attempting to solicit its support. The amount expended for travel, lodging, food, and similar expenses are for an exempt function.

(ii) *Example 2*. B, a member of the United States House of Representatives, is a candidate for reelection. B travels with B's spouse to the district B represents. B feels it is important for B's reelection that B's spouse accompany B. While in the district, B makes speeches and appearances for the purpose of persuading voters to reelect B. The travel expenses of B and B's spouse are for an exempt function.

(iii) *Example 3*. C is a candidate for public office. In connection with C's campaign, C takes voice and speech lessons to improve C's skills. The expenses for these lessons are for an exempt function.

(iv) *Example 4.* D, an officeholder and candidate for reelection, purchases tickets to a testimonial dinner. D's attendance at the dinner is intended to aid D's reelection. Such expenditures are for an exempt function.

(v) *Example 5.* E, an officeholder, expends amounts for periodicals of general circulation in order to keep informed on national and local issues. Such expenditures are not for an exempt function.

(vi) *Example 6.* N is an organization described in section 501(c) and is exempt from taxation under section 501(a). F is employed as president of N. F, as a representative of N, testifies in response to a written request from a Congressional committee in support of the confirmation of an individual to a cabinet position. The expenditures by N that are directly related to F's testimony are not for an exempt function.

(vii) *Example 7.* P is a political organization described in section 527(e)(2). Between elections P does not support any particular individual for public office. However, P does train staff members for the next election, drafts party rules, implements party reform proposals, and sponsors a party convention. The expenditures for these activities are for an exempt function.

(viii) *Example 8.* Q is a political organization described in section 527(e)(2). Q finances seminars and conferences which are intended to influence persons who attend to support individuals to public office whose political philosophy is in harmony with the political philosophy of Q. The expenditures for these activities are for an exempt function.

(d) *Public office.* The facts and circumstances of each case will determine whether a particular Federal, State, or local office is a *public office.* Principles consistent with those found under § 53.4946–1(g)(2) (relating to the definition of public office) will be applied.

(e) *Principal campaign committee.* A *principal campaign committee* is the political committee designated by a candidate for Congress as his or her principal campaign committee for purposes of section 302(e) of the Federal Election Campaign Act of 1971 (2 U.S.C. section 432(e)), as amended, and section 527(h) and § 1.527–9.

[T.D. 7744, 45 FR 85731, Dec. 30, 1980, as amended by T.D. 8041, 50 FR 30817, July 30, 1985]

§ 1.527–3 Exempt function income.

(a) *General rule*—(1) For purposes of section 527, exempt function income consists solely of amounts received as:

(i) Contributions of money or other property,

(ii) Membership dues, fees, or assessments from a member of a political organization, or

(iii) Proceeds from a political fund raising or entertainment event, or proceeds from the sale of political campaign materials, which are not received in the ordinary course of any trade or business,

but only to the extent such income is segregated for use only for exempt functions of the political organization.

(2) Income will be considered segregated for use only for an exempt function only if it is received into and disbursed from a segregated fund as defined in § 1.527–2(b).

(b) *Contributions.* The rules of section 271(b)(2) apply in determining whether the transfer of money or other property constitutes a contribution. Generally, money or other property, whether solicited personally, by mail, or through advertising, qualifies as a contribution. In addition, to the extent a political organization receives Federal, State, or local funds under the $1 *checkoff* provision (sections 9001–9013), or any other provision for financing of campaigns, such amounts are to be treated as contributions.

(c) *Dues, fees, and assessments.* Amounts received as membership fees and assessments from members of a political organization may constitute exempt function income to the political organization. Membership fees and assessments received in consideration for services, goods, or other items of value do not constitute exempt function income. However, filing fees paid by an individual directly or indirectly to a political party in order that the individual may run as a candidate in a primary election of the party (or run in a general election as a candidate of that party) are to be treated as exempt

function income. For example, some States provide that a certain percentage of the first year's salary of the office sought must be paid to the State as a filing (or *qualifying*) fee and party assessment. The State then transfers part of this fee to the candidate's party. In such a case, the entire amount transferred to the party is to be treated as exempt function income. Furthermore, amounts paid by an individual directly to the party as a qualification fee are treated similarly.

(d) *Fund raising events*—(1) *In general.* Amounts received from fund raising and entertainment events are eligible for treatment as exempt function income if the events are political in nature and are not carried on in the ordinary course of a trade or business. Whether an event is *political* in nature depends on all facts and circumstances. One factor that indicates an event is a political event is the extent to which the event is related to a political activity aside from the need of the organization for income or funds. For example, an event that is intended to rally and encourage support for an individual for public office would be a political fund raising event. Examples of political events can include dinners, breakfasts, receptions, picnics, dances, and athletic exhibitions.

(2) *Ordinary course of any trade or business.* Whether an activity is in the ordinary course of a trade or business depends on the facts and circumstances of each case. Generally, proceeds from casual, sporadic fund raising or entertainment events are not in the ordinary course of a trade or business. Factors to be taken into account in determining whether an activity is a trade or business include the frequency of the activity, the manner in which the activity is conducted, and the span of time over which the activity is carried on.

(e) *Sale of campaign materials.* Amounts received from the sale of campaign materials are eligible for treatment as exempt function income if the sale is not carried on in the ordinary course of a trade or business (as defined in paragraph (d)(2) of this section), and is related to a political activity of the organization aside from the need of such organization for income or funds. Proceeds from the sale of political memorabilia, bumper stickers, campaign buttons, hats, shirts, political posters, stationery, jewelry, or cookbooks are related to such a political acitivity where such items can be identified as relating to distributing political literature or organizing voters to vote for a candidate for public office.

[T.D. 7744, 45 FR 85732, Dec. 30, 1980]

§ 1.527–4 Special rules for computation of political organization taxable income.

(a) *In general.* Political organization taxable income is determined according to the provisions of section 527(b) and the rules set forth in this section.

(b) *Limitation on capital losses.* If for any taxable year a political organization has a net capital loss, the rules of sections 1211(a) and 1212(a) apply.

(c) *Allowable deductions*—(1) *In general.* To be deductible in computing political organization taxable income, expenses, depreciation, and similar items must not only qualify as deductions allowed by chapter 1 of the Code, but must also be directly connected with the production of political organization taxable income.

(2) *Directly connected with defined.* To be *directly connected with* the production of political organization taxable income, an item of deduction must have a proximate and primary relationship to the production of such income and have been incurred in the production of such income. Items of deduction attributable solely to items of political organization taxable income are proximately and primarily related to such income. Whether an item of deduction is incurred in the production of political organization taxable income is determined on the basis of all the facts and circumstances of each case.

(3) *Dual use of facilities or personnel.* Expenses, depreciation, and similar items that are attributable to the production of exempt function income and political organization taxable income shall be allocated between the two on a reasonable and consistent basis. For example, where facilities are used both for an exempt function of the organization and for the production of political organization taxable income, expenses,

depreciation, and similar items attributable to such facilities (for example, items of overhead) shall be allocated between the two uses of a reasonable and consistent basis. Similarly, where personnel are employed both for an exempt function and for the production of political organization taxable income, expenses and similar items attributable to such personnel (for example, items of salary) shall be allocated between the activities on a reasonable and consistent basis. The portion of any such item so allocated to the production of political organization taxable income is directly connected with such income and is allowable as a deduction in computing political organization taxable income to the extent that it qualifies as an item of deduction allowed by chapter 1 of the Code. Thus, for example, assume that X, a political organization, pays its manager a salary of $10,000 a year and that it derives political organization taxable income. If 10 percent of the manager's time during the year is devoted to deriving X's gross income (other than exempt function income), a deduction of $1,000 (10 percent of $10,000) would generally be allowable for purposes of computing X's political organization taxable income.

[T.D. 7744, 45 FR 85733, Dec. 30, 1980]

§ 1.527–5 Activities resulting in gross income to an individual or political organization.

(a) *In general*—(1) *General rule.* Amounts expended by a political organization for an exempt function are not income to the individual or individuals on whose behalf such expenditures are made. However, where a political organization expends any other amount for the personal use of any individual, the individual on whose behalf the amount is expended will be in receipt of income. Amounts are expended for the personal use of an individual where a direct or indirect financial benefit accrues to such individual. For example, if a political organization pays a personal legal obligation of a candidate for public office, such as the candidate's federal income tax liability, the amount paid is includible in such candidate's gross income. Similarly, if a political organization expends anyamount of its exempt function income for other than an exempt function, and the expenditure results in a direct or indirect financial benefit to the political organization, it must include the amount of such expenditure in its gross income. For example, if a political organization expends exempt function income for making an improvement or addition to its facilities, or for equipment, which is not necessary for or used in carrying out an exempt function, the amount of the expenditure will be included in the political organization's gross income. However, if a political organization expends exempt function income to make ordinary and necessary repairs on the facilities the political organization uses in conducting its exempt function, such amounts will not be included in the political organization's gross income.

(2) *Expenditure for an illegal activity.* Expenditures by a political organization that are illegal or for an activity that is judicially determined to be illegal are treated as amounts not segregated for use only for the exempt function and shall be included in the political organization's taxable income. However, expenses incurred in defense of civil or criminal suits against the organization are not treated as taxable to the organization. Similarly, voluntary reimbursement to the participants in the illegal activity for similar expenses incurred by them are not taxable to the organization if the organization can demonstrate that such payments do not constitute a part of the inducement to engage in the illegal activity or part of the agreed upon compensation therefor. However, if the organization entered into an agreement with the participants to defray such expenses as part of the inducement, such payments would be treated as an expenditure for an illegal activity. Except where necessary to prevent the period of limitation for assessment and collection of a tax from expiring, a notice of deficiency will not generally be issued until after there has been a final determination of illegality by an appropriate court in a criminal proceeding.

(b) *Certain uses not treated as income to a candidate.* Except as otherwise provided in paragraph (a) of this section, if a political organization:

(1) Contributes any amount to or for the use of any political organization described in section 527(e)(1) or newsletter fund described in section 527(g),

(2) Contributes any amount to or for the use of any organization described in paragraph (1) and (2) of section 509(a) which is exempt from taxation under section 501(a), or

(3) Deposits any amount in the general fund of the U.S. Treasury or in the general fund of any State or local government,

such amount shall not be treated as an amount expended for the personal use of a candidate or other person. No deduction shall be allowed under the Internal Revenue Code of 1954 for the contribution or deposit described in the preceding sentence.

(c) *Excess funds*—(1) *General rule.* Generally, funds controlled by a political organization or other person after a campaign or election are excess funds and are treated as expended for the personal use of the person having control over the ultimate use of such funds. However, such funds will not be treated as excess funds to the extent they are:

(i) Transferred within a reasonable period of time by the person controlling the funds in accordance with paragraph (b) of this section, or

(ii) Held in reasonable anticipation of being used by the political organization for future exempt functions.

(2) *Excess funds transferred at death.* Where excess funds are held by an individual who dies, and these funds go to the individual's estate or any other person (other than an organization or fund described in paragraph (b) of this section), the funds are income of the decedent and will be included in the decedent's gross estate unless the estate or other person receiving such funds transfers the funds within a reasonable period of time in accordance with paragraph (b) of this section.

This paragraph (c)(2) will not apply where the individual who dies provides that the funds be transferred to an organization or fund described in paragraph (b) of this section.

[T.D. 7744, 45 FR 85733, Dec. 30, 1980]

§ 1.527–6 Inclusion of certain amounts in the gross income of an exempt organization which is not a political organization.

(a) *Exempt organizations—General rule.* If an organization described in section 501(c) which is exempt from tax under section 501(a) expends any amount for an exempt function, it may be subject to tax. There is included in the gross income of such organization for the taxable year an amount equal to the lesser of:

(1) The net investment income of such organization for the taxable year, or

(2) The aggregate amount expended during the taxable year for an exempt function.

The amount included will be treated as political organization taxable income.

(b) *Exempt function expenditures*—(1) *Directly related expenses.* (i) Except as provided in this section, the term *exempt function* will generally have the same meaning it has in § 1.527–2(c). Thus, expenditures which are directly related to the selection process as defined in § 1.527–2(c)(1) are expenditures for an exempt function. Expenditures for indirect expenses as defined in § 1.527–2(c)(2), when made by a section 501(c) organization are for an exempt function only to the extent provided in paragraph (b)(2) of this section. Expenditures of a section 501 (c) organization which are otherwise allowable under the Federal Election Campaign Act or similar State statute are for an exempt function only to the extent provided in paragraph (b)(3) of this section.

(ii) An expenditure may be made for an exempt function directly or through another organization. A section 501(c) organization will not be absolutely liable under section 527(f)(1) for amounts transferred to an individual or organization. A section 501(c) organization is, however, required to take reasonable steps to ensure that the transferee does not use such amounts for an exempt function.

(2) *Indirect expenses.* [Reserved]

(3) *Expenditures allowed by Federal Election Campaign Act.* [Reserved]

(4) *Appointments or confirmations.* Where an organization described in paragraph (a) of this section appears before any legislative body in response to a written request by such body for the purpose of influencing the appointment or confirmation of an individual to a public office, any expenditure directly related to such appearance is not treated as an expenditure for an exempt function.

(5) *Nonpartisan activity.* Expenditures for nonpartisan activities by an organization to which paragraph (a) of this section applies are not expenditures for an exempt function. Nonpartisan activities include voter registration and *get-out-the-vote* campaigns. To be nonpartisan voter registration and *get-out-the-vote* campaigns must not be specifically identified by the organization with any candidate or political party.

(c) *Character of items included in gross income*—(1) *General rule.* The items of income included in the gross income of an organization under paragraph (a) of this section retain their character as ordinary income or capital gain.

(2) *Special rule in determining character of item.* If the amount included in gross income is determined under paragraph (a)(2)(ii) of this section, the character of the items of income is determined by multiplying the total amount included in gross income under such paragraph by a fraction, the numerator of which is the portion of the organization's net investment income that is gain from the sale or exchange of a capital asset, and the denominator of which is the organization's net investment income. For example, if $5,000 is included in the gross income of an organization under paragraph (a)(2) of this section, and the organization had $100,000 of net investment income of which $10,000 is long term capital gain, then $500 would be treated as long term capital gain:

$$\frac{\text{Capital gain}}{\text{net investment income}} \times \begin{matrix}\text{Amount expended}\\ \text{on an exempt function}\end{matrix} = \begin{matrix}\text{Portion of income}\\ \text{subject to tax under SS}\\ \text{section 1201}\end{matrix}$$

$$\frac{\$10{,}000}{\$100{,}000} \times \$5{,}000 = \$500$$

(d) *Modifications.* The modifications described in section 527(c)(2) apply in computing the tax under paragraph (a)(2) of this section. Thus, no net operating loss is allowed under section 172 nor is any deduction allowed under part VIII of subchapter B. However, there is allowed a specific deduction of $100.

(e) *Transfer not treated as exempt function expenditures.* Provided the provisions of this paragraph (e) are met, a transfer of political contributions or dues collected by a section 501(c) organization to a separate segregated fund as defined in paragraph (f) of this section is not treated as an expenditure for an exempt function (within the meaning of § 1.527–2(c)). Such transfers must be made promptly after the receipt of such amounts by the section 501(c) organization, and must be made directly to the separate segregated fund. A transfer is considered promptly and directly made if:

(1) The procedures followed by the section 501(c) organization satisfy the requirements of applicable Federal or State campaign law and regulations;

(2) The section 501(c) organization maintains adequate records to demonstrate that amounts transferred in fact consist of political contributions or dues, rather than investment income; and

(3) The political contributions or dues transferred were not used to earn investment income for the section 501(c) organization.

(f) *Separate segregated fund.* An organization or fund described in section 527(f)(3) is a separate segregated fund.

To avoid the application of paragraph (a) of this section, an organization described in section 501(c) that is exempt from taxation under section 501(a) may, if it is consistent with its exempt status, establish and maintain such a separate segregated fund to receive contributions and make expenditures in a political campaign. If such a fund meets the requirements of § 1.527–2(a) (relating to the definition of a political organization), it shall be treated as a political organization subject to the provisions of section 527. A segregated fund established under the Federal Election Campaign Act will continue to be treated as a segregated fund when it engages in exempt function activities as defined in § 1.527–2(c), relating to State campaigns.

(g) *Effect of expenditures on exempt status.* Section 527(f) and this section do not sanction the intervention in any political campaign by an organization described in section 501(c) if such activity is inconsistent with its exempt status under section 501(c). For example, an organization described in section 501(c)(3) is precluded from engaging in any political campaign activities. The fact that section 527 imposes a tax on the exempt function (as defined in § 1.527–2(c)) expenditures of section 501(c) organizations and permits such organizations to establish separate segregated funds to engage in campaign activities does not sanction the participation in these activities by section 501(c)(3) organizations.

[T.D. 7744, 45 FR 85734, Dec. 30, 1980]

§ 1.527–7 Newsletter funds.

(a) *In general.* For purposes of this section, a fund established and maintained by an individual who holds, has been elected to, or is a candidate (within the meaning of section 41(c)(2)) for nomination or election to, any Federal, State, or local elective public office for the use by such individual exclusively for an exempt function, as defined in paragraph (c) of this section, shall be a newsletter fund. If assets of a newsletter fund are used for any purpose other than the exempt function of the newsletter fund as defined in paragraph (c) of this section, such amount shall be treated as expended for the personal use of the individual who established and maintained such fund. In addition, future contributions to such fund are treated as income to the individual who established and maintained the fund. In such a case, the facts and circumstances may indicate that the fund was never established and maintained exclusively for an exempt function as defined in paragraph (c) of this section.

(b) *Determination of taxable income.* A newsletter fund shall be treated as if it were a political organization for purposes of determining its taxable income. However, the specific $100 deduction provided by section 527(c)(2)(A) shall not be allowed.

(c) *Exempt function.* For purposes of this section, the exempt function of a newsletter fund consists solely of the preparation and circulation of the newsletter. Among the expenditures treated as preparation and circulation expenditures of the newsletter are:

(1) Secretarial services,

(2) Printing,

(3) Addressing, and

(4) Mailing.

(d) *Nonexempt function purposes.* Newsletter fund assets may not be used for campaign activities. Therefore, an exempt function of a newsletter fund does not include:

(1) Expenditures for an exempt function as defined in § 1.527–2(c) or

(2) Transfers of unexpended amounts to a political organization described in section 527(e)(1).

(e) *Excess funds.* Excess funds held by a newsletter fund which has ceased to engage in the preparation and circulation of the newsletter are treated as expended for the personal use of the individual who established and maintained such fund. However, to the extent such excess funds are within a reasonable period of time:

(1) Contributed to or for the use of any organization described in paragraph (1) or (2) of section 509(a) which is exempt from taxation under section 501(a),

(2) Deposited in the general fund of the U.S. Treasury or in the general fund of any State or local government (including the District of Columbia), or

(3) Contributed to any other newsletter fund as described in paragraph (a) of this section,

the excess funds are not treated as expended for the personal use of such individual. In such a case the individual is not allowed a deduction under the Internal Revenue Code of 1954 for such contribution or deposit.

[T.D. 7744, 45 FR 85735, Dec. 30, 1980]

§ 1.527–8 Effective date; filing requirements; and miscellaneous provisions.

(a) *Assessment and collections.* Since the taxes imposed by section 527 are taxes imposed by subtitle A of the Code, all provisions of law and of the regulations applicable to the taxes imposed by subtitle A are applicable to the assessment and collection of the taxes imposed by section 527. Organizations subject to the tax imposed by section 527 are subject to the same provisions, including penalties, as are provided for corporations, in general, except that the requirements of section 6154 concerning the payment of estimated tax do not apply. See, generally, sections 6151, et. seq., and the regulations prescribed thereunder, for provisions relating to payment of tax.

(b) *Returns.* For requirements of filing annual returns with respect to political organization taxable income, see section 6012 (a) (6) and the applicable regulations.

(c) *Taxable years, method of accounting, etc.* The taxable year (fiscal year or calendar year, as the case may be) of a political organization is determined without regard to the fact that such organization may have been exempt from tax during any prior period. See sections 441 and 446, and the regulations thereunder in this part, and section 7701 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration). Similarly, in computing political organization taxable income, the determination of the taxable year for which an item of income or expense is taken into account is made under the provisions of sections 441, 446, 451, 461, and the regulations thereunder, whether or not the item arose during a taxable year beginning before, on, or after the effective date of the provisions imposing a tax upon political organization taxable income. If a method for treating bad debts was selected in a return of income (other than an information return) for a previous taxable year, the taxpayer must follow such method in its returns under section 527, unless such method is changed inaccordance with the provisions of § 1.166–1. A taxpayer who has not previously selected a method for treating bad debts may, in its first return under section 6012 (a) (6), exercise the option granted in § 1.166–1.

(d) *Effective date.* Except as provided in paragraph (b)(2) of § 1.527–6 and in paragraph (a) of § 1.527–9, the regulations under section 527 apply to taxable years beginning after December 31, 1974.

[T.D. 7744, 45 FR 85735, Dec. 30, 1980, as amended by T.D. 8041, 50 FR 30817, July 30, 1985]

§ 1.527–9 Special rule for principal campaign committees.

(a) *In general.* Effective with respect to taxable years beginning after December 31, 1981, the tax imposed by section 527(b) on the political organization taxable income of a principal campaign committee shall be computed by multiplying the political organization taxable income by the appropriate rates of tax specified in section 11(b). The political organization taxable income of a campaign committee not a principal campaign committee is taxed at the highest rate of tax specified in section 11(b). A candidate for Congress may designate one political committee to serve as his or her principal campaign committee for purposes of section 527(h)(1). If a designation is made, it shall be made in accordance with the requirements of paragraph (b) of this section. A candidate for Congress may have only one designation in effect at any time. Under 11 CFR 102.12, no political committee may be designated as the principal campaign committee of more than one candidate for Congress. Further, no political committee that supports or has supported more than one candidate for Congress may be designated as a principal campaign committee. No designation need be made where there is only one political campaign committee with respect to a candidate.

(b) *Manner of designation.* If a candidate for Congress elects to make a

designation under section 527(h) and this section, he or she shall designate his or her principal campaign committee by appending a copy of his or her Statement of Candidacy (that is, the Federal Election Commission Form 2, or equivalent statement that the candidate filed with the Federal Election Commission under 11 CFR 101.1(a)), to the Form 1120–POL filed by the principal campaign committee for each taxable year for which the designation is effective. This designation may also be made by appending to the Form 1120–POL statement containing the following information: The name and address of the candidate for Congress; his or her taxpayer identification number; his or her party affiliation and the office sought; the district and State in which the office is sought; and the name and address of the principal campaign committee. This designation shall be made on or before the due date (as extended) for filing Form 1120–POL. Only a candidate for Congress may make a designation in accordance with this paragraph.

(c) *Manner of revoking designation.* A designation of a principal campaign committee that has been filed in accordance with this section may be revoked only with the consent of the Commissioner. In general, the Commissioner will grant such consent in every case where the candidate for Congress has revoked his or her designation in compliance with the requirements of the Federal Election Commission by filing an amended Statement of Organization or its equivalent pursuant to 11 CFR 102.2(a)(2). In the case of the revocation of the designation of a principal campaign committee by a candidate followed by the designation of another principal campaign committee by such candidate, for purposes of determining the appropriate rate of tax under section 11(b) for a taxable year, the political organization taxable income of the first principal campaign committee shall be treated as that of the subsequent principal campaign committee. In a case where consent to revoke a designation of a principal campaign committee is granted and a new designation is filed, the Commissioner may condition his consent upon the agreement of the candidate for Congress to insure compliance with the preceding sentence.

[T.D. 8041, 50 FR 30817, July 30, 1985]

HOMEOWNERS ASSOCIATIONS

§ 1.528–1 Homeowners associations.

(a) *In general.* Section 528 only applies to taxable years of homeowners associations beginning after December 31, 1973. To qualify as a homeowners association an organization must either be a condominium management association or a residential real estate management association. For the purposes of Section 528 and the regulations under that section, the term *homeowners association* shall refer only to an organization described in section 528. Cooperative housing corporations and organizations based on a similar form of ownership are not eligible to be taxed as homeowners associations. As a general rule, membership in either a condominium management association or a residential real estate management association is confined to the developers and the owners of the units, residences, or lots. Furthermore, membership in either type of association is normally required as a condition of such ownership. However, if the membership of an organization consists of other homeowners associations, the owners of units, residences, or lots who are members of such other homeowners associations will be treated as the members of the organization for the purposes of the regulations under section 528.

(b) *Condominium.* The term *condominium* means an interest in real property consisting of an undivided interest in common in a portion of a parcel of real property (which may be a fee simple estate or an estate for years, such as a leasehold or subleasehold) together with a separate interest in space in a building located on such property. An interest in property is not a condominium unless the undivided interest in the common elements are vested in the unit holders. In addition, a condominium must meet the requirements of applicable state or local law relating to condominiums or horizontal property regimes.

(c) *Residential real estate management association.* Residential real estate

management associations are normally composed of owners of single-family residential units located in a subdivision, development, or similar area. However, they may also include as members, owners of multiple-family dwelling units located in such areas. They are commonly formed to administer and enforce covenants relating to the architecture and appearance of the real estate development as well as to perform certain maintenance duties relating to common areas.

(d) *Tenants*. Tenants will not be considered members for purposes of meeting the source of income test under section 528(c)(1)(B) and § 1.528–5. However, the fact that tenants of members of a homeowners association are permitted to be members of the association will not disqualify an association under section 528(c)(1) if it otherwise meets the requirements of section 528(c) and these regulations.

[T.D. 7692, 45 FR 26321, Apr. 18, 1980]

§ 1.528–2 Organized and operated to provide for the acquisition, construction, management, maintenance and care of association property.

(a) *Organized and operated*—(1) *Organized*. To be treated as a homeowners association an organization must be organized and operated primarily for the purpose of carrying on one or more of the exempt functions of a homeowners association. For the purposes of section 528 and these regulations, the exempt functions of a homeowners association are the acquisition, construction, management, maintenance, and care of association property. In determining whether an organization is organized and operated primarily to carry on one or more exempt functions, all the facts and circumstances of each case shall be considered. For example, when an organization provides in its articles of organization that its sole purpose is to carry on one or more exempt functions, in the absence of other relevant factors it will be considered to have met the organizational test. (The term *articles of organization* means the organization's corporate charter, trust instruments, articles of association or other instrument by which it is created.)

(2) *Operated*. An organization will be treated as being operated for the purpose of carrying on one or more of the exempt functions of a homeowners association if it meets the provisions of §§ 1.528–5 and 1.528–6.

(b) *Terms to be interpreted according to common meaning and usage*. As used in section 528 and these regulations, the terms acquisition, construction, management, maintenance, and care are to be interpreted according to their common meaning and usage. For example, maintenance of association property includes the painting and repairing of such property as well as the gardening and janitorial services associated with its upkeep. Similarly, the term *construction* of association property includes covenants or other rules for preserving the architectural and general appearance of the area. The term also includes regulations relating to the location, color and allowable building materials to be used in all structures. (For the definition of association property see § 1.528–3.)

[T.D. 7692, 45 FR 26321, Apr. 18, 1980]

§ 1.528–3 Association property.

(a) *Property owned by the organization*. *Association property* includes real and personal property owned by the organization or owned as tenants in common by the members of the organization. Such property must be available for the common benefit of all members of the organization and must be of a nature that tends to enhance the beneficial enjoyment of the private residences by their owners. If two or more facilities or items of property of a similar nature are owned by a homeowners association, and if the use of any particular facility or item is restricted to fewer than all association members, such facilities or items neverthelesswill be considered association property if all association members are treated equitably and have similar rights with respect to comparable items or facilities. Among the types of property that ordinarily will be considered association property are swimming pools and tennis courts. On the other hand, facilities or areas set aside for the use of nonmembers, or in fact used primarily by nonmembers, are not association property for the

purposes of this section. For example, property owned by an organization for the purpose of leasing it to groups consisting primarily of nonmembers to be used as a meeting place or a retreat will not be considered association property.

(b) *Property normally owned by a governmental unit. Association property* also includes areas and facilities traditionally recognized and accepted as being of direct governmental concern in the exercise of the powers and duties entrusted to governments to regulate community health, safety and welfare. Such areas and facilities would normally include roadways, parklands, sidewalks, streetlights and firehouses. Property described in this paragraph will be considered association property regardless of whether it is owned by the organization itself, by its members as tenants in common or by a governmental unit and used for the benefit of the residents of such unit including the members of the organization.

(c) *Privately owned property. Association property* may also include property owned privately by members of the organization. However, to be so included the condition of such property must affect the overall appearance or structure of the residential units which make up the organization. Such property may include the exterior walls and roofs of privately owned residences as well as the lawn and shrubbery on privately owned land and any other privately owned property the appearance of which may directly affect the appearance of the entire organization. However, privately owned property will not be considered association property unless:

(1) There is a covenant or similar requirement relating to exterior appearance or maintenance that applies on the same basis to all such property (or to a reasonable classification of such property);

(2) There is a pro rata mandatory assessment (at least once a year) on all members of the association for maintaining such property; and

(3) Membership in the organization is a condition of ownership of such property.

[T.D. 7692, 45 FR 26321, Apr. 18, 1980]

§ 1.528–4 Substantiality test.

(a) *In general.* In order for an organization to be considered a condominium management association or a residential real estate management association (and therefore in order for it to be considered a homeowners association), substantially all of its units, lots or buildings must be used by individuals for residences. For the purposes of applying paragraph (b) or (c) of this section, and organization which has attributes of both a condominium management association and a residential real estate management association shall be considered that association which, based on all the facts and circumstances, it more closely resembles. In addition, those paragraphs shall be applied based on conditions existing on the last day of the organization's taxable year.

(b) *Condominium management associations.* Substantially all of the units of a condominium management association will be considered as used by individuals for residences if at least 85% of the total square footage of all units within the project is used by individuals for residential purposes. If a completed unit has never been occupied, it will nonetheless be considered as used for residential purposes if, based on all the facts and circumstances, it appears to have been constructed for use as a residence. Similarly, a unit which is not occupied but which has been in the past will be considered as used for residential purposes if, based on all the facts and circumstances, it appears that it was constructed for use as a residence, and the last individual to occupy it did in fact use it as a residence. Units which are used for purposes auxiliary to residential use (such as laundry areas, swimming pools, tennis courts, storage rooms and areas used by maintenance personnel) shall be considered used for residential purposes.

(c) *Residential real estate management associations.* Substantially all of the lots or buildings of a residential real estate management association (including unimproved lots) will be considered as used by individuals as residences if at least 85% of the lots are zoned for residential purposes. Lots shall be treated as zoned for residential

purposes even if under such zoning lots may be used for parking spaces, swimming pools, tennis courts, schools, fire stations, libraries, churches and other similar purposes which are auxiliary to residential use. However, commercial shopping areas (and their auxiliary parking areas) are not lots zoned for residential purposes.

(d) *Exception*. Notwithstanding any other provision of this section, a unit, or building will not be considerd used for residential purposes, if for more than one-half the days in the association's taxable year, such unit, or building is occupied by a person or series of persons, each of whom so occupies such unit, or building for less than 30 days.

[T.D. 7692, 45 FR 26322, Apr. 18, 1980; T.D. 7692, 45 FR 24879, May 23, 1980]

§ 1.528–5 Source of income test.

An organization cannot qualify as a homeowners association under section 528 for a taxable year unless 60 percent or more of its gross income for such taxable year is exempt function income as defined in §1.528–9. The determiniation of whether an organization meets the provisions of this section shall be made after the close of the organization's taxable year.

[T.D. 7692, 45 FR 26322, Apr. 18, 1980]

§ 1.528–6 Expenditure test.

(a) *In general*. An organization cannot qualify as a homeowners association under section 528 for a taxable year unless 90 percent or more of its expenditures for such taxable year are qualifying expenditures as defined in paragraphs (b) and (c) of this section. The determination of whether an organization meets the provisions of this section shall be made after the close of the organization's taxable year. Investments or transfers of funds to be held to meet future costs shall not be taken into account as expenditures. For example, transfers to a sinking fund account for the replacement of a roof would not be considered an expenditure for the purposes of this section even if the roof is association property. In addition, excess assessments which are either rebated to members or applied against the members' following year's assessments will not be considered an expenditure for the purposes of this section.

(b) *Qualifying expenditures*. Qualifying expenditures are expenditures by an organization for the acquisition, construction, management, maintenance, and care of the organization's association property. They include both current operating and capital expenditures on association property. Qualifying expenditures include expenditures on association property despite the fact that such property may produce income which is not exempt function income. Thus expenditures on a swimming pool are qualifying expenditures despite the fact that fees from guests of members using the pool are not exempt function income. Where expenditures by an organization are used both for association property as well as other property, an allocation shall be made between the two uses on a reasonable basis. Only that portion of the expenditures which is properly allocable to the acquisition, construction, management, maintenance or care of association property, shall constitute qualifying expenditures.

(c) *Examples of qualifying expenditures*. Qualifying expenditures may include (but are not limited to) expenditures for:

(1) Salaries of an association manager and secretary;

(2) Paving of streets;

(3) Street signs;

(4) Security personnel;

(5) Legal fees;

(6) Upkeep of tennis courts;

(7) Swimming pools;

(8) Recreation rooms and halls;

(9) Replacement of common buildings, facilities, air conditioning, etc;

(10) Insurance premiums on association property;

(11) Accountant's fees;

(12) Improvement of private property to the extent it is association property; and

(13) Real estate and personal property taxes imposed on association property by a State or local government.

[T.D. 7692, 45 FR 26322, Apr. 18, 1980]

§ 1.528–7 Inurement.

An organization is not a homeowners association if any part of its net earnings inures (other than as a direct result of its engaging in one or more exempt functions) to the benefit of any private person. Thus, to the extent that members receive a benefit from the general maintenance, etc., of association property, this benefit generally would not constitute inurement. If an organization pays rebates from amounts other than exempt function income, such rebates will constitute inurement. In general, in determining whether an organization is in violation of this section, the principles used in making similar determinations under Section 501(c) will be applied.

[T.D. 7692, 45 FR 26323, Apr. 18, 1980]

§ 1.528–8 Election to be treated as a homeowners association.

(a) *General rule.* An organization wishing to be treated as a homeowners association under section 528 and this section for a taxable year must elect to be so treated. Except as otherwise provided in this section such election shall be made by the filing of a properly completed Form 1120–H (or such other form as the Secretary may prescribe). A separate election must be made for each taxable year.

(b) *Taxable years ending after December 30, 1976.* For taxable years ending after December 30, 1976, the election must be made not later than the time, including extensions, for filing an income tax return for the year in which the election is to apply.

(c) *Taxable years ending before December 31, 1976, for which a return was filed before January 31, 1977.* For taxable years ending before December 31, 1976, for which a return was filed before January 31, 1977, the election must be made not later than the time provided by law for filing a claim for credit or refund of overpayment of taxes for the year in which the election is to apply. Such an election shall be made by filing an amended return on Form 1120–H (or such other form as the Secretary may prescribe).

(d) *Taxable years ending before December 31, 1976, for which a return was not filed before January 31, 1977.* For taxable years ending before December 31, 1976, for which a return was not filed before January 31, 1977, the election must be made by October 20, 1980. Instead of making such an election in the manner described in paragraph (a) of this section, such an election may be made by a statement attached to the applicable income tax return or amended return for the year in which the election is made. The statement should identify the election being made, the period for which it applies and the taxpayer's basis for making the election.

(e) *Revocation of exempt status.* If an organization is notified after the close of a taxable year that its exemption for such taxable year under section 501(a) is being revoked retroactively, it may make a timely election under section 528 for such taxable year. Notwithstanding any other provisions of this section, such an election will be considered timely if it is made within 6 months after the date of revocation. The preceding sentence shall apply to revocations made after April 18, 1980. If the revocation was made on or before April 18, 1980, the election will be considered timely if it is made before the expiration of the period for filing a claim for credit or refund for the taxable year for which it is to apply.

(f) *Effect of election*—(1) *Revocation.* An election to be treated as an organization described in section 528 is binding on the organization for the taxable year and may not be revoked without the consent of the Commissioner.

(2) *Exception.* Notwithstanding paragraph (f)(1) of this section, an election under this section may be revoked prior to July 18, 1980. Such a revocation shall be made by filing a statement with the director of the Internal Revenue Service Center with whom the return of the organization for the year in which the revocation is to apply was filed. The statement shall include the following information:

(i) The name of the organization.

(ii) The fact that it is revoking an election made under section 528.

(iii) The taxable year for which the revocation is to apply.

[T.D. 7692, 45 FR 26323, Apr. 18, 1980]

§ 1.528–9 Exempt function income.

(a) *General rule.* For the purposes of section 528 exempt function income consists solely of income which is attributable to membership dues, fees, or assessments of owners of residential units or residential lots. It is not necessary that the source of income be labeled as membership dues, fees, or assessments. What is important is that such income be derived from owners of residential units or residential lots in their capacity as owner-members rather than in some other capacity such as customers for services. Generally, for the membership dues, fees, or assessments with respect to a residential unit or lot to be exempt function income, the unit must be used for (or the unit or lot must be expected to be used) for residential purposes. However, dues, fees, or assessments paid to an organization by a developerwith respect to unfinished or finished but unsold units or lots shall be exempt function income even though the developer does not use the units or lots. If an assessment is more in the nature of a fee for the provision of services in the course of a trade or business than a fee for a common activity undertaken by a collective group of owners for the purpose of enhancing or maintaining the value of their residences, the assessment will not be considered exempt function income to the organization. Furthermore, income attributable to dues, fees, or assessments will not be considered exempt function income unless each member's liability for payment arises solely from membership in the association. Dues, fees, or assessments that are based on the extent, if any, to which a member avails him or herself of a facility or facilities are not exempt function income. For the purposes of section 528, dues, fees, or assessments which are based on the assessed value or size of property will be considered as arising solely as a result of membership in the organization. Regardless of the organization's method of accounting, excess assessments during a taxable year which are either rebated to the members or applied to their future assessments are not considered gross income and therefore will not be considered exempt function income for such taxable year. However, if such excess assessments are applied to a future year's assessments, they will be considered gross income and exempt function income for that future year. In addition, assessments in a taxable year, such as an assessment for a capital improvement, which are not treated as gross income do not enter into the determination of whether the organization meets the source of income test for that taxable year.

(b) *Examples of exempt function income.* Assessments which are considered more in the nature of a fee for common activity than for the providing of services and which will therefore generally be considered exempt function income include assessments made for the purpose of:

(1) Paying the principal and interest on debts incurred for the acquisition of association property;

(2) Paying real estate taxes on association property;

(3) Maintaining association property;

(4) Removing snow from public areas; and

(5) Removing trash.

(c) *Examples of receipts which are not exempt function income.* Exempt function income does not include:

(1) Amounts which are not includible in the organization's gross income other than by reason of section 528 (for example, tax-exempt interest);

(2) Amounts received from persons who are not members of the association;

(3) Amounts received from members for special use of the organization's facilities, the use of which is not available to all members as a result of having paid the dues, fees or assessments required to be paid by all members;

(4) Interest earned on amounts set aside in a sinking fund;

(5) Amounts received for work done on privately owned property which is not association property; or

(6) Amounts received from members in return for their transportation to or from shopping areas, work location, etc.

(d) *Special rule.* Notwithstanding paragraphs (a) and (c)(3) of this section, amounts received from members or tenants of residential units owned by members (notwithstanding § 1.528–1(d))

for special use of an association's facilities will be considered exempt function income if:

(1) The amounts paid by the members are not paid more than once in any 12 month period; and

(2) The privilege obtained from the payment of such amounts lasts for the entire 12 month period or portion thereof in which the facility is commonly in use.

Thus, amounts received as the result of payments by members of a yearly fee for use of tennis courts or a swimming pool shall be considered exempt function income. However, amounts received for the use of a building for an evening, weekend, week, etc., shall not be considered exempt function income.

[T.D. 7692, 45 FR 26323, Apr. 18, 1980]

§ 1.528–10 Special rules for computation of homeowners association taxable income and tax.

(a) *In general.* Homeowners association taxable income shall be determined according to the provisions of section 528(d) and the rules set forth in this section.

(b) *Limitation on capital losses.* If for any taxable year a homeowners association has a net capital loss, the rules of sections 1211(a) and 1212(a) shall apply.

(c) *Allowable deductions*—(1) *In general.* To be deductible in computing the unrelated business taxable income of a homeowners association, expenses, depreciation and similar items must not only qualify as items of deduction allowed by chapter 1 of the Code but must also be directly connected with the production of gross income (excluding exempt function income). To be *directly connected with* the production of gross income (excluding exempt function income), an item of deduction must have both proximate and primary relationship to the production of such income and have been incurred in the production of such income. Items of deduction attributable solely to items of gross income (excluding exempt function income) are proximately and primarily related to such income. Whether an item of deduction is incurred in the production of gross income (excluding exempt function income) is determined on the basis of all the facts and circumstances involved in each case.

(2) *Dual use of facilities or personnel.* Where facilities are used both for exempt functions of the organization and for the production of gross income (excluding exempt function income), expenses, depreciation and similar items attributable to such facilities (for example, items of overhead) shall be allocated between the two uses on a reasonable basis. Similarly where personnel are employed both for exempt functions and for the production of gross income (excluding exempt function income), expenses and similar items attributable to such personnel (for example, items of salary) shall be allocated between the two activities on a reasonable basis. The portion of any such item so allocated to the production of gross income (excluding exempt function income) is directly connected with such income and shall be allowable as a deduction in computing homeowners association taxable income to the extent that it qualifies as an item of deduction allowed by chapter 1 of the Code. Thus, for example, assume that X, a homeowners association, pays its manager a salary of $10,000 a year and that it derives gross income other than exempt function income. If 10 percent of the manager's time during the year is devoted to deriving X's gross income (other than exempt function income), a deduction of $1,000 (10 percent of $10,000) would generally be allowable for purposes of computing X's homeowners association taxable income.

(d) *Investment credit.* A homeowners association is not entitled to an investment credit.

(e) *Cross reference.* For the definition of exempt function income, see § 1.528–9.

[T.D. 7692, 45 FR 26324, Apr. 18, 1980]

CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS

Corporations Improperly Accumulating Surplus

§ 1.531–1 Imposition of tax.

Section 531 imposes (in addition to the other taxes imposed upon corporations by chapter 1 of the Code) a graduated tax on the accumulated taxable income of every corporation described in section 532 and § 1.532–1. In the case of an affiliated group which makes or is required to make a consolidated return see § 1.1502–43. All of the taxes on corporations under chapter 1 of the Code are treated as one tax for purposes of assessment, collection, payment, period of limitations, etc. See section 535 and §§ 1.535–1, 1.535–2, and 1.535–3 for the definition and determination of accumulated taxable income.

(Secs. 1502 and 7805 of the Internal Revenue Code of 1954 (68A Stat. 637, 917; 26 U.S.C. 1502, 7805))

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7937, 49 FR 3462, Jan. 27, 1984]

§ 1.532–1 Corporations subject to accumulated earnings tax.

(a) *General rule.* (1) The tax imposed by section 531 applies to any domestic or foreign corporation (not specifically excepted under section 532(b) and paragraph (b) of this section) formed or availed of to avoid or prevent the imposition of the individual income tax on its shareholders, or on the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of dividing or distributing them. See section 533 and § 1.533–1, relating to evidence of purpose to avoid income tax with respect to shareholders.

(2) The tax imposed by section 531 may apply if the avoidance is accomplished through the formation or use of one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation, the earnings and profits of the M Corporation would not be returned as income subject to the individual income tax until such earnings and profits of the M Corporation were distributed to the N Corporation and distributed in turn by the N Corporation to its shareholders. If either the M Corporation or the N Corporation was formed or is availed of for the purpose of avoiding or preventing the imposition of the individual income tax upon the shareholders of the N Corporation, the accumulated taxable income of the corporation so formed or availed of (M or N, as the case may be) is subject to the tax imposed by section 531.

(b) *Exceptions.* The accumulated earnings tax imposed by section 531 does not apply to a personal holding company (as defined in section 542), to a foreign personal holding company (as defined in section 552), or to a corporation exempt from tax under subchapter F, chapter 1 of the Code.

(c) *Foreign corporations.* Section 531 is applicable to any foreign corporation, whether resident or nonresident, with respect to any income derived from sources, within the United States, if any of its shareholders are subject to income tax on the distributions of the corporation by reason of being (1) citizens or residents of the United States, or (2) nonresident alien individuals to whom section 871 is applicable, or (3) foreign corporations if a beneficial interest therein is owned directly or indirectly by any shareholder specified in subparagraph (1) or (2) of this paragraph.

§ 1.533–1 Evidence of purpose to avoid income tax.

(a) *In general.* (1) The Commissioner's determination that a corporation was formed or availed of for the purpose of avoiding income tax with respect to shareholders is subject to disproof by competent evidence. Section 533(a) provides that the fact that earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders unless the corporation, by the preponderance of the evidence, shall prove to the contrary. The burden of proving that earnings and profits have been permitted to accumulate beyond the reasonable needs of the business may be shifted to the Commissioner

under section 534. See §§1.534–1 through 1.534–4. Section 533(b) provides that the fact that the taxpayer is a mere holding or investment company shall be prima facie evidence of the purpose to avoid income tax with respect to shareholders.

(2) The existence or nonexistence of the purpose to avoid income tax with respect to shareholders may be indicated by circumstances other than the conditions specified in section 533. Whether or not such purpose was present depends upon the particular circumstances of each case. All circumstances which might be construed as evidence of the purpose to avoid income tax with respect to shareholders cannot be outlined, but among other things, the following will be considered:

(i) Dealings between the corporation and its shareholders, such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders,

(ii) The investment by the corporation of undistributed earnings in assets having no reasonable connection with the business of the corporation (see §1.537–3), and

(iii) The extent to which the corporation has distributed its earnings and profits.

The fact that a corporation is a mere holding or investment company or has an accumulation of earnings and profits in excess of the reasonable needs of the business is not absolutely conclusive against it if the taxpayer satisfies the Commissioner that the corporation was neither formed nor availed of for the purpose of avoiding income tax with respect to shareholders.

(b) *General burden of proof and statutory presumptions.* The Commissioner may determine that the taxpayer was formed or availed of to avoid income tax with respect to shareholders through the medium of permitting earnings and profits to accumulate. In the case of litigation involving any such determination (except where the burden of proof is on the Commissioner under section 534), the burden of proving such determination wrong by a preponderance of the evidence, together with the corresponding burden of first going forward with the evidence, is on the taxpayer under principles applicable to income tax cases generally. For the burden of proof in a proceeding before the Tax Court with respect to the allegation that earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, see section 534 and §§1.534–2 through 1.534–4. For a definition of a holding or investment company, see paragraph (c) of this section. For determination of the reasonable needs of the business, see section 537 and §§1.537–1 through 1.537–3. If the taxpayer is a mere holding or investment company, and the Commissioner therefore determines that the corporation was formed or availed of for the purpose of avoiding income tax with respect to shareholders, then section 533(b) gives further weight to the presumption ofcorrectness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid income tax with respect to shareholders. Further, if it is established (after complying with section 534 where applicable) that earnings and profits were permitted to accumulate beyond the reasonable needs of the business and the Commissioner has therefore determined that the corporation was formed or availed of for the purpose of avoiding income tax with respect to shareholders, then section 533(a) adds still more weight to the Commissioner's determination. Under such circumstances, the existence of such an accumulation is made determinative of the purpose to avoid income tax with respect to shareholders unless the taxpayer proves to the contrary by the preponderance of the evidence.

(c) *Holding or investment company.* A corporation having practically no activities except holding property and collecting the income therefrom or investing therein shall be considered a holding company within the meaning of section 533(b). If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or marginal basis) so that the income is derived not only from the investment

yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 533(b).

(d) *Small business investment companies.* A corporation which is licensed to operate as a small business investment company under the Small Business Investment Act of 1958 (15 U.S.C. ch. 14B) and the regulations thereunder (13 CFR part 107) will generally be considered to be a *mere holding or investment company* within the meaning of section 533(b). However, the presumption of the existence of the purpose to avoid income tax with respect to shareholders which results from the fact that such a company is a *mere holding or investment company* will be considered overcome so long as such company:

(1) Complies with all the provisions of the Small Business Investment Act of 1958 and the regulations thereunder; and

(2) Actively engages in the business of providing funds to small business concerns through investment in the equity capital of, or through the disbursement of long-term loans to, such concerns in such manner and under such terms as the company may fix in accordance with regulations promulgated by the Small Business Administration (see secs. 304 and 305 of the Small Business Investment Act of 1958, as amended (15 U.S.C. 684, 685)).

On the other hand, if such a company violates or fails to comply with any of the provisions of the Small Business Investment Act of 1958, as amended, or the regulations thereunder, or ceases to be actively engaged in the business of providing funds to small business concerns in the manner provided in subparagraph (2) of this paragraph, it will not be considered to have overcome the presumption by reason of any rules provided in this paragraph.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6652, 28 FR 4786, May 14, 1963]

§ 1.533–2 Statement required.

The corporation may be required to furnish a statement of its accumulated earnings and profits, the payment of dividends, the name and address of, and number of shares held by, each of its shareholders, the amounts that would be payable to each of the shareholders if the income of the corporation were distributed and other information required under section 6042.

§ 1.534–1 Burden of proof as to unreasonable accumulations generally.

For purposes of applying the presumption provided for in section 533(a) and in determining the extent of the accumulated earnings credit under section 535(c)(1), the burden of proof with respect to an allegation by the Commissioner that all or any part of the earnings and profits of the corporation have been permitted to accumulate beyond the reasonable needs of the business may vary under section 534 as between litigation in the Tax Court and that in any other court. In case of a proceeding in a court other than the Tax Court, see paragraph (b) of § 1.533–1.

§ 1.534–2 Burden of proof as to unreasonable accumulations in cases before the Tax Court.

(a) *Burden of proof on Commissioner.* Under the general rule provided in section 534(a), in any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation is upon the Commissioner if:

(1) A notification, as provided for in section 534(b) and paragraph (c) of this section, has not been sent to the taxpayer; or

(2) A notification, as provided for in section 534(b) and paragraph (c) of this section, has been sent to the taxpayer and, in response to such notification, the taxpayer has submitted a statement, as provided in section 534(c) and paragraph (d) of this section, setting forth the ground or grounds (together with facts sufficient to show the basis thereof) on which it relies to establish that all or any part of its earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business. However, the burden of proof in the latter case is upon the Commissioner only with respect to the relevant ground or grounds set forth in

the statement submitted by the taxpayer, and only if such ground or grounds are supported by facts (contained in the statement) sufficient to show the basis thereof.

(b) *Burden of proof on the taxpayer*. The burden of proof in a Tax Court proceeding with respect to an allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business is upon the taxpayer if:

(1) A notification, as provided for in section 534(b) and paragraph (c) of this section, has been sent to the taxpayer and the taxpayer has not submitted a statement, in response to such notification, as provided in section 534(c) and paragraph (d) of this section; or

(2) A statement has been submitted by the taxpayer in response to such notification, but the ground or grounds on which the taxpayer relies are not relevant to the allegation or, if relevant, the statement does not contain facts sufficient to show the basis thereof.

(c) *Notification to the taxpayer*. Under section 534(b) a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531 may be sent by registered mail (or by certified or registered mail, if the notification is mailed after September 2, 1958) to the taxpayer at any time before the mailing of the notice of deficiency in the case of a taxable year beginning after December 31, 1953, and ending after August 16, 1954. See §1.534–4 for rules relating to taxable years subject to the Internal Revenue Code of 1939. See section 534(d) and §1.534–3 with respect to a notification in the case of a jeopardy assessment.

(d) *Statement by taxpayer*. (1) A taxpayer who has received a notification, as provided in section 534(b) and paragraph (c) of this section, that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531, may, under section 534(c), submit a statement that all or any part of the earnings and profits of the corporation have not been permitted to accumulate beyond the reasonable needs of the business. Such statement shall set forth the ground or grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that there has been no accumulation of earnings and profits beyond the reasonable needs of the business. See paragraphs (a) and (b) of this section for rules concerning the effect of the statement with respect to burden of proof. See §§1.537–1 to 1.537–3, inclusive, relating to reasonable needs of the business.

(2) The taxpayer's statement, under section 534(c) and this paragraph, must be submitted to the Internal Revenue office which issued the notification (referred to in section 534(b) and paragraph (c) of this section) within 60 days after the mailing of such notification. If the taxpayer is unable, for good cause, to submit the statement within such 60-day period, an additional period not exceeding 30 days may be granted upon receipt in the Internal Revenue office concerned (before the expiration of the 60-day period provided herein) of a request from the taxpayer, setting forth the reasons for such request. See section 534(d) and §1.534–3 with respect to a statement in the case of a jeopardy assessment.

§1.534–3 Jeopardy assessments in Tax Court cases.

In the case of a jeopardy assessment, a notice of deficiency is required to be sent to the taxpayer by registered mail (or by certified or registered mail, if the notice is mailed after September 2, 1958) within 60 days after the making of the assessment. See section 6861. If a jeopardy assessment is made before the mailing of the deficiency notice, then in the case of a proceeding in the Tax Court, if the deficiency notice informs the taxpayer that an amount of accumulated earnings tax is included in the deficiency, such notice shall constitute the notification provided for in section 534(b) and paragraph (c) of §1.534–2. Under such circumstances the statement described in section 534(c) and paragraph (d) of §1.534–2 shall instead be included in the taxpayer's petition to the Tax Court, if the taxpayer desires to submit such statement. See paragraph (b) of §1.534–2, relating to burden of proof on the taxpayer.

§ 1.535–1 Definition.

(a) The accumulated earnings tax is imposed by section 531 on the accumulated taxable income. Accumulated taxable income is the taxable income of the corporation with the adjustments prescribed by section 535(b) and § 1.535–2, minus the sum of the dividends paid deduction and the accumulated earnings credit. See section 561 and the regulations thereunder, relating to the definition of the deduction for dividends paid, and section 535(c) and § 1.535–3, relating to the accumulated earnings credit.

(b) In the case of a foreign corporation, whether resident or nonresident, which files or causes to be filed a return, the accumulated taxable income shall be the taxable income from sources within the United States with the adjustments prescribed by section 535(b) and § 1.535–2 minus the sum of the dividends paid deduction and the accumulated earnings credit. In the case of a foreign corporation which files no return, the accumulated taxable income shall be the gross income from sources within the United States without allowance of any deductions (including the accumulated earnings credit).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972]

§ 1.535–2 Adjustments to taxable income.

(a) *Taxes*—(1) *United States taxes.* In computing accumulated taxable income for any taxable year, there shall be allowed as a deduction the amount by which Federal income and excess profits taxes accrued during the taxable year exceed the credit provided by section 33 (relating to taxes of foreign countries and possessions of the United States), except that no deduction shall be allowed for (i) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (ii) the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (iii) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939, for taxable years beginning after December 31, 1940. The deduction is for taxes accrued during the taxable year, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursements method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(2) *Taxes of foreign countries and United States possessions.* In determining accumulated taxable income for any taxable year, if the taxpayer chooses the benefits of section 901 for such taxable year, a deduction shall be allowed for:

(i) The income, war profits, and excess profits taxes imposed by foreign countries or possessions of the United States and accrued during such taxable year, and

(ii) In the case of a domestic corporation, the foreign income taxes deemed to be paid for such taxable year under section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(a)(1) in accordance with § 1.960–7.

In no event shall the amount under subdivision (ii) of this subparagraph exceed the amount includible in gross income with respect to such taxes under section 78 and § 1.78–1. The credit for such taxes provided by section 901 shall not be allowed against the accumulated earnings tax imposed by section 531. See section 901(a).

(b) *Charitable contributions.* Section 535(b)(2) provides that, in computing the accumulated taxable income of a corporation, the deduction for charitable contributions shall be computed without regard to section 170(b)(2). Thus, the amount of charitable contributions made during the taxable year not allowable as a deduction under section 170 by reason of the limitations imposed by section 170(b)(2) shall be allowed as a deduction in computing accumulated taxable income for the taxable year. However, any excess of the amount of the charitable contributions made in a prior taxable year over the amount allowed as a deduction under section 170 for such year shall not be allowed as a deduction from taxable income in computing accumulated taxable income for the taxable year.

(c) *Special deductions disallowed.* Sections 241 through 248 provide for the allowance of special deductions for such items as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, and organizational expenses. Such special deductions, except the deduction provided by section 248 (relating to organizational expenses) shall be disallowed in computing accumulated taxable income.

(d) *Net operating loss.* The net operating loss deduction provided in section 172 is not allowed for purposes of computing accumulated taxable income.

(e) *Capital losses.* (1) Losses from sales or exchanges of capital assets during the taxable year, which are disallowed as deductions under section 1211(a) in computing taxable income, shall be allowed as deductions in computing accumulated taxable income.

(2) The computation of the capital losses allowable as a deduction in computing accumulated taxable income may be illustrated by the following example:

Example. X Corporation has capital losses of $30,000 which are disallowed under section 1211(a) for the taxable year ended December 31, 1956. This amount represents a loss of $25,000 from the sale or exchange of capital assets during the taxable year ended December 31, 1956, plus a $5,000 capital loss carryover resulting from the sale or exchange of capital assets during the taxable year ended December 31, 1955. In computing accumulated taxable income for the taxable year ended December 31, 1956, only the loss of $25,000 arising from the sale or exchange of capital assets during that taxable year will be allowed as a deduction.

(f) *Long-term capital gains.* (1) There is allowed as a deduction in computing accumulated taxable income, the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryover provided in section 1212) minus the taxes attributable to such excess as provided by section 535(b)(6). The tax attributable to such excess is the difference between:

(i) The taxes (except the accumulated earnings tax) imposed by subtitle A of the Code for such year, and

(ii) The taxes (except the accumulated earnings tax) imposed by subtitle A computed for such year as if taxable income were reduced by the excess of the net long-term capital gain over net short-term capital loss (including the capital loss carryover to such year)

Where the tax (except the accumulated earnings tax) imposed by subtitle A includes an amount computed under section 1201(a)(2), the tax attributable to such excess is such amount computed under section 1201(a)(2).

(2) The application of the rule in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Assume that D Corporation, for the taxable year ended December 31, 1956, has taxable income of $103,000 of which $8,000 is the excess of net long-term capital gain of $12,000 over a net short-term capital loss of $9,000. The $9,000 net short-term capital loss includes a capital loss carryover of $5,000. The amount allowable as a deduction under section 535(b)(6) and subparagraph (1) of this paragraph is $7,250, computed as follows: Net long-term capital gain less net short-term capital loss (computed without regard to the capital loss carryover) is $8,000 (that is, $12,000 net long-term capital gain less $4,000 net short-term capital loss computed without regard to the capital loss carryover of $5,000). The tax attributable to the excess of net long-term capital gain over net short-term capital loss (computed by taking the capital loss carryover into account) is $750, that is, 25 percent of such excess of $3,000, computed under section 1201(a)(2). The difference of $7,250 ($8,000 less $750) is the amount allowable as a deduction in computing accumulated taxable income.

(3) Section 631(c) (relating to gain or loss in the case of disposal of coal or domestic iron ore) shall have no application in determining the amount of the deduction allowable under section 535(b)(6).

(g) *Capital loss carrybacks and carryovers.* Capital losses carried to a taxable year under section 1212(a) shall have no application for purposes of computing accumulated taxable income for such year.

(h) *Bank affiliates.* There is allowed the deduction provided by section 601

in the case of bank affiliates (as defined in section 2 of the Banking Act of 1933; 12 U. S. C. 221a(c)).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6805, 30 FR 3209, Mar. 9, 1965; T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7301, 39 FR 964, Jan. 4, 1974; T.D. 7649, 44 FR 60086, Oct. 18, 1979]

§ 1.535–3 Accumulated earnings credit.

(a) *In general.* As provided in section 535(a) and § 1.535–1, the accumulated earnings credit, provided by section 535(c), reduces taxable income in computing accumulated taxable income. In the case of a corporation, not a mere holding or investment company, the accumulated earnings credit is determined as provided in paragraph (b) of this section and, in the case of a holding or investment company, as provided in paragraph (c) of this section.

(b) *Corporation which is not a mere holding or investment company*—(1) *General rule.* (i) In the case of a corporation, not a mere holding or investment company, the accumulated earnings credit is the amount equal to such part of the earnings and profits of the taxable year which is retained for the reasonable needs of the business, minus the deduction allowed by section 535(b)(6) (see paragraph (f) of § 1.535–2, relating to the deduction for long-term capital gains). In no event shall the accumulated earnings credit be less than the minimum credit provided for in section 535(c)(2) and subparagraph (2) of this paragraph. The amount of the earnings and profits for the taxable year retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction for such taxable year. See section 561 and §§ 1.561–1 and 1.561–2, relating to the deduction for dividends paid.

(ii) In determining whether any amount of the earnings and profits of the taxable year has been retained for the reasonable needs of the business, the accumulated earnings and profits of prior years will be taken into consideration. Thus, for example, if such accumulated earnings and profits of prior years are sufficient for the reasonable needs of the business, then any earnings and profits of the current taxable year which are retained will not be considered to be retained for the reasonable needs of the business. See section 537 and §§ 1.537–1 and 1.537–2.

(2) *Minimum credit.* Section 535(c)(2) provides for the allowance of a minimum accumulated earnings credit in the case of a corporation which is not a mere holding or investment company. Except as otherwise provided in section 243(b)(3) and § 1.243–5 (relating to effect of 100-percent dividends received deduction under section 243(b)) and sections 1561, 1562, and 1564 (relating to limitations on certain tax benefits in the case of certain controlled corporations), in the case of such a corporation, this minimum credit shall in no case be less than the amount by which $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. See paragraph (d) of this section for the effect of dividends paid after the close of the taxable year in determining accumulated earnings and profits at the close of the preceding taxable year. In determining the amount of the minimum credit allowable under section 535(c)(2), the needs of the business are not taken into consideration. If the taxpayer has accumulated earnings and profits at the close of the preceding taxable year equal to or in excess of $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975), thecredit, if any, is determined without regard to section 535(c)(2). It is not intended that the provision for the minimum credit shall in any way create an inference that an accumulation in excess of $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) is unreasonable. The reasonable needs of the business may require the accumulation of more or less than $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975), depending upon the circumstances in the case, but such needs shall not be taken into consideration to any extent in cases where the minimum accumulated earnings credit is applicable. For a discussion of the reasonable needs of the business, see section 537 and §§ 1.537–1, 1.537–2, and 1.537–3.

(3) *Illustrations of accumulated earnings credit.* The computation of the accumulated earnings credit provided by

section 535(c) may be illustrated by the following examples:

Example 1. The X Corporation, which is not a mere holding or investment company, has accumulated earnings and profits in the amount of $125,000 as of December 31, 1974. Thus, the minimum credit provided by section 535(c)(2) exceeds the accumulated earnings and profits of X by $25,000. It has earnings and profits for the taxable year ended December 31, 1975, in the amount of $100,000 and has a dividends paid deduction under section 561 in the amount of $30,000 so that the earnings and profits for the taxable year which are retained in the business amount to $70,000. Assume that it has been determined that the earnings and profits for the taxable year which may be retained for the reasonable needs of the business amount to $55,000 and that a deduction has been allowed under section 535(b)(6) in the amount of $5,000. Since the amount by which $150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year is less than $50,000 ($55,000–$5,000), the minimum credit provided by section 535(c)(2) will not apply and the accumulated earnings credit must be computed under section 535(c)(1) on the basis of the reasonable needs of the business. In this case, the accumulated earnings credit for the taxable year ended December 31, 1975, will be $50,000 computed as follows:

Earnings and profits of the taxable year determined to be retained for the reasonable needs of the business	$55,000
Less: The deduction for long-term capital gains (less applicable tax) allowed under sec. 535(b)(6)	5,000
Accumulated earnings credit allowable under sec. 535(c)(1)	50,000

Example 2. The Z Corporation which is not a mere holding or investment company, has accumulated earnings and profits in the amount of $45,000 as of December 31, 1974; it has earnings and profits for the taxable year ended December 31, 1975, in the amount of $115,000 and has a dividends paid deduction under section 561 in the amount of $10,000, so that the earnings and profits for the taxable year which are retained amount to $105,000. Assume that it has been determined that the accumulated earnings and profits of the taxable year which may be retained for the reasonable needs of the business amount to $20,000 and that no deduction is allowable for long-term capital gains under section 535(b)(6). The accumulated earnings credit allowable under section 535(c)(1) on the basis of the reasonable needs of the business is determined to be only $20,000. However, since the amount by which $150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year is more than $20,000, the minimum accumulated earnings credit provided by section 535(c)(2) is applicable. The allowable credit will be the amount by which $150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year (*i.e.*, $105,000, $150,000 less $45,000 of accumulated earnings and profits at the close of the preceding taxable year).

(c) *Holding and investment companies.* Section 535(c)(3) provides that, in the case of a mere holding or investment company, the accumulated earnings credit shall be the amount, if any, by which $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. Thus, if such a corporation has accumulated earnings equal to or in excess of $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) at the close of its preceding taxable year, no accumulated earnings credit is allowable in computing the accumulated taxable income. See paragraph (c) of § 1.533–1 for a definition of a holding or investment company. For the accumulated earnings credit of a mere holding or investment company which is a member of an affiliated group which has elected the 100-percent dividends received deduction under section 243(b), see section 243(b)(3) and § 1.243–5. For the accumulated earnings credit of a mere holding or investment company which is a component member of a controlled group of corporations (as defined in section 1563), see sections 1561, 1562, and 1564.

(Sec. 1561(a) (83 Stat. 599; 26 U.S.C. 1561(a)))

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6992, 34 FR 826, Jan. 18, 1969; T.D. 7181, 37 FR 8066, Apr. 25, 1972; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7376, 40 FR 42744, Sept. 16, 1975; T.D. 7528, 42 FR 64694, Dec. 28, 1977]

§ 1.536–1 Short taxable years.

Accumulated taxable income for a taxable year consisting of a period of less than 12 months shall not be placed on an annual basis for the purpose of the accumulated earnings tax imposed by section 531. In such cases accumulated taxable income shall be computed on the basis of the taxable income for such period of less than 12 months, adjusted in the manner provided by section 535(b) and § 1.535–2.

§ 1.537–1 Reasonable needs of the business.

(a) *In general.* The term *reasonable needs of the business* includes (1) the reasonably anticipated needs of the business (including product liability loss reserves, as defined in paragraph (f) of this section), (2) the section 303 redemption needs of the business, as defined in paragraph (c) of this section, and (3) the excess business holdings redemption needs of the business as described in paragraph (d) of this section. See paragraph (e) of this section for additional rules relating to the section 303 redemption needs and the excess business holdings redemption needs of the business. An accumulation of the earnings and profits (including the undistributed earnings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business. The need to retain earnings and profits must be directly connected with the needs of thecorporation itself and must be for bona fide business purposes. For purposes of this paragraph the section 303 redemption needs of the business and the excess business holdings redemption needs of the business are deemed to be directly connected with the needs of the business and for a bona fide business purpose. See § 1.537–3 for a discussion of what constitutes the business of the corporation. The extent to which earnings and profits have been distributed by the corporation may be taken into account in determining whether or not retained earnings and profits exceed the reasonable needs of the business. See § 1.537–2, relating to grounds for accumulation of earnings and profits.

(b) *Reasonable anticipated needs.* (1) In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.

(2) Consideration shall be given to reasonably anticipated needs as they exist on the basis of the facts at the close of the taxable year. Thus, subsequent events shall not be used for the purpose of showing that the retention of earnings or profits was unreasonable at the close of the taxable year if all the elements of reasonable anticipation are present at the close of such taxable year. However, subsequent events may be considered to determine whether the taxpayer actually intended to consummate or has actually consummated the plans for which the earnings and profits were accumulated. In this connection, projected expansion or investment plans shall be reviewed in the light of the facts during each year and as they exist as of the close of the taxable year. If a corporation has justified an accumulation for future needs by plans never consummated, the amount of such an accumulation shall be taken into account in determining the reasonableness of subsequent accumulations.

(c) *Section 303 redemption needs of the business.* (1) The term *section 303 redemption needs* means, with respect to the taxable year of the corporation in which a shareholder of the corporation died or any taxable year thereafter, the amount needed (or reasonably anticipated to be needed) to redeem stock included in the gross estate of such shareholder but not in excess of the amount necessary to effect a distribution to which section 303 applies. For purposes of this paragraph, the term *shareholder* includes an individual in

whose gross estate stock of the corporation is includable upon his death for Federal estate tax purposes.

(2) This paragraph applies to a corporation to which section 303(c) would apply if a distribution described therein were made.

(3) If stock included in the gross estate of a decedent is stock of two or more corporations described in section 303(b)(2)(B), the amount needed by each such corporation for section 303 redemption purposes under this section shall, unless the particular facts and circumstances indicate otherwise, be that amount which bears the same ratio to the amount described in section 303(a) as the fair market value of such corporation's stock included in the gross estate of such decedent bears to the fair market value of all of the stock of such corporations included in the gross estate. For example, facts and circumstances indicating that the allocation prescribed by this subparagraph is not required would include notice given to the corporations by the executor or administrator of the decedent's estate that he intends to request the redemption of stock of only one of such corporations or the redemption of stock of such corporations in a ratio which is unrelated to the respective fair market values of the stock of the corporations included in the decedent's gross estate.

(4) The provisions of this paragraph apply only to taxable years ending after May 26, 1969.

(d) *Excess business holdings redemption needs.* (1) The term *excess business holdings redemption needs* means, with respect to taxable years of the corporation ending after May 26, 1969, the amount needed (or reasonably anticipated to be needed) to redeem from a private foundation stock which:

(i) Such foundation held on May 26, 1969 (or which was received by such foundation pursuant to a will or irrevocable trust to which section 4943(c)(5) applies), and either

(ii) Constituted excess business holdings on such date or would have constituted excess business holdings as of that date if there were taken into account (*a*) stock received pursuant to a will or trust described in subdivision (i) of this subparagraph and (*b*) the reduction in the total outstanding stock of the corporation which would have resulted solely from the redemption of stock held by the private foundation, or

(iii) Constituted stock redemption of which before January 1, 1975, or after October 4, 1976, and before January 1, 1977, is, by reason of section 101(l)(2)(B) of the Tax Reform Act of 1969, as amended by section 1309 of the Tax Reform Act of 1976, and § 53.4941(d)–4(b), permitted without imposition of tax under section 4941, but only to the extent such stock is to be redeemed before January 1, 1975 or after October 4, 1976, and before January 1, 1977, or is to be redeemed thereafter pursuant to the terms of a binding contract entered into on or before such date to redeem all of the stock of the corporation held by the private foundation on such date.

(2) The purpose of subparagraph (1) of this paragraph is to facilitate a private-foundation's disposition of certain excess business holdings, in order for the private foundation not to be liable for tax under section 4943. See section 4943(c) and the regulations thereunder for the definition of excess business holdings. For purposes of section 537(b)(2) and this paragraph, however, any determination of the existence of excess business holdings shall be made without taking into account the provisions of section 4943(c)(4) which treat certain excess business holdings as held by a disqualified person (rather than by the private foundation), except that the periods described in section 4943(c)(4) (B), (C), and (D), if applicable, shall be taken into account in determining the period during which an excess business holdings redemption need may be deemed to exist. Thus, an excess business holdings redemption need may, depending upon the facts and circumstances, be deemed to exist for a part or all of the 20-year, 15-year, or 10-year period specified in section 4943(c)(4)(B) during which the interest in the corporation held by the private foundation is treated as held by a disqualified person rather than by the private foundation, and, if applicable, (i) any suspension of such 20-year, 15-year, or 10-year period as provided by section 4943(c)(4)(C) and (ii) the 15-year *second phase* specified in section 4943(c)(4)(D).

The foregoing sentence is not to be construed to prevent an accumulation of earnings and profits for the purpose of effecting a redemption of excess business holdings at a time or times prior to expiration of the periods described in such sentence. This subparagraph is not to be construed to prevent an accumulation of earnings and profits for the purpose of effecting a redemption described in subdivision (iii) of subparagraph (1) of this paragraph.

(3) The extent of an excess business holdings redemption need cannot exceed the total number of shares of stock so held or received by the private foundation (i) redemption of which alone would sufficiently reduce such private foundation's proportionate share of the corporation's total outstanding stock in order for the private foundation not to be liable for tax under section 4943, or (ii) redemption of which is, by reason of § 53.4941(d)–4(b), permitted without imposition of tax under section 4941 provided that such redemption is accomplished within the period and in the manner prescribed in subdivision (iii) of subparagraph (1) of this paragraph. Thus, excess business holdings of a private foundation attributable to an increase in the private foundation's proportionate share of the corporation's total outstanding stock by reason of a redemption of stock after May 26, 1969, from any person other than the private foundation do not give rise to an excess business holdings redemption need.

(4) For purposes of subdivision (ii) of subparagraph (1) of this paragraph, an excess business holdings redemption need can arise with respect to shares of the corporation's stock under section 537(a)(3) only following actual acquisition by the private foundation of such shares and their characterization as an excess business holding. Thus, this paragraph does not apply to an accumulation of earnings and profits in one taxable year in anticipation of redemption of excess business holdings to be acquired by a private foundation in a subsequent year pursuant to a will or irrevocable trust to which section 4943(c)(5) applies or in anticipation of shares held becoming excess business holdings of the private foundation in a subsequent year by reason of additional shares to be received by the private foundation in such subsequent year pursuant to a will or irrevocable trust to which section 4943(c)(5) applies. Once having arisen, however, an excess business holdings redemption need may continue until redemption of the private foundation's excess business holdings described in this paragraph or other disposition of such excess business holdings by the private foundation.

(5) Notwithstanding any other provision of this paragraph, an excess business holdings redemption need will not be deemed to exist with respect to stock held by a private foundation the redemption of which would subject any person to tax under section 4941.

(6) For purposes of subdivision (ii) of subparagraph (1) of this paragraph, the number of shares of stock held by a private foundation on May 26, 1969 (or received pursuant to a will or irrevocable trust to which section 4943(c)(5) applies), redemption of which alone would sufficiently reduce such foundation's proportionate share of a corporation's total outstanding stock in order for the foundation not to be liable for tax under section 4943 may be determined by application of the following formula:

$$X = \frac{PH - (Y \times SO)}{1 - Y}$$

X = Number of shares to be redeemed.

Y = Maximum percentage of outstanding stock which private foundation can hold without being liable for tax under section 4943.

PH = Number of shares of stock held by private foundation on May 26, 1969, or received pursuant to a will or irrevocable trust to which section 4943(c)(5) applies.

SO = Total number of shares of stock outstanding unreduced by any redemption from a person other than the private foundation.

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

Example. (i) On May 26, 1969, Private Foundation A holds 60 of the 100 outstanding shares of the capital stock of corporation X, which is not a disqualified person with respect to A. None of the remaining 40 shares is owned by a disqualified person within the meaning of section 4946(a). On June 1, 1975, X

redeems 10 shares of its stock from individual B, thus reducing its outstanding stock to 90 shares. On June 1, 1976, A receives 20 additional shares of X stock by bequest under a will to which section 4943(c)(5) applies. As of June 1, 1976, then, A holds 80 of the 90 outstanding shares of X. Solely for purposes of this example and to illustrate the application of this paragraph, it will be assumed that in order not to be liable for the initial tax under section 4943, A must, before the close of the *second phase* described in section 4943(c)(4)(D), reduce its proportionate stock interest in X to 35 percent. A requests X to redeem from it a sufficient number of its shares to so reduce its proportionate stock interest in X to 35 percent, and X agrees to effect such a redemption.

(ii) As of May 26, 1969, A's excess business holdings are 25 shares of X, the number of shares which A would be required to dispose of to a person other than X in order to reduce its proportionate holdings in X to no more than 35percent. If the disposition is to be by means of a redemption, however, A's excess business holdings on May 26, 1969, for purposes of determining X's excess business holdings redemption needs, are 39 shares, i.e., the number of shares X would be required to redeem in order to reduce A's proportionate stock interest to 35 percent. Although the redemption of 10 shares from B on June 1, 1975, creates additional excess business holdings of A because it effectively increases A's proportionate stock interest in X, this increase does not create an additional excess business holdings redemption need because it resulted from a redemption from a person other than A. The bequest of 20 shares of X received by A on June 1, 1976, creates a further excess business holdings redemption need as of that date in the amount needed (or reasonably anticipated to be needed) to redeem an additional 31 shares from A, *i.e.*, the number of shares which, when added to the excess business holdings of A on May 26, 1969, would have to be redeemed to reduce A's proportionate stock interest in X to 35 percent without taking the earlier redemption from B into account.

(e)(1) A determination whether and to what extent an amount is needed (or reasonably anticipated to be needed) for the purpose described in subparagraph (1) of paragraph (c) or (d) of this section is dependent upon the particular circumstances of the case, including the total amount of earnings and profits accumulated in prior years which may be available for such purpose and the existence of a reasonable expectation that a redemption described in paragraph (c) or (d) of this section will in fact be effected. Although paragraph (c) or (d) of this section may apply even though no redemption of stock is in fact effected, the failure to effect such redemption may be taken into account in determining whether the accumulation was needed (or reasonably anticipated to be needed) for a purpose described in paragraph (c) or (d).

(2) In applying subparagraph (1) of paragraph (c) or (d) of this section, the discharge of an obligation incurred to make a redemption shall be treated as the making of the redemption.

(3) In determining whether an accumulation is in excess of the reasonable needs of the business for a particular year, the fact that one of the exceptions specified in paragraph (c) or (d) of this section applies in a subsequent year is not to give rise to an inference that the accumulation would not have been for the reasonable needs of the business in the prior year. Also, no inference is to be drawn from the enactment of section 537(a) (2) and (3) that accumulations in any prior year would not have been for the reasonable needs of the business in the absence of such provisions. Thus, the reasonableness of accumulations in years prior to a year in which one of the exceptions specified in paragraph (c) or (d) of this section applies is to be determined solely upon the facts and circumstances existing at the times the accumulations occur.

(f) *Product liability loss reserves.* (1) The term *product liability loss reserve* means, with respect to taxable years beginning after September 30, 1979, reasonable amounts accumulated for the payment of reasonably anticipated product liability losses, as defined in section 172(j) and §1.172–13(b)(1).

(2) For purposes of this paragraph, whether an accumulation for anticipated product liability losses is reasonable in amount and whether such anticipated product liability losses are likely to occur shall be determined in light of all facts and circumstances of the taxpayer making such accumulation. Some of the factors to be considered in determining the reasonableness of the accumulation include the taxpayer's previous product liability experience, the extent of the taxpayer's

coverage by commercial product liability insurance, the income tax consequences of the taxpayer's ability to deduct product liability losses and related expenses, and the taxpayer's potential future liability due to defective products in light of the taxpayer's plans to expand the production of products currently being manufactured, provided such plans are specific, definite and feasible. Additionally, a factor to be considered in determining whether the accumulation is reasonable in amount is whether the taxpayer, in accounting for its potential future liability, took into account the reasonably estimated present value of the potential future liability.

(3) Only those accumulations made with respect to products that have been manufactured, leased, or sold shall be considered as accumulations made under this paragraph. Thus, for example, accumulations with respect to a product which has not progressed beyond the development stage are not reasonable accumulations under this paragraph.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7165, 37 FR 5022, Mar. 9, 1972, 37 FR 5703, Mar. 18, 1972; T.D. 7678, 44 FR 12416, Feb. 26, 1980; T.D. 8096, 51 FR 30483, Aug. 27, 1986]

§ 1.537–2 Grounds for accumulation of earnings and profits.

(a) *In general.* Whether a particular ground or grounds for the accumulation of earnings and profits indicate that the earnings and profits have been accumulated for the reasonable needs of the business or beyond such needs is dependent upon the particular circumstances of the case. Listed below in paragraphs (b) and (c) of this section are some of the grounds which may be used as guides under ordinary circumstances.

(b) *Reasonable accumulation of earnings and profits.* Although the following grounds are not exclusive, one or more of such grounds, if supported by sufficient facts, may indicate that the earnings and profits of a corporation are being accumulated for the reasonable needs of the business provided the general requirements under §§ 1.537–1 and 1.537–3 are satisfied:

(1) To provide for bona fide expansion of business or replacement of plant;

(2) To acquire a business enterprise through purchasing stock or assets;

(3) To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;

(4) To provide necessary working capital for the business, such as, for the procurement of inventories;

(5) To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation; or

(6) To provide for the payment of reasonably anticipated product liability losses, as defined in section 172(j), § 1.172–13(b)(1), and § 1.537–1(f).

(c) *Unreasonable accumulations of earnings and profits.* Although the following purposes are not exclusive, accumulations of earnings and profits to meet any one of such objectives may indicate that the earnings and profits of a corporation are being accumulated beyond the reasonable needs of the business:

(1) Loans to shareholders, or the expenditure of funds of the corporation for the personal benefit of the shareholders;

(2) Loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders, or to other persons;

(3) Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations;

(4) Investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation; or

(5) Retention of earnings and profits to provide against unrealistic hazards.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 8096, 51 FR 30484, Aug. 27, 1986]

§ 1.537–3 Business of the corporation.

(a) The business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake.

(b) If one corporation owns the stock of another corporation and, in effect, operates the other corporation, the business of the latter corporation may be considered in substance, although not in legal form, the business of the first corporation. However, investment by a corporation of its earnings and profits in stock and securities of another corporation is not, of itself, to be regarded as employment of the earnings and profits in its business. Earnings and profits of the first corporation put into the second corporation through the purchase of stock or securities or otherwise, may, if a subsidiary relationship is established, constitute employment of the earnings and profits in its own business. Thus, the business of one corporation may be regarded as including the business of another corporation if such other corporation is a mere instrumentality of the first corporation; that may be established by showing that the first corporation owns at least 80 percent of the voting stock of the second corporation. If the taxpayer's ownership of stock is less than 80 percent in the other corporation, the determination of whether the funds are employed in a business operated by the taxpayer will depend upon the particular circumstances of the case. Moreover, the business of one corporation does not include the business of another corporation if such other corporation is a personal holding company, an investment company, or a corporation not engaged in the active conduct of a trade or business.

PERSONAL HOLDING COMPANIES

§ 1.541–1 Imposition of tax.

(a) Section 541 imposes a graduated tax upon corporations classified as personal holding companies under section 542. This tax, if applicable, is in addition to the tax imposed upon corporations generally under section 11. Unless specifically excepted under section 542(c) the tax applies to domestic and foreign corporations and, to the extent provided by section 542(b), to an affiliated group of corporations filing a consolidated return. Corporations classified as personal holding companies are exempt brom the accumulated earnings tax imposed under section 531 but are not exempt from other income taxes imposed upon corporations, generally, under any other provisions of the Code. Unlike the accumulated earnings tax imposed under section 531, the personal holding company tax imposed by section 541 applies to all personal holding companies as defined in section 542, whether or not they were formed or availed of to avoid income tax upon shareholders. See section 6501(f) and § 301.6501(f)–1 of this chapter (Regulations on Procedure and Administration) with respect to the period of limitation on assessment of personal holding company tax upon failure to file a schedule of personal holding company income.

(b) A foreign corporation, whether resident or nonresident, which is classified as a personal holding company is subject to the tax imposed under section 541 with respect to its income from sources within the United States, even though such income is not fixed or determinable annual or periodical income specified in section 881. A foreign corporation is not classified as a personal holding company subject to tax under section 541 if it is a foreign personal holding company as defined in section 552 or if it meets the requirements of the exception provided in section 542(c)(10).

§ 1.542–1 General rule.

A personal holding company is any corporation (other than one specifically excepted under section 542(c)) which, for the taxable year, meets:

(a) The gross income requirement specified in section 542(a)(1) and § 1.542–2, and

(b) The stock ownership requirement specified in section 542(a)(2) and § 1.542–3

Both requirements must be satisfied with respect to each taxable year.

§ 1.542–2 Gross income requirement.

To meet the gross income requirement it is necessary that at least 80 percent of the total gross income of the

corporation for the taxable year be personal holding company income as defined in section 543 and §§ 1.543–1 and 1.543–2. For the definition of *gross income* see section 61 and §§ 1.61–1 through 1.61–14. Under such provisions gross income is not necessarily synonymous with gross receipts. Further, in the case of transactions in stocks and securities and in commodities transactions, gross income for personal holding company tax purposes shall include only the excess of gains over losses from such transactions. See section 543(b), paragraph (b) (5) and (6) of § 1.543–1 and § 1.543–2. For determining the character of the amount includible in gross income under section 951(a), see paragraph (a) of § 1.951–1.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6795, 30 FR 934, Jan. 29, 1965]

§ 1.542–3 Stock ownership requirement.

(a) *General rule.* To meet the stock ownership requirement, it is necessary that at some time during the last half of the taxable year more than 50 percent in value of the outstanding stock of the corporation be owned, directly or indirectly, by or for not more than 5 individuals. Any organization or trust to which subparagraph (1) of this paragraph applies shall be considered as one individual for purposes of this stock ownership requirement subject, however, to the exception in subparagraph (2) of this paragraph which is applicable only to taxable years beginning after December 31, 1954. Thus, if an organization or trust which is considered as an individual owns 51 percent in value of the outstanding stock of the corporation at any time during the last half of the taxable year, the stock ownership requirement will be met by ownership of the required percentage by one individual. See section 544 and §§ 1.544–1 through 1.544–7 for the determination of stock ownership.

(1) *An organization or trust considered as an individual.* Any of the following organizations or trusts shall be considered as an individual:

(i) An organization to which section 503 applies, namely, any organization described in section 501(c)(3) (relating to charitable, etc., organizations) or section 401(a) (relating to employees' pension trust, etc.) other than an organization excepted from the application of section 503 by paragraphs (1) to (5) of section 503(b). Therefore, a religious organization (other than a trust) excepted under section 503(b)(1) is not considered an individual for purposes of the stock ownership requirement of section 542(a)(2).

(ii) A portion of a trust permanently set aside or to be used exclusively for the purposes described in section 642(c), relating to amounts set aside for charitable purposes, or described in a corresponding provision of the prior income tax law (such as section 162(a), Internal Revenue Code of 1939).

(2) *Exception.* For taxable years beginning after December 31, 1954, an organization or trust to which subparagraph (1) of this paragraph applies shall not be considered an individual if all of the following conditions are met:

(i) It was organized or created before July 1, 1950.

(ii) At all times on or after July 1, 1950, and before the close of the taxable year, it owned all of the common stock and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(iii) For the taxable year it is not denied exemption under section 504(a) or the unlimited charitable deduction under section 681(c). In determining whether, for the purpose of section 542(a)(2), exemption is not denied under section 504(a) or the unlimited charitable deduction is not denied under section 681(c) all the income of the corporation which is available for distribution as dividends to its shareholders shall be deemed to have been distributed at the close of the taxable year whether or not any portion of such income was in fact distributed. If the amounts described in section 504(a) or section 681(c), increased by the income of the corporation deemed distributed pursuant to the preceding sentence, would be sufficient to deny exemption or the unlimited charitable deduction, the organization or trust will be considered to be an individual for the purpose of section 542(a)(2). For the purpose of this subdivision the restrictions in sections 504(a)(1) and

681(c)(1) against unreasonable accumulations will not apply to income attributable to property of a decedent dying before January 1, 1951, which was transferred during his lifetime to a trust or property that was transferred under his will to such trust, and

(iv) This subparagraph is illustrated by the following example:

Example. The X Charitable Foundation (an organization described in section 501(c)(3) to which section 503 is applicable) has owned all of the stock of the Y Corporation since Y's organization in 1949. Both X and Y are calendar-year corporations. At the end of the year 1955, X has accumulated $100,000 out of income and has actually paid out only $75,000 of this amount, leaving a balance of $25,000 on December 31, 1955. X was not denied an exemption under section 504(a) for the year 1955. Y, during the calendar year 1955, has $400,000 taxable income of which $200,000 is available for distribution as dividends at the end of the year. X will be considered to have accumulated out of income during the calendar year 1955 the amount of $225,000 for the purpose of determining whether it would have been denied an exemption under section 504(a)(1). If X would have been denied an exemption under section 504(a)(1) by reason of having been deemed to have accumulated $225,000, the stock ownership requirement of section 542(a)(2) and this section will have been satisfied. If Y Corporation also satisfies the gross income requirement of section 542(a)(1) and § 1.542–2 it will be a personal holding company.

(b) *Changes in stock outstanding*. It is necessary to consider any change in the stock outstanding during the last half of the taxable year, whether in the number of shares or classes of stock, or in the ownership thereof. Stock subscribed and paid for will be considered as stock outstanding, whether or not such stock is evidenced by issued certificates. Treasury stock shall not be considered as stock outstanding.

(c) *Value of stock outstanding*. The value of the stock outstanding shall be determined in the light of all the circumstances. The value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7713, June 17, 1964]

§ 1.542–4 Corporations filing consolidated returns.

(a) *General rule*. A consolidated return under section 1501 shall determine the application of the personal holding company tax to the group and to any member thereof on the basis of the consolidated gross income and consolidated personal holding company income of the group, as determined under the regulations prescribed pursuant to section 1502 (relating to consolidated returns); however, this rule shall not apply to either (1) an ineligible affiliated group as defined in section 542(b)(2) and paragraph (b) of this section, or (2) an affiliated group of corporations a member of which is excluded from the definition of a personal holding company under section 542(c) and paragraph (c) of this section. Thus, in the latter two instances the gross income requirement provided in section 542(a)(1) and § 1.542–2 shall apply to each individual member of the affiliated group of corporations.

(b) *Ineligible affiliated group*. (1) Except for certain affiliated railroad corporations, as provided in subparagraph (2) of this paragraph, an affiliated group of corporations is an ineligible affiliated group and therefore may not use its consolidated gross income and consolidated personal holding company income to determine the liability of the group or any member thereof for personal holding company tax (as provided in paragraph (a) of this section), if (i) any member of such group, including the common parent, derived gross income from sources outside the affiliated group for the taxable year in an amount equal to 10 percent or more of its gross income from all sources for that year and (ii) 80 percent or more of the gross income from sources outside the affiliated group consists of personal holding company income as defined in section 543 and §§ 1.543–1 and 1.543–2.

For purposes of subdivision (i) of this subparagraph gross income shall not include certain dividend income receivedby a common parent from a corporation not a member of the affiliated group which qualifies under section 542(b)(4) and paragraph (d) of this section. See particularly the examples contained in paragraph (d)(2) of this section. Intercorporate dividends received by members of the affiliated group (including the common parent) are to be included in the gross income from all sources for purposes of the test in subdivision (i) of this subparagraph. For purposes of subdivision (ii) of this subparagraph, section 543 and paragraph (a) of §1.543–1 shall be applied as if the amount of gross income derived from sources outside the affiliated group by a corporation which is a member of such group is the gross income of such corporation.

(2) An affiliated group of railroad corporations shall not be considered to be an ineligible affiliated group, notwithstanding any other provisions of section 542(b)(2) and this paragraph, if the common parent of such group would be eligible to file a consolidated return under section 141 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942 (56 Stat. 798).

(3) See section 562(d) and §1.562–3 for dividends paid deduction in the case of a distribution by a member of an ineligible affiliated group.

(4) The determination of whether an affiliated group of corporations is an ineligible group under section 542(b)(2) and this paragraph, may be illustrated by the following examples:

Example 1. Corporations X, Y, and Z constitute an affiliated group of corporations which files a consolidated return for the calendar year 1954; Corporations Y and Z are wholly-owned subsidiaries of Corporation X and derive no gross income from sources outside the affiliated group; Corporation X, the common parent, has gross income in the amount of $250,000 for the taxable year 1954. $200,000 of such gross income consists of dividends received from Corporations Y and Z. The remaining $50,000 was derived from sources outside the affiliated group, $40,000 of which represents personal holding company income as defined in section 543. The $50,000 included in the gross income of Corporation X and derived from sources outside the affiliated group is more than 10 percent of X's gross income ($50,000/$250,000) and the $40,000 which represents personal holding company income is 80 percent of $50,000 (the amount considered to be the gross income of Corporation X). Accordingly, Corporations X, Y, and Z would be an ineligible affiliated group and the gross income requirement under section 542(a)(1) and §1.542–2 would be applied to each corporation individually.

Example 2. If, in the above example, only $30,000 of the $50,000 derived from sources outside the affiliated group by Corporation X represented personal holding company income, this group of affiliated corporations would not be an ineligible affiliated group. Although the $50,000 representing the gross income of Corporation X from sources outside the affiliated group is more than 10 percent of its total gross income, the amount of $30,000 representing personal holding company income is not 80 percent or more of the amount considered to be gross income for the purpose of this test. Under section 542(b)(2) and subparagraph (1) of this paragraph both the gross income and the personal holding company income requirements must be satisfied in determining that an affiliated group constitutes an ineligible group. Since both of these requirements have not been satisfied in this example this group of affiliated corporations would not be an ineligible group.

(c) *Excluded corporations.* The general rule for determining liability of an affiliated group under paragraph (a) of this section shall not apply if any member thereof is a corporation which is excluded, under section 542(c), from the definition of a personal holding company.

(d) *Certain dividend income received by a common parent.* (1) Dividends received by the common parent of an affiliated group from a corporation which is not a member of the affiliated group shall not be included in gross income or personal holding company income, for the purpose of the test under section 542(b)(2):

(i) If such common parent owned, directly or indirectly, more than 50 percent of the outstanding voting stock of the dividend paying corporation at the time such common parent became entitled to the dividend, and

(ii) If the dividend paying corporation is not a personal holding company for the taxable year in which the dividends are paid

Thus, if the tests in subdivisions (i) and (ii) of this subparagraph are met, the

dividend income received by the common parent from such other corporation will not be considered gross income for purposes of the test in section 542(b)(2)(A) (paragraph (b) of this section), that is, either to determine gross income from sources outside the affiliated group or to determine gross income from all sources.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. Corporation X is the common parent of Corporation Y and Corporation Z and together they constitute an affiliated group which files a consolidated return under section 1501. Corporation Y and Corporation Z derived no income from sources outside the affiliated group. Corporation X, the common parent, had gross income of $100,000 for the calendar year 1954 of which amount $20,000 represented a dividend received from Corporation W, and $4,000 represented interest from Corporation T. The remaining gross income of X, $76,000, was received from Corporations Y and Z. Corporation X, for its entire taxable year, owned 60 percent of the voting stock of Corporation W which was not a personal holding company for the calendar year 1954. For the purpose of the gross income and personal holding company income test under section 542(b)(2) and paragraph (b) of this section, the $20,000 dividend received from Corporation W would not be included in the gross income or personal holding company income of Corporation X. The affiliated group would not be an ineligible group under section 542(b)(2) because 10 percent or more of its gross income was not from sources outside the affiliated group as required by section 542(b)(2)(A). Inasmuch as the $20,000 dividend from Corporation W is not included in the gross income of Corporation X for purposes of section 542(b)(2) Corporation X only has $4,000 gross income from sources outside the affiliated group which is only 5 percent of its gross income from all sources, $80,000.

Example 2. If, in example 1, Corporation X owned 50 percent or less of the voting stock of Corporation W at the time X became entitled to the dividend, or if Corporation W had been a personal holding company for the taxable year in which the dividends were paid, the $20,000 dividends received by Corporation X would be included in gross income and personal holding company income of Corporation X for the purpose of the test under section 542(b)(2) and paragraph (b) of this section. Thus, the affiliated group would be an ineligible affiliated group under section 542(b)(2) because 24 percent of its gross income was from sources outside the affiliated group ($24,000/$100,000) and 100 percent of this $24,000 was personal holding company income.

§ 1.543–1 Personal holding company income.

(a) *General rule.* The term *personal holding company income* means the portion of the gross income which consists of the classes of gross income described in paragraph (b) of this section. See section 543(b) and § 1.543–2 for special limitations on gross income and personal holding company income in cases of gains from stocks', securities', and commodities' transactions.

(b) *Definitions*—(1) *Dividends.* The term *dividends* includes dividends as defined in section 316 and amounts required to be included in gross income under section 551 and §§ 1.551–1—1.551–2 (relating to foreign personal holding company income taxed to United States shareholders).

(2) *Interest.* The term *interest* means any amounts, includible in gross income, received for the use of money loaned. However, (i) interest which constitutes *rent* shall not be classified as interest but shall be classified as *rents* (see subparagraph (10) of this paragraph) and (ii) interest on amounts set aside in a reserve fund under section 511 or 607 of the Merchant Marine Act, 1936 (46 U.S.C. 1161 or 1177), shall not be included in personal holding company income.

(3) *Royalties (other than mineral, oil, or gas royalties or certain copyright royalties).* The term *royalties* (other than mineral, oil, or gas royalties or certain copyright royalties) includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. It does not, however, include rents. For rules relating to rents see section 543(a)(7) and subparagraph (10) of this paragraph. For rules relating to mineral, oil, or gas royalties, see section 543(a)(8) and subparagraph (11) of this paragraph. For rules relating to certain copyright royalties for taxable years beginning after December 31, 1959, see section 543(a)(9) and subparagraph (12) of this paragraph.

(4) *Annuities.* The term *annuities* includes annuities only to the extent includible in the computation of gross income. See section 72 and §§ 1.72–1—1.72–14 for rules relating to the inclusion of annuities in gross income.

(5) *Gains from the sale or exchange of stock or securities.* (i) Except in the case of regular dealers in stock or securities as provided in subdivision (ii) of this subparagraph, gross income and personal holding company income include the amount by which the gains exceed the losses from the sale or exchange of stock or securities. See section 543(b)(1) and § 1.543–2 for provisions relating to this limitation. For this purpose, there shall be taken into account all those gains includible in gross income (including gains from liquidating dividends and other distributions from capital) and all those losses deductible from gross income which are considered under chapter 1 of the Code to be gains or losses from the sale or exchange of stock or securities. The term *stock or securities* as used in section 543(a)(2) and this subparagraph includes shares or certificates of stock, stock rights or warrants, or interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation by the Code), certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral property, or lease, collateral trust certificates, voting trust certificates, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, obligations issued by or on behalf of a State, Territory, or political subdivision thereof.

(ii) In the case of *regular dealers in stock or securities* there shall not be included gains or losses derived from the sale or exchange of stock or securities made in the normal course of business. The term *regular dealer in stock or securities* means a corporation with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers. However, such corporations shall not be considered as regular dealers with respect to stock or securities which are held for investment. See section 1236 and § 1.1236–1.

(6) *Gains from futures transactions in commodities.* Gross income and personal holding company income include the amount by which the gains exceed the losses from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. See § 1.543–2 for provisions relating to this limitation. In general, for the purpose of determining such excess, there are included all gains and losses on futures contracts which are speculative. However, for the purpose of determining such excess, there shall not be included gains or losses from cash transactions, or gains or losses by a producer, processor, merchant, or handler of the commodity, which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. See section 1233 and § 1.1233–1.

(7) *Estates and trusts.* Under section 543(a)(4) personal holding company income includes amounts includible in computing the taxable income of the corporation under part I, subchapter J, chapter 1 of the Code (relating to estates, trusts, and beneficiaries); and any gain derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(8) *Personal service contracts.* (i) Under section 543(a)(5) amounts received under a contract under which the corporation is to furnish personal services, as well as amounts received from the sale or other disposition of such contract, shall be included as personal holding company income if:

(*a*) Some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(*b*) At any time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services. For this purpose, the amount of stock outstanding

and its value shall be determined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of § 1.542–3. It should be noted that the stock ownership requirement of section 543(a)(5) and this subparagraph relates to the stock ownership at any time during the taxable year. For rules relating to the determination of stock ownership, see section 544 and §§ 1.544–1 through 1.544–7.

(ii) If the contract, in addition to requiring the performance of services by a 25-percent stockholder who is designated or who could be designated (as specified in section 543(a)(5) and subdivision (i) of this subparagraph), requires the performance of services by other persons which are important and essential, then only that portion of the amount received under such contract which is attributable to the personal services of the 25-percent stockholder shall constitute personal holding company income. Incidental personal services of other persons employed by the corporation to facilitate the performance of the services by the 25-percent stockholder, however, shall not constitute important or essential services. Under section 482 gross income, deductions, credits, or allowances between or among organizations, trades, or businesses may be allocated if it is determined that allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

(iii) The application of section 543(a)(5) and this subparagraph may be illustrated by the following examples:

Example 1. A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation. The M Corporation entered into a contract with A under which A was to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which A was to receive $10,000 a year from the M Corporation. The M Corporation entered into a contract with the O Corporation in which A was designated to perform personal services for the O Corporation in consideration of which the O Corporation was to pay the M Corporation $500,000 a year. The $500,000 received by the M Corporation from the O Corporation constitutes personal holding company income.

Example 2. Assume the same facts as in example 1, except that, in addition to A's contract with the M Corporation, B, whose profession is that of a dancer and C, whose profession is that of a singer, were also under contract to the M Corporation to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which they were each to receive $25,000 a year from the M Corporation. Neither B nor C were stockholders of the M Corporation. The contract entered into by the MCorporation with the O Corporation, in addition to designating that A was to perform personal services for the O Corporation, designated that B and C were also to perform personal services for the O Corporation. Although the O Corporation particularly desired the services of A for an entertainment program it planned, it also desired the services of B and C, who were prominent in their fields, to provide a good supporting cast for the program. The services of B and C required under the contract are determined to be important and essential; therefore, only that portion of the $500,000 received by the M Corporation which is attributable to the personal services of A constitutes personal holding company income. The same result would obtain although the dancer and the singer required by the contract were not designated by name but the contract gave the M Corporation discretion to select and provide the services of a singer and a dancer for the program and such services were provided.

Example 3. The N Corporation is engaged in engineering. Its entire outstanding capital stock is owned by four individuals. The N Corporation entered into a contract with the R Corporation to perform engineering services in consideration of which the R Corporation was to pay the N Corporation $50,000. The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N Corporation had the right to designate (by name or by description) such individual. The $50,000 received by the N Corporation from the R Corporation does not constitute personal holding company income.

(9) *Compensation for use of property.* Under section 543(a)(6) amounts received as compensation for the use of, or right to use, property of the corporation shall be included as personal holding company income if, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property. Thus, if a shareholder who meets the stock ownership requirement of section 543(a)(6) and this subparagraph uses, or has the right to use, a yacht, residence, or other property

owned by the corporation, the compensation to the corporation for such use, or right to use, the property constitutes personal holding company income. This is true even though the shareholder may acquire the use of, or the right to use, the property by means of a sublease or under any other arrangement involving parties other than the corporation and the shareholder. However, if the personal holding company income of the corporation (after excluding any such income described in section 543(a)(6) and this subparagraph, relating to compensation for use of property, and after excluding any such income described in section 543(a)(7) and subparagraph (10) of this paragraph, relating to rents) is not more than 10 percent of its grossincome, compensation for the use of property shall not constitute personalholding company income. For purposes of the preceding sentence, in determining whether personal holding company income is more than 10 percent of gross income, copyright royalties constitute personal holding company income, regardless of whether such copyright royalties are excluded from personal holding company income under section 543(a)(9) and subparagraph (12)(ii) of this paragraph. For purposes of applying section 543(a)(6) and this subparagraph, the amount of stock outstanding and its value shall be determined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of § 1.542–3. It should be noted that the stock ownership requirement of section 543(a)(6) and this subparagraph relates to the stock outstanding at any time during the entire taxable year. For rules relating to the determination of stock ownership, see section 544 and §§ 1.544–1 through 1.544–7.

(10) *Rents (including interest constituting rents)*. Rents which are to be included as personal holding company income consist of compensation (however designated) for the use, or right to use, property of the corporation. The term *rents* does not include amounts includible in personal holding company income under section 543(a)(6) and subparagraph (9) of this paragraph. The amounts considered as rents include charter fees, etc., for the use of, or the right to use, property, as well as interest on debts owed to the corporation (to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of the corporation's trade or business was sold or exchanged by the corporation). However, if the amount of the rents includible under section 543(a)(7) and this subparagraph constitutes 50 percent or more of the gross income of the corporation, such rents shall not be considered to be personal holding company income.

(11) *Mineral, oil, or gas royalties*. (i) The income from mineral, oil, or gas royalties is to be included as personal holding company income, unless (*a*) the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year and (*b*) the aggregate amount of deductions allowable under section 162 (other than compensation for personal services rendered by the shareholders of the corporation) equals 15 percent or more of the gross income of the corporation for the taxable year.

(ii) The term *mineral, oil, or gas royalties* means all royalties, including overriding royalties and, to the extent not treated as loans under section 636, mineral production payments, received from any interest in mineral, oil, or gas properties. The term *mineral* includes those minerals which are included within the meaning of the term *minerals* in the regulations under section 611.

(iii) The first sentence of subdivision (ii) of this subparagraph shall apply to overriding royalties received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid, and to mineral, oil, or gas production payments, only with respect to amounts received after September 30, 1958.

(12) *Copyright royalties*—(i) *In general*. The income from copyright royalties constitutes, generally, personal holding company income. However, for taxable years beginning after December 31, 1959, those copyright royalties which come within the definition of *copyright royalties* in section 543(a)(9) and subdivision (iv) of this subparagraph shall

be excluded from personal holding company income only if the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) *Exclusion from personal holding company income.* For taxable years beginning after December 31, 1959, copyright royalties (as defined in section 543(a)(9) and subdivision (iv) of this subparagraph) shall be excluded from personal holding company income only if the conditions set forth in (*a*), (*b*), and (*c*) of this subdivision are met.

(*a*) Such copyright royalties for the taxable year must constitute 50 percent or more of the corporation's gross income. For this purpose, copyright royalties shall be computed by excluding royalties received for the use of, or the right to use, copyrights or interests in copyrights in works created, in whole or in part, by any person who, at any time during the corporation's taxable year, is a shareholder.

(*b*) Personal holding company income for the taxable year must be 10 percent or less of the corporation's gross income. For this purpose, personal holding company income shall be computed by excluding (*1*) copyright royalties (except that there shall be included royalties received for the use of, or the right to use, copyrights or interests in copyrights in works created, in whole or in part, by any shareholder owning, at any time during the corporation's taxable year, more than 10 percent in value of the outstanding stock of the corporation), and (*2*) dividends from any corporation in which the taxpayer owns, on the date the taxpayer becomes entitled to the dividends, at least 50 percent of all classes of stock entitled to vote and at least 50 percent of the total value of all classes of stock, provided the corporation which pays the dividends meets the requirements of subparagraphs (A), (B), and (C) of section 543(a)(9).

(*c*) The aggregate amount of the deductions allowable under section 162 must constitute 50 percent or more of the corporation's gross income for the taxable year. For this purpose, the deductions allowable under section 162 shall be computed by excluding deductions for compensation for personal services rendered by, and deductions for copyright and other royalties to, shareholders of the corporation.

(iii) *Determination of stock value and stock ownership.* For purposes of section 543(a)(9) and this subparagraph, the following rules shall apply:

(*a*) The amount and value of the outstanding stock of a corporation shall be determined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of § 1.542–3.

(*b*) The ownership of stock shall be determined in accordance with the rules set forth in section 544 and §§ 1.544–1 through 1.544–7.

(*c*) Any person who is considered to own stock within the meaning of section 544 and §§ 1.544–1 through 1.544–7 shall be a shareholder.

(iv) *Copyright royalties defined.* For purposes of section 543(a)(9) and this subparagraph, the term *copyright royalties* means compensation, however designated, for the use of, or the right to use, copyrights in works protected by copyright issued under title 17 of the United States Code (other than by reason of section 2 or 6 thereof), and to which copyright protection is also extended by the laws of any foreign country as a result of any international treaty, convention, or agreement to which the United States is a signatory. Thus, *copyright royalties* includes not only royalties from sources within the United States under protection of United States laws relating to statutory copyrights but also royalties from sources within a foreign country with respect to United States statutory copyrights protected in such foreign country by any international treaty, convention, or agreement to which the United States is a signatory. The term *copyright royalties* includes compensation for the use of, or right to use, an interest in any such copyrighted works as well as payments from any person for performing rights in any such copyrighted works.

(v) *Compensation which is rent.* Section 543(a)(9) and subdivisions (i) through (iv) of this subparagraph shall not apply to compensation which is

rent within the meaning of the second sentence of section 543(a)(7).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7713, June 17, 1964; T.D. 7261, 38 FR 5467, Mar. 1, 1973]

§ 1.543–2 Limitation on gross income and personal holding company income in transactions involving stocks, securities, and commodities.

(a) Under section 543(b)(1) the gains which are to be included in gross income, and in personal holding company income with respect to transactions described in section 543(a)(2) and paragraph (b)(5) of § 1.543–1, shall be the net gains from the sale or exchange of stock or securities. If there is an excess of losses over gains from such transactions, such excess (or net loss) shall not be used to reduce gross income or personal holding company income for purposes of the personal holding company tax. Similarly, under section 543(b)(2) the gains which are to be included in gross income, and in personal holding company income with respect to transactions described in section 543(a)(3) and paragraph (b)(6) of § 1.543–1, shall be the net gains from commodity transactions which reflect personal holding company income. Any excess of losses over gains from such transactions (resulting in a net loss) shall not be used to reduce gross income or personal holding company income. The capital loss carryover under section 1212 shall not be taken into account.

(b) The application of section 543(b) may be illustrated by the following examples:

Example 1. The P Corporation, not a regular dealer in stocks and securities, received rentals of $250,000 for its property from a 25-percent shareholder, and also had gains of $50,000 during the taxable year from the sale of stocks and securities. It also had losses on the sale of stocks and securities in the amount of $30,000. Accordingly, P Corporation had gross income during the taxable year of $270,000 ($250,000 plus $20,000 net gain from the sales of stocks and securities). It had personal holding company income of $20,000. (The rentals of $250,000 would not be personal holding company income under section 543(a)(6) since the personal holding company income of the corporation, $20,000 (after excluding any such income described in section 543(a)(6)), is not more than 10 percent of its gross income.)

Example 2. The R Corporation, not a regular dealer in stocks or securities, realized total gains during the taxable year of $900,000 from commodity futures transactions and $200,000 from the sales of stocks and securities. It also sustained total losses of $1,000,000 on such commodity futures transactions, resulting in a net gain for the taxable year or $100,000. None of the commodity futures transactions are hedging or other types of futures transactions excluded from the application of section 543(a)(3). No part of the loss on commodity futures transactions is to be taken into account in determining personal holding company income and gross income for personal holding company tax purposes for the taxable year. The full amount of the $200,000 in gains from the sales of stocks and securities is to be included in personal holding company income and in gross income for personal holding company tax purposes for the taxable year.

§ 1.544–1 Constructive ownership.

(a) Rules relating to the constructive ownership of stock are provided by section 544 for the purpose of determining whether the stock ownership requirements of the following sections are satisfied:

(1) Section 542(a)(2), relating to ownership of stock by five or fewer individuals.

(2) Section 543(a)(5), relating to personal holding company income derived from personal service contracts.

(3) Section 543(a)(6), relating to personal holding company income derived from property used by shareholders.

(4) Section 543(a)(9), relating to personal holding company income derived from copyright royalties.

(b) Section 544 provides four general rules with respect to constructive ownership. These rules are:

(1) Constructive ownership by reason of indirect ownership. See section 544(a)(1) and § 1.544–2.

(2) Constructive ownership by reason of family and partnership ownership. See section 544(a) (2), (4), (5), and (6), and §§ 1.544–3, 1.544–6, and 1.544–7.

(3) Constructive ownership by reason of ownership of options. See section 544(a) (3), (4), (5), and (6), and §§ 1.544–4, 1.544–6, and 1.544–7.

(4) Constructive ownership by reason of ownership of convertible securities. See section 544(b) and § 1.544–5.

Each of the rules referred to in subparagraphs (2), (3), and (4) of this paragraph is applicable only if it has the effect of satisfying the stock ownership requirement of the section to which applicable; that is, when applied to section 542(a)(2), its effect is to make the corporation a personal holding company, or when applied to section 543(a)(5), section 543(a)(6), or section 543(a)(9), its effect is to make the amounts described in such provisions includible as personal holding company income.

(c) All forms and classes of stock, however denominated, which represent the interests of shareholders, members, or beneficiaries in the corporation shall be taken into consideration in applying the constructive ownership rules of section 544.

(d) For rules applicable in treating constructive ownership, determined by one application of section 544, as actual ownership for purposes of a second application of section 544, see section 544(a)(5) and § 1.544–6.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7715, June 17, 1964]

§ 1.544–2 Constructive ownership by reason of indirect ownership.

The following example illustrates the application of section 544(a)(1), relating to constructive ownership by reason of indirect ownership:

Example. A and B, two individuals, are the exclusive and equal beneficiaries of a trust or estate which owns the entire capital stock of the M Corporation. The M Corporation in turn owns the entire capital stock of the N Corporation. Under such circumstances the entire capital stock of both the M Corporation and the N Corporation shall be considered as being owned equally by A and B as the individuals owning the beneficial interest therein.

§ 1.544–3 Constructive ownership by reason of family and partnership ownership.

(a) The following example illustrates the application of section 544(a)(2), relating to constructive ownership by reason of family and partnership ownership.

Example. The M Corporation at some time during the last half of the taxable year, had 1,800 shares of outstanding stock, 450 of which were held by various individuals having no relationship to one another and none of whom were partners, and the remaining 1,350 were held by 51 shareholders as follows:

Relationships	Shares	Shares	Shares	Shares	Shares
An individual	(A)100	(B)20	(C)20	(D)20	(E)20
His father	(AF)10	(BF)10	(CF)10	(DF)10	(EF)10
His wife	(AW)10	(BW)40	(CW)40	(DW)40	(EW)40
His brother	(AB)10	(BB)10	(CB)10	(DB)10	(EB)10
His son	(AS)10	(BS)40	(CS)40	(DS)40	(ES)40
His daughter by former marriage (son's. half-sister)	(ASHS)10	(BSHS)40	(CSHS)40	(DSHS)40	(ESHS)40
His brother's wife	(ABW)10	(BBW)10	(CBW)10	(DBW)160	(EBW)10
His wife's father	(AWF)10	(BWF)10	(CWF)110	(DWF)10	(EWF)10
His wife's brother	(AWB)10	(BWB)10	(CWB)10	(DWB)10	(EWB)10
His wife's brother's wife	(AWBW)10	(BWBW)10	(CWBW)10	(DWBW)10	(EWBW)110
Individual's partner	(AP)10	.....	.....	.....	.....

By applying the statutory rule provided in section 544(a)(2) five individuals own more than 50 percent of the outstanding stock as follows:

A (including AF, AW, AB, AS, ASHS, AP)	160
B (including BF, BW, BB, BS, BSHS)	160
CW (including C, CS, CWF, CWB)	220
DB (including D, DF, DBW)	200
EWB (including EW, EWF, EWBW)	170
Total, or more than 50 percent	910

Individual A represents the obvious case where the head of the family owns the bulk of the family stock and naturally is the head of the group. A's partner owns 10 shares of the stock. Individual B represents the case where he is still head of the group because of the ownership of stock by his immediate family. Individuals C and D represent cases where the individuals fall in groups headed in C's case by his wife and in D's case by his brother because of the preponderance of holdings on the part of relatives by marriage. Individual E represents the case where the preponderant holdings of others eliminate that individual from the group.

(b) For the restriction on the applicability of the family and partnership ownership rules of this section, see paragraph (b) of § 1.544–1. For rules relating to constructive ownership as actual ownership, see § 1.544–6.

§ 1.544–4 Options.

The shares of stock which may be acquired by reason of an option shall be considered to be constructively owned by the individual having the option to acquire such stock. For example: If C, an individual, on March 1, 1955, purchases an option, or otherwise comes into possession of an option, to acquire 100 shares of the capital stock of M Corporation, such 100 shares of stock shall be considered to be constructively owned by C as if C had actually acquired the stock on that date. If C has an option on an option (or one of a series of options) to acquire such stock, he shall also be considered to have constructive ownership of the stock which may be acquired by reason of the option (or the series of options). Under such circumstances, C shall be considered to have acquired constructive ownership of the stock on the date he acquired his option. For the restriction on the applicability of the rule of this section, see paragraph (b) of § 1.544–1.

§ 1.544–5 Convertible securities.

Under section 544(b) outstanding securities of a corporation such as bonds, debentures, or other corporate obligations, convertible into stock of the corporation (whether or not convertible during the taxable year) shall be considered as outstanding stock of the corporation. The consideration of convertible securities as outstanding stock is subject to the exception that, if some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be considered as outstanding stock although the others are not so considered, but no convertible securities shall be considered as outstanding stock unless all outstanding securities having a prior conversion date are also so considered. For example, if outstanding securities are convertible in 1954, 1955 and 1956, those convertible in 1954 can be properly considered as outstanding stock without so considering those convertible in 1955 or 1956, and those convertible in 1954 and 1955 can be properly considered as outstanding stock without so considering those convertible in 1956. However, the securities convertible in 1955 could not be properly considered as outstanding stock without so considering those convertible in 1954 and the securities convertible in 1956 could not be properly considered as outstanding stock without so considering those convertible in 1954 and 1955. For the restriction on the applicability of the rule of this section, see paragraph (b) of § 1.544–1.

§ 1.544–6 Constructive ownership as actual ownership.

(a) *General rules.* (1) Stock constructively owned by a person by reason of the application of the rule provided in section 544(a)(1), relating to stock not owned by an individual, shall be considered as actually owned by such person for the purpose of again applying such rule or of applying the family and partnership rule provided in section 544(a)(2), in order to make another person the constructive owner of such stock, and

(2) Stock constructively owned by a person by reason of the application of the option rule provided in section 544(a)(3) shall be considered as actually owned by such person for the purpose of applying either the rule provided in section 544(a)(1), relating to stock not owned by an individual, or the family and partnership rule provided in section 544(a)(2) in order to make another person the constructive owner of such stock, but

(3) Stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 544(a)(2) shall not be considered as actually owned by such individual for the purpose of again applying such rule in order to make another individual the constructive owner of such stock.

(b) *Examples.* The application of this section may be illustrated by the following examples:

Example 1. A's wife, AW, owns all the stock of the M Corporation, which in turn owns all the stock of the O Corporation. The O Corporation in turn owns all the stock of the P

Corporation. Under the rule provided in section 544(a)(1), relating to stock not owned by an individual, the stock in the P Corporation owned by the O Corporation is considered to be owned constructively by the M Corporation, the sole shareholder of the O Corporation. Such constructive ownership of the stock of the M Corporation is considered as actual ownership for the purpose of again applying such rule in order to make AW, the sole shareholder of the M Corporation, the constructive owner of the stock of the P Corporation. Similarly, the constructive ownership of the stock by AW is considered as actual ownership for the purpose of applying the family and partnership rule provided in section 544(a)(2) in order to make A the constructive owner of the stock of the P Corporation, if such application is necessary for any of the purposes set forth in paragraph (b) of § 1.544–1. But the stock thus constructively owned by A may not be considered as actual ownership for the purpose of again applying the family and partnership rule in order to make another member of A's family, for example, A's father, the constructive owner of the stock of the P Corporation.

Example 2. B, an individual, owns all the stock of the R Corporation which has an option to acquire all the stock of the S Corporation, owned by C, an individual, who is not related to B. Under the option rule provided in section 544(a)(3) the R Corporation may be considered as owning constructively the stock of the S Corporation owned by C. Such constructive ownership of the stock by the R Corporation is considered as actual ownership for the purpose of applying the rule provided in section 544(a)(1), relating to stock not owned by an individual, in order to make B, the sole shareholder of the R Corporation, the constructive owner of the stock of the S Corporation. The stock thus constructively owned by B by reason of the application of the rule provided in section 544(a)(1) likewise is considered as actual ownership for the purpose, if necessary, of applying the family and partnership rule provided in section 544(a)(2), in order to make another member of B's family, for example, B's wife, BW, the constructive owner of the stock of the S Corporation. However, the family and partnership rule could not again be applied so as to make still another individual the constructive owner of the stock of the S Corporation, that is, the stock constructively owned by BW could not be considered as actually owned by her in order to make BW's father the constructive owner of such stock by a second application of the family and partnership rule.

§ 1.544–7 Option rule in lieu of family and partnership rule.

(a) If, in determining the ownership of stock, such stock may be considered as constructively owned by an individual by an application of either the family and partnership rule (section 544(a)(2)) or the option rule (section 544(a)(3)), such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

(b) The application of this section may be illustrated by the following example:

Example. Two brothers, A and B, each own 10 percent of the stock of the M Corporation, and A's wife, AW, also owns 10 percent of the stock of such corporation. AW's husband, A, has an option to acquire the stock owned by her at any time. It becomes necessary, for one of the purposes stated in section 544(a)(4), to determine the stock ownership of B in the M Corporation. If the family and partnership rule were the only rule that applied in the case, B would be considered, under that rule, as owning 20 percent of the stock of the M Corporation, namely, his own stock plus the stock owned by his brother. In that event, B could not be considered as owning the stock held by AW since (1) AW is not a member of B's family and (2) the constructive ownership of such stock by A through the application of the family and partnership rule in his case is not considered as actual ownership so as to make B the constructive owner by a second application of the same rule with respect to the ownership of the stock. However, there is more than the family and partnership rule involved in this example. As the holder of an option upon the stock, A may be considered the constructive owner of his wife's stock by the application of the option rule and without reference to the family relationship between A and AW. If A is considered as owning the stock of his wife by application of the option rule, then such constructive ownership by A is regarded as actual ownership for the purpose of applying the family and partnership rule so as to make another member of A's family, for example, B, the constructive owner of the stock. Hence, since A may be considered as owning his wife's stock by applying either the family-partnership rule or the option rule, the provisions of section 544(a)(6) apply and accordingly A must be considered the constructive owner of his wife's stock under the option rule rather than the family-partnership rule. B thus becomes the constructive owner of 30 percent of the stock of the M corporation, namely, his own 10 percent, A's 10 percent, and AW's 10 percent constructively owned by A as the holder of an option on the stock.

§ 1.545–1 Definition.

(a) Undistributed personal holding company income is the amount which is subject to the personal holding company tax imposed under section 541. Undistributed personal holding company income is the taxable income of the corporation adjusted in the manner described in section 545(b) and § 1.545–2, and section 545(c) and § 1.545–3, less the deduction for dividends paid. See part IV (section 561 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder, relating to the dividends paid deduction.

(b) For purposes of the imposition of the personal holding company tax on a foreign corporation, resident or nonresident, which files or causes to be filed a return, the undistributed personal holding company income shall be computed on the basis of the taxable income from sources within the United States, and such income shall be adjusted in accordance with the principles of section 545(b) and § 1.545–2, and section 545(c) and § 1.545–3. For purposes of the imposition of such tax on a foreign corporation, resident or nonresident, which files no return, the undistributed personal holding company income shall be computed on the basis of the gross income from sources within the United States without allowance of any deductions. For purposes of this paragraph, a nonresident foreign corporation will be considered to have filed a return for any taxable year ending before September 9, 1958, if the return for any such taxable year is filed on or before February 5, 1960.

[T.D. 6949, 33 FR 5525, Apr. 9, 1968]

§ 1.545–2 Adjustments to taxable income.

(a) *Taxes*—(1) *General rule.* (i) In computing undistributed personal holding company income for any taxable year, there shall be allowed as a deduction the amount by which Federal income and excess profits taxes accrued during the taxable year exceed the credit provided by section 33 (relating to taxes of foreign countries and possessions of the United States), and the income, war profits, and excess profits taxes of foreign countries and possessions of the United States accrued during the taxable year (to the extent provided by subparagraph (3) of this paragraph), except that no deduction shall be allowed for (*a*) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (*b*) the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (*c*) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939, for taxable years beginning after December 31, 1940. The deduction is for taxes for the taxable year, determined under the accrual method of accounting, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursement method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(ii) However, the taxpayer shall deduct taxes paid, rather than taxes accrued, if it used that method with respect to Federal taxes for each taxable year for which it was subject to the tax imposed by section 500 of the Internal Revenue Code of 1939, unless an election is made under subparagraph (2) of this paragraph to deduct taxes accrued.

(2) *Election by taxpayer which deducted taxes paid.* (i) If the corporation was subject to the personal holding company tax imposed by section 500 of the Internal Revenue Code of 1939 and, for the purpose of that tax, deducted Federal taxes paid rather than such taxes accrued for each taxable year for which it was subject to such taxes, the corporation may elect for any taxable year ending after June 30, 1954, to deduct taxes accrued, including taxes of foreign countries and possessions of the United States, rather than taxes paid, for the purposes of the tax imposed by section 541 of the Internal Revenue Code of 1954. The election shall be made by deducting such taxes accrued on Schedule PH, Form 1120, to be filed with the return. The schedule shall, in addition, contain a statement that the corporation has made such election and shall set forth the year to which such election was first applicable. The deduction of taxes accrued in the year of election precludes the deduction of

taxes paid during such year. The election, if made, shall be irrevocable and the deduction for taxes accrued shall be allowed for the year of election and for all subsequent taxable years.

(ii) Pursuant to section 7851(a)(1)(C), the election provided for in subdivision (i) of this subparagraph may be made with respect to a taxable year ending after June 30, 1954, even though such taxable year is subject to the Internal Revenue Code of 1939.

(3) *Taxes of foreign countries and United States possessions.* In determining undistributed personal holding company income for any taxable year, if the taxpayer chooses the benefits of section 901 for such taxable year, a deduction shall be allowed for:

(i) The income, war profits, and excess profits taxes imposed by foreign countries or possessions of the United States and accrued (or paid, if required under subparagraph (1)(ii) of this paragraph) during such taxable year, and

(ii) In the case of a domestic corporation, the foreign income taxes deemed to be paid for such taxable year under section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(a)(1) in accordance with § 1.960–7.

In no event shall the amount under subdivision (ii) of this subparagraph exceed the amount includible in gross income with respect to such taxes under section 78 and § 1.78–1. The credit for such taxes provided by section 901 shall not be allowed against the personal holding company tax imposed by section 541. See section 901(a).

(b) *Charitable contributions*—(1) *Taxable years beginning before January 1, 1970.* (i) Section 545(b)(2) provides that, in computing the deduction for charitable contributions for purposes of determining undistributed personal holding company income of a corporation for taxable years beginning before January 1, 1970, the limitations in section 170(b)(1) (A) and (B), relating to charitable contributions by individuals, shall apply and section 170(b) (2) and (5), relating to charitable contributions by corporations and carryover of certain excess charitable contributions made by individuals, respectively, shall not apply.

(ii) Although the limitations of section 170(b)(1) (A) and (B) are 10 and 20 percent, respectively, of the individual's adjusted gross income, the limitations are applied for purposes of section 545(b)(2) by using 10 and 20 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applied. Thus, the term *adjusted gross income* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in the first sentence of section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 545(b)(8), relating to expenses and depreciation applicable to property of the taxpayer. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(2) and, with respect to contributions paid in taxable years beginning after December 31, 1963, in section 170(b)(5), shall not be allowed as a deduction in computing undistributed personal holding company income for any taxable year.

(iii) See § 1.170–2 with respect to the charitable contributions to which the 10-percent limitation is applicable and the charitable contributions to which the 20-percent limitation is applicable.

(2) *Taxable years beginning after December 31, 1969.* (i) Section 545(b)(2) provides that, in computing the deduction allowable for charitable contributions for purposes of determining undistributed personal holding company income of a corporation for taxable years beginning after December 31, 1969, the limitations in section 170(b)(1) (A), (B), and (D)(i) (relating to charitable contributions by individuals) shall apply, and section 170(b)(1)(D)(ii) (relating to excess charitable contributions by individuals of certain capital gain property, section 170(b)(2) (relating to the 5-percent limitation on charitable contributions by corporations), and section 170(d) (relating to carryovers of excess contributions of individuals and corporations) shall not apply.

(ii) Although the limitations of section 170(b)(1) (A), (B), and (D)(i) are 50, 20, and 30 percent, respectively, of an individual's contribution base, these limitations are applied for purposes of section 545(b)(2) by using 50, 20, and 30 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applies. Thus, the term *contribution base* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 545(b)(8), relating to expenses and depreciation applicable to property of the taxpayer. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(1)(D)(ii) and (d), shall not be allowed as a deduction in computing undistributed personal holding company income for any taxable year.

(iii) See §1.170A–8 for the rules with respect to the charitable contributions to which the 50-, 20-, and 30-percent limitations apply.

(c) *Special deductions disallowed.* Part VIII, subchapter B, chapter 1 of the Code, allows corporations, in computing taxable income, special deductions for such matters as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, organizational expenses, etc. See section 241. Such special deductions, except the deduction provided by section 248 (relating to organizational expenses) shall be disallowed in computing undistributed personal holding company income.

(d) *Net operating loss.* The net operating loss deduction provided in section 172 is not allowed for purposes of the computation of undistributed personal holding company income. For purposes of such a computation, however, there is allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year, except that, in computing undistributed personal holding company income for a taxable year beginning after December 31, 1957, the amount of such net operating loss shall be computed without the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code.

(e) *Long-term capital gains.* (1) There is allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes attributable to such excess, as provided in section 545(b)(5).

(2) Section 631(c) (relating to gain or loss in the case of disposal of coal or domestic iron ore) shall have no application.

(f) *Bank affiliates.* There is allowed the deduction provided by section 601 in the case of bank affiliates (as defined in section 2 of the Banking Act of 1933; 12 U.S.C. 221a (c)).

(g) *Payment of indebtedness incurred prior to January 1, 1934*—(1) *General rule.* In computing undistributed personal holding company income, section 545(b)(7) provides that there shall be allowed as a deduction amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred before January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness. See §1.545–3 for the deduction in computing undistributed personal holding company income of amounts used or irrevocably set aside to pay or retire qualified indebtedness (as defined in paragraph (d) of §1.545–3).

(2) *Indebtedness.* The term *indebtedness* means an obligation absolute and not contingent, to pay on demand or within a given time, in cash or other medium, a fixed amount. The term *indebtedness* does not include the obligation of a corporation on its capital stock. The indebtedness must have been incurred (or, if incurred by assumption, assumed) by the taxpayer before January 1, 1934. An indebtedness evidenced by bonds, notes, or other obligations issued by a corporation is ordinarily incurred as of the date such obligations are issued and the amount

of such indebtedness is the amount represented by the face value of the obligations. In the case of refunding, renewal, or other change in the form of an indebtedness, the giving of a new promise to pay by the taxpayer will not have the effect of changing the date the indebtedness was incurred.

(3) *Amounts used or irrevocably set aside*. The deduction is allowable, in any taxable year, only for amounts used or irrevocably set aside in that year. The use or irrevocable setting aside must be to effect the extinguishment or discharge of indebtedness. In the case of refunding, renewal, or other change in the form of an indebtedness, the mere giving of a new promise to pay by the taxpayer will not result in an allowable deduction. If amounts are set aside in one year, no deduction is allowable for such amounts for a later year in which actually paid. As long as all other conditions are satisfied, the aggregate amount allowable as a deduction for any taxable year includes all amounts (from whatever source) used and all amounts (from whatever source) irrevocably set aside, irrespective of whether in cash or other medium. Double deductions shall not be allowed.

(4) *Reasonableness of the amounts with reference to the size and terms of the indebtedness*. (i) The reasonableness of the amounts used or irrevocably set aside must be determined by reference to the size and terms of the particular indebtedness. Hence, all the facts and circumstances with respect to the nature, scope, conditions, amount, maturity, and other terms of the particular indebtedness must be shown in each case.

(ii) Ordinarily an amount used to pay or retire an indebtedness, in whole or in part, at or prior to the maturity and in accordance with the terms thereof will be considered reasonable, and may be allowable as a deduction for the year in which so used. However, if an amount has been set aside in a prior year for payment or retirement of the same indebtedness, the amount so set aside shall not be allowed as a deduction in the year of the payment.

(iii) All amounts irrevocably set aside for the payment or retirement of an indebtedness in accordance with and pursuant to the terms of the obligation, for example, the annual contribution to trustees required by the provisions of a mandatory sinking fund agreement, will be considered as complying with the requirement of reasonableness. To be considered reasonable, it is not necessary that the plan of retirement provide for a retroactive setting aside of amounts for years prior to that in which the plan is adopted. However, if a voluntary plan was adopted before 1934, no adjustment is allowable in respect of the amounts set aside in the years prior to 1934.

(5) *Burden of proof*. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, the taxpayer must furnish the information required by the return, and such other information as the district director may require in substantiation of the deduction claimed.

(6) *Allowance to a successor corporation*. For allowance of deduction for pre-1934 indebtedness to a successor corporation, see section 381(c)(15).

(h) *Expenses and depreciation applicable to property of the taxpayer*. (1) In computing undistributed personal holding company income in the case of a personal holding company which owns or operates property, section 545(b)(8) provides a specific limitation with respect to the allowance of deductions for trade or business expenses and depreciation allocable to the operation or maintenance of such property. Under this limitation, these deductions shall not be allowed in an amount in excess of the aggregate amount of the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner:

(i) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(ii) That the property was held in the course of a business carried on bona fide for profit; and

(iii) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(2) The burden of proof will rest upon the taxpayer to sustain the deduction

claimed. If, in computing undistributed personal holding company income, a personal holding company claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, it shall attach to its income tax return a statement setting forth its claim for allowance of the additional deductions, together with a complete statement of the facts and circumstances pertinent to its claim and the arguments on which it relies. Such statement shall set forth:

(i) A description of the property;

(ii) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(iii) The name and address of the person from whom the property was acquired and the date the property was acquired;

(iv) The name and address of the person to whom the property is leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(v) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(vi) Evidence that the rent or other compensation was the highest obtainable or, if none was received, a statement of the reasons therefore;

(vii) A copy of the contract, lease or rental agreement;

(viii) The purpose for which the property was used;

(ix) The business, carried on by the corporation, with respect to which the property was held and the gross income, expenses, and taxable income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(x) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(xi) Any other information pertinent to the taxpayer's claim.

(i) *Amount of a lien in favor of the United States.* (1) If notices of lien are filed in the manner provided in section 6323(f), the amount of the liability to the United States outstanding at the close of the taxable year, and secured by such liens which are in effect at that time, shall be allowed as a deduction in computing undistributed personal holding company income. However, the amount of such deduction which may be allowed for any taxable year shall not exceed the taxable income (as adjusted for purposes of determining the undistributed personal holding company income, but without regard to the deduction under section 545(b)(9)) for such year. The fact that the amount of, or any part of, the outstanding obligation to the United States was deducted for one taxable year does not prevent its deduction for a subsequent taxable year to the extent the obligation is still outstanding at the close of the subsequent taxable year and is secured by a lien, notice of which has been filed.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. If the taxpayer (on the calendar year basis) is subject to a lien (notice of which has been properly filed) in the amount of $500,000 at the close of the calendar year 1954 and has taxable income of $400,000 for such taxable year, the deduction allowable by reason of the lien for the calendar year 1954 is $400,000. If, at the close of the taxable year ended December 31, 1955, the taxpayer is still subject to the same lien of $500,000 and it has taxable income of $450,000, a deduction is allowed by reason of such lien in the amount of $450,000.

(3) When the obligation secured by the lien in favor of the United States has been satisfied or released, the sum of the amounts which have been allowed as deductions under section 545(b)(9) in respect of such obligation shall be restored to taxable income for the year in which such lien is satisfied

or released. If only a part of the obligation secured by the lien has been satisfied, the sum of the amounts which have been allowed as deductions under section 545(b)(9) in respect of such part shall be included in taxable income for the year of the satisfaction for the purpose of determining undistributed personal holding company income. It should be noted, however, that only the sum of the amounts which have been allowed as deductions under section 545(b)(9) and subparagraph (1) of this paragraph shall be included in taxable income. Thus, any amounts which were allowed as deductions under section 504(e) of the Internal Revenue Code of 1939 shall not be included as taxable income for any taxable year under section 545(b)(9) and subparagraph (1) of this paragraph.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (2) of this paragraph, and assume further that the corporation has $100,000 taxable income both for 1956 (before including the $400,000 described below) and for 1957. In 1956, the corporation pays $200,000 of the obligation, thereby reducing its liability from $500,000 to $300,000. In such case, $400,000 is included in taxable income in computing its undistributed personal holding company income for 1956, that is, the sum of the $200,000 deduction for 1954 and the $200,000 deduction for 1955 in respect of the liability which is paid in 1956. In 1957, property of the corporation is discharged from the lien by reason of the fact that the value of the remaining property of the corporation exceeds double the outstanding liability. (See section 6325(b)(1).) Since this was not a release or satisfaction of the lien, no amount is added to taxable income for 1957 with respect to the property discharged from the lien. In 1958, the remaining property is released from the lien by reason of a bond being accepted under section 6325(a)(2). There is added to taxable income in computing undistributed personal holding company income for 1958, $850,000, that is, the sum of the deductions allowed for 1954, 1955, 1956, and 1957 in respect of the $300,000 liability, the lien for which was released in 1958. This amount of $850,000, is computed as follows:

Year	Outstanding liability	Taxable income	Deduction as limited by taxable income	Amount attributable to part payment of $200,000 in 1956	Amount attributable to release of lien in 1958
1954	$500,000	$400,000	$400,000	$200,000	$200,000
1955	500,000	450,000	450,000	200,000	250,000
1956	300,000	500,000	300,000	.....	300,000
1957	300,000	100,000	100,000	.....	100,000
Total	.....	.....	.....	.....	850,000

(5)(i) If an amount has been included in undistributed personal holding company income of the personal holding company by reason of section 545(b)(9), any shareholder of the company may elect to compute his income tax with respect to such of his dividends as are attributable to such amount as though such dividends were received ratably over the period the lien was in effect.

(ii) For purposes of section 545(b)(9), the dividends paid during the taxable year of the personal holding company (computed as of the close of such year) shall be deemed attributable first to undistributed personal holding company income by reason of section 545(b)(9) (computed as of the close of the taxable year of the personal holding company). If the period over which the lien was in effect consists of several taxable years of the personal holding company, the dividend deemed received for any taxable year shall be deemed received on the last day of such taxable year of the personal holding company.

(iii) Such election shall be made in a statement showing the amount of the deduction under section 545(b)(9) for each taxable year of the period in which the lien was in effect, the amount of such deduction, if any, which was added to undistributed personal holding company income in a later year or years as a result of partial satisfaction or release of such lien, and the details thereof, the taxable

year or years to which such dividends are allocable, and a computation of tax, on the basis of the election, for all taxable years affected by such ratable allocation of the dividends. Further, the statement shall show the district director's office in which the returns, for the years to which the dividends are allocable, were filed, the kind of returns which were filed (separate returns or joint returns), and the name and address under which the returns were filed. The statement shall be attached to the shareholder's return for the taxable year for which the dividend would be reported but for such election.

(iv) The operation of this subparagraph may be illustrated as follows: If, in the example under subparagraph (4) of this paragraph, shareholder A owns 75 percent in value of the outstanding stock of the personal holding company, and receives a dividend of $540,000 from such company during 1958 (the total dividend distribution being $720,000) he may elect to compute his income tax with respect to the $540,000 in dividends for 1958 as if he had received $127,058.82 of such dividends for 1954 ($200,000/850,000 of $540,000), $158,823.53 of such dividends for 1955 ($250,000/850,000 of $540,000), $190,588.23 of such dividends for 1956 ($300,000/850,000 of $540,000), and $63,529.41 of such dividends for 1957 ($100,000/850,000 of $540,000). Accordingly, the tax computed for 1958 with respect to such dividends shall be the aggregate of the taxes attributable to such amounts had they been distributed in the respective years.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6805, 30 FR 3209, Mar. 9, 1965; T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 6949, 33 FR 5526, Apr. 9, 1968; T.D. 7207, 37 FR 20796, Oct. 5, 1972; T.D. 7429, 41 FR 35492, Aug. 23, 1976; T.D. 7649, 44 FR 60086, Oct. 18, 1979]

§ 1.545–3 Special adjustment to taxable income.

(a) *In general.* In computing undistributed personal holding company income for any taxable year beginning after December 31, 1963, section 545(c)(1) provides that, except as otherwise provided in section 545(c), there shall be allowed as a deduction amounts used or amounts irrevocably set aside (to the extent reasonable with reference to the size and terms of the indebtedness) during such year to pay or retire qualified indebtedness (as defined in section 545(c)(3) and paragraph (d) of this section). The reasonableness of amounts irrevocably set aside shall be determined under the rules of paragraph (g)(4) of § 1.545–2.

(b) *Amounts used or irrevocably set aside*—(1) *In general.* The deduction is allowable, in any taxable year, only for amounts used or irrevocably set aside in that year to extinguish or discharge qualified indebtedness. If amounts are set aside in 1 year, no deduction is allowable for a later year in which such amounts are actually paid. As long as all other conditions are satisfied, the aggregate amount allowable as a deduction for any taxable year includes all amounts (from whatever source) used and all amounts (from whatever source) irrevocably set aside, irrespective of whether in cash or other medium. The same item shall not be deducted more than once.

(2) *Refunding, etc., of qualified indebtedness.* (i) A refunding, renewal or mere change in the form of a qualified indebtedness which does not involve a substantial change in the economic terms of the indebtedness will not result in an allowable deduction whether or not funds are obtained from such refunding, renewal, or change in form, and whether or not such funds are applied on the prior obligation, and will not constitute a reduction in the amount of such qualified indebtedness. For purposes of this section, if, in connection with a refunding, renewal, or other change in the form of an indebtedness, the rate of interest or principal amount of such debt, or the date when payment is due with respect to such debt or significantly changed, or if, after the refunding, renewal, or other change in the form of such debt, the creditor to whom such debt is owed is neither the creditor to whom such debt was owed before such refunding, renewal, or other change, nor a person standing in a relationship to such creditor described in section 267(b), then a substantial change in the economic terms of such indebtedness will normally have occurred.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. On December 31, 1963, M owes $10,000 to X represented by a 6-percent, 90-day note payable on January 31, 1964. On January 31, 1964, M renews the debt, giving X a new 6-percent, 90-day note (payable on Apr. 30, 1964) and paying the accrued interest on the old note. Since the date when payment is due has been significantly changed, a substantial change in the economic terms of the indebtedness has occurred.

Example 2. On December 31, 1963, S owes $5,000 to T represented by a 6-percent note payable on January 1, 1965. On December 23, 1964, S liquidates the note, giving T a new note for $5,000 due on January 2, 1965, and bearing interest at 6 percent. Since the transaction does not involve a substantial change in the economic terms of the indebtedness, the transaction will not result in an allowable deduction, and the amount of the qualified indebtedness will not be reduced.

Example 3. (i) On December 31, 1963, Q owes $45,000 to R represented by a demand note. On July 1, 1964, Q renews $30,000 of the indebtedness by issuing a new demand note to R and liquidates $15,000 of the debt. Since the principal amount of the debt has been significantly changed, there has been a substantial change in the economic terms of the indebtedness.

(ii) If Q had issued renewal notes for $44,000 and had paid only $1,000 of the total indebtedness, then a significant change in the principal amount of the debt would not have occurred and Q would have been entitled to only a $1,000 deduction (the amount actually paid during the taxable year). In addition, the amount of qualified indebtedness would have been reduced to $44,000.

(c) *Corporations to which applicable.* Section 545(c)(2) describes the corporations to which section 545(c) applies. In order to qualify under section 545(c)(2), the corporation must be one:

(1) Which for at least one of its two most recent taxable years ending before February 26, 1964, was not a personal holding company under section 542, but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such taxable year; or

(2) Which is an acquiring corporation treated as a corporation described in subparagraph (1) of this paragraph by reason of section 381(c)(15) (relating to the carryover of certain indebtedness in corporate acquisitions), but only to the extent of the qualified indebtedness to which it has succeeded under section 381(c)(15) and the indebtedness referred to in paragraph (d)(1)(ii) of this section incurred to replace qualified indebtedness to which it has succeeded under section 381(c)(15)

The law applicable for the first taxable year beginning after December 31, 1963, for purposes of this paragraph means part II (section 541 and following), subchapter G, chapter 1 of the Code as applicable to such year but does not include amendments to other parts of the Code first applicable with respect to such year. For an example of a corporation described in subparagraph (1) of this paragraph see paragraph (f)(1) of § 1.333–5.

(d) *Qualified indebtedness*—(1) *General definition.* Except as provided in subparagraphs (2), (3), and (4) of this paragraph the term *qualified indebtedness* means:

(i) The outstanding indebtedness (as defined in subparagraph (6) of this paragraph) incurred after December 31, 1933, and before January 1, 1964, by the taxpayer (or to which the taxpayer succeeded in a transaction to which section 381(c)(15) applies), and

(ii) The outstanding indebtedness (as defined in subparagraph (6) of this paragraph) incurred after December 31, 1963, by the taxpayer (or to which the taxpayer succeeded in a transaction to which section 381(c)(15) applies) for the purpose of making a payment or set-aside referred to in paragraph (a) of this section in the same taxable year of the debtor in which such indebtedness was incurred. An indebtedness shall be deemed not to have been incurred for the purpose of making a payment or set-aside referred to in paragraph (a) of this section when such indebtedness is a consequence of a refunding, renewal or mere change in the form of a qualified indebtedness which does not involve a substantial change in the economic terms of the qualified indebtedness. (See paragraph (b)(2) of this section for the meaning of *substantial change in the economic terms of the indebtedness.*) In the case of such a payment or set-aside which is made on or after the first day of the first taxable year beginning after December 31, 1963,

such indebtedness incurred after December 31, 1963, is treated as qualified indebtedness only to the extent that the deduction from taxable income otherwise allowed by section 545(c)(1) with respect to such payment or set-aside is treated as non-deductible by reason of the election referred to in paragraph (e) of this section.

(2) *Exception for indebtedness owed to certain shareholders.* For purposes of subparagraph (1) of this paragraph, qualified indebtedness does not include any amounts which were, at any time after December 31, 1963, and before the payment or set-aside to which this section applies, owed directly or indirectly to a person who at such time owned more than 10 percent in value of the taxpayer's outstanding stock. The rules of section 318(a) and the regulations thereunder apply for the purpose of determining ownership under this subparagraph. Amounts which cease to be qualified indebtedness by reason of this subparagraph may not subsequently become qualified indebtedness as a result of any change in the facts (for example, a subsequent sale of stock by the person to whom the amounts are directly or indirectly owed).

(3) *Reduction for amounts irrevocably set aside.* For purposes of subparagraph (1) of this paragraph, qualified indebtedness with respect to a particular contract is reduced when and to the extent that amounts are irrevocably set aside to pay or retire such indebtedness. An amount is not considered to be irrevocably set aside if any person could use such amount for any purpose other than the retirement of the qualified indebtedness with respect to which it was set aside. No deduction is allowed under section 545(c)(1) and this section for payments out of amounts previously set aside. Thus, for example, if a corporation, which is a June 30 fiscal year taxpayer, incurs indebtedness of $1 million on February 1, 1962, and, in accordance with its contract of indebtedness, irrevocably sets aside $50,000 in a sinking fund on February 1, of each of the years 1963, 1964, and 1965, then its qualified indebtedness on January 1, 1964, is $950,000 ($1 million less one set-aside of $50,000 in 1963). The corporation is not allowed a deduction under section 545(c)(1) for the set-aside of $50,000 made during its taxable year ending on June 30, 1964, since section 545(c) is applicable only to taxable years beginning after December 31, 1963, but the qualified indebtedness is nevertheless reduced by such amount. The corporation is allowed a deduction of $50,000 for its taxable year ending June 30, 1965, as a result of the set-aside made during such taxable year, and qualified indebtedness on July 1, 1965, is $850,000. No deduction is allowed to the corporation for a payment in any subsequent taxable year from the amounts so set aside.

(4) *Reduction on disposition of certain property.* (i) Section 545(c)(6) provides that the total amount of the taxpayer's qualified indebtedness (as determined under subdivision (ii) of this subparagraph) shall be reduced if property of a character subject to the allowance for exhaustion, wear and tear, obsolescence, amortization, or depletion is disposed of after December 31, 1963. The reduction is made pro rata (in accordance with subdivision (iii) of this subparagraph) for the taxable year of such disposition and is equal in total amount to the excess, if any, of:

(*a*) The adjusted basis of the property disposed of (determined under section 1011 and the regulations thereunder) immediately before such disposition; over

(*b*) The amount of qualified indebtedness which ceased to be qualified indebtedness with respect to the taxpayer by reason of the assumption of indebtedness by the transferee of the property disposed of (whether or not such indebtedness was incurred by the taxpayer in connection with the property disposed of).

For purposes of (*b*) of this subdivision, the transferee will be treated as having assumed qualified indebtedness if such transferee acquires real estate of which the taxpayer is the legal or equitable owner immediately before the transfer and which is subject to indebtedness that, with respect to the taxpayer, is qualified indebtedness immediately before the transfer, provided the taxpayer shows to the satisfaction of the Commissioner that under all the facts and circumstances it no longer bears the

burden of discharging such indebtedness.

(ii) The indebtedness reduced under the rule of this subparagraph is the qualified indebtedness which is outstanding with respect to the taxpayer immediately after the disposition referred to in subdivision (i) of this subparagraph.

(iii) The reduction with respect to any particular contract of indebtedness under the rules of this subparagraph shall be determined by multiplying the total reduction (determined under subdivision (i) of this subparagraph) by the ratio which the amount of the qualified indebtedness owed with respect to such contract by the taxpayer on the date referred to in subdivision (ii) of this subparagraph bears to the aggregate qualified indebtedness owed by the taxpayer with respect to all contracts on such date.

(5) *Total debt consisting of both qualified and nonqualified indebtedness.* In any case where, with respect to a particular contract of indebtedness, a part of the total indebtedness owed with respect to such contract is qualified indebtedness and the other part is indebtedness which is not qualified indebtedness, then, any amount paid or irrevocably set aside with respect to such contract shall be allocated between both such parts pro rata unless the taxpayer clearly indicates in its return the part of the payment or set-aside which shall be allocated to the qualified indebtedness.

(6) *Outstanding indebtedness.* For purposes of determining qualified indebtedness, the term *indebtedness* has the same meaning that it has under section 545(b)(7) and paragraph (g)(2) of § 1.545–2. Indebtedness ceases to be outstanding when the taxpayer no longer has an obligation absolute and not contingent with respect to the payment of such debt. An indebtedness evidenced by bonds, notes, or other obligations issued by a corporation is ordinarily incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. However, a refunding, renewal, or mere change in the form of an indebtedness which does not involve a substantial change in the economic terms of the indebtedness will not have the effect of changing the date the indebtedness was incurred. (See paragraph (b)(2) of this section for the meaning of *substantial change in the economic terms of the indebtedness.*) For purposes of this section, the outstanding indebtedness of a taxpayer includes a mortgage or other security interest on real estate of which such taxpayer is the legal or equitable owner (even though the taxpayer is not directly liable on the underlying evidence of indebtedness secured by such mortgage or security interest) provided such taxpayer shows to the satisfaction of the Commissioner that under all of the facts and circumstances it bears the burden of discharging such indebtedness. Thus, for example, if X acquires from Y property which is subject to a mortgage (X not assuming the indebtedness underlying such mortgage) and if X actually bears the burden of discharging the indebtedness, then, after the date of acquisition, such underlying indebtedness is outstanding indebtedness with respect to X, and, since Y's obligation to pay is in fact contingent upon X failing to discharge the indebtedness, such indebtedness is not outstanding indebtedness with respect to Y.

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

Example 1. M Corporation, a calendar year taxpayer has $600,000 of indebtedness outstanding on December 31, 1963 (which was incurred after 1933), represented by three demand notes. Individuals A and B (who are not shareholders) each hold one of M Corporation's notes in the amount of $150,000 and N Corporation (which is not a shareholder) holds M Corporation's note in the amount of $300,000. The note held by N Corporation is secured by a mortgage on certain depreciable real estate owned by M Corporation which has an adjusted basis to it on July 1, 1964, of $500,000. On July 1, 1964, M Corporation sells the depreciable real estate to O Corporation in consideration for $200,000 in cash and the assumption by O Corporation of the indebtedness on the note held by N Corporation. M Corporation borrows $200,000 on September 30, 1964, of which amount $150,000 is simultaneously applied to liquidate the note held by B. M Corporation's qualified indebtedness is reduced on July 1, 1964, by $300,000, the qualified indebtedness which ceased to be outstanding by reason of

the transfer. In addition, the reduction (computed under section 545(c)(6) and subparagraph (4) of this paragraph) of M Corporation's qualified indebtedness by reason of the disposition of depreciable property on July 1, 1964, is as follows:

Outstanding qualified indebtedness after reduction of qualified indebtedness which ceased to be outstanding by reason of the transfer but before the sec. 545(c)(6) reduction	$300,000
Reduced by:	
The excess of the adjusted basis of depreciable real estate disposed of on July 1, 1964 ($500,000), over the amount of qualified indebtedness assumed by O Corporation ($300,000)	200,000
Qualified indebtedness after reductions from transfer and assumption of indebtedness	100,000

The pro-rata share of the reduction with respect to each debt is computed as follows:

Note held by A:	
Qualified indebtedness owed by taxpayer on the note held by A before the disposition of depreciable property	$150,000
Less the pro-rata share of the total reduction computed under subparagraph (4) of this paragraph allocable to such note $200,000 × ($150,000 ÷ $300,000)	100,000
Qualified indebtedness owed on the note held by A after the transfer	50,000
Note held by B:	
Qualified indebtedness owed by taxpayer on the note held by B before the transfer of depreciable property	$150,000
Less the pro-rata share of the total reduction computed under subparagraph (4) of this paragraph allocable to such note $200,000 × ($150,000 ÷ $300,000)	100,000
Qualified indebtedness owed on the note held by B after the transfer	50,000

Of the $150,000 paid by M Corporation on September 30, 1964, to retire the note held by B only $50,000 qualified as a use of an amount to pay or retire qualified indebtedness and, thus, only $50,000 is allowable as a deduction for purposes of computing undistributed personal holding company income for 1964.

Example 2. The facts are the same as in example 1 except that M Corporation elects in accordance with paragraph (e) of this section not to deduct $25,000 of the $50,000 amount otherwise deductible. Then $25,000 of the $200,000 of new indebtedness incurred by M Corporation is qualified indebtedness. If the payment on the note held by B had not been made until January 1, 1965, then the new indebtedness would not be qualified indebtedness since the payment was not made in the taxable year in which the new indebtedness was incurred. If M Corporation pays $40,000 on April 1 and July 1, 1965, on the indebtedness incurred September 30, 1964, then (unless M indicates otherwise in its return for 1965 in accordance with subparagraph (5) of this paragraph) the payments made on such dates must be allocated between qualified and nonqualified indebtedness in the following manner:

	Qualfied	Non-qualified
April 1 payment:		
$40,000 × $25,000 (qualified) ÷ $200,000 (total indebtedness)	$5,000	
$40,000 × $175,000 (nonqualified) ÷ $200,000 (total indebtedness)		$35,000
July 1 payment:		
$40,000 × $20,000 (qualified) ÷ $160,000 (total indebtedness)	5,000	
$40,000 × $140,000 (nonqualified) ÷ $160,000 (total indebtedness)		35,000
Total	10,000	70,000

Thus, a total of $10,000 of the two payments would be considered used to pay or retire qualified indebtedness. The results in examples 1 and 2 would be the same if O Corporation purchased the real estate subject to the indebtedness (not assuming the indebtedness) on the note held by N Corporation, provided M Corporation does not bear the burden of discharging such indebtedness after July 1, 1964.

Example 3. C owns all of the 1000 shares of outstanding capital stock of P Corporation. On December 31, 1963, P Corporation, a calendar year taxpayer, owes $200,000 of outstanding indebtedness to D and$500,000 of outstanding indebtedness to E. These debts were incurred after 1933. On January 15, 1964, P Corporation pays $100,000 in partial liquidation of the $500,000 indebtedness. On March 15, 1964, P Corporation pays $50,000 into a sinking fund with respect to the $200,000 indebtedness owed to D. On April 15, 1964, D purchases one-half of the shares owned by C, constituting 50 percent in value of P Corporation's outstanding stock. P Corporation, on June 15, 1964, pays $50,000 into a sinking fund with respect to the indebtedness owed to D. For purposes of the March 15, 1964, set-aside, the indebtedness owed to D ($200,000) is qualified indebtedness. However, the indebtedness owed to D is not qualified indebtedness for purposes of the June set-aside with respect to such indebtedness since D is a person who after December 31, 1963, and before the June set-aside, owned more than 10 percent in value of P Corporation's outstanding stock. Moreover, any subsequent set-asides made with respect to the indebtedness owed to D will not be made with respect to qualified indebtedness even if the shares owned by D are subsequently sold. Assuming no payments or set-asides are made by P Corporation after June 15, 1964, the P Corporation is entitled to a deduction of $150,000 under section 545(c)(1) for the calendar year 1964 for amounts paid and for amounts irrevocably set aside to pay or retire qualified indebtedness, and the total qualified indebtedness at the end of 1964 is

$400,000. No additional deduction is allowed in subsequent taxable years for amounts paid out of the amounts set aside in 1964.

(e) *Election not to deduct*—(1) *In general.* Section 545(c)(4) provides that a taxpayer may elect to treat as nondeductible amounts otherwise deductible under section 545(c)(1) for the taxable year. The election shall be in the form of a statement of election filed on or before the 15th day of the third month following the close of the taxable year with respect to which the election applies. The election shall be irrevocable after such date.

(2) *Statement of election.* The statement of election referred to in subparagraph (1) of this paragraph shall be attached to the taxpayer's Schedule PH (Form 1120) for the year with respect to which such election applies, if such schedule is filed on or before the date referred to in subparagraph (1) of this paragraph. If the taxpayer's Schedule PH (Form 1120) is not filed on or before such date, then the statement of election shall clearly set forth the taxpayer's name, address, and employer identification number, shall be signed by an officer of the taxpayer who is authorized to sign a return of the taxpayer with respect to income, and shall be filed with the district director for the internal revenue district in which the taxpayer's income tax return (for the year with respect to which the election is applicable) would be filed. The following information shall be included in the statement of election:

(i) A statement that the taxpayer wishes to elect in accordance with section 545(c)(4);

(ii) The amounts paid or set aside which are to be treated as nondeductible under section 545(c)(4) and this section;

(iii) All information necessary to identify the qualified indebtedness with respect to which such amounts were paid or set aside;

(iv) The date on which such payments or set-asides were made; and

(v) All information necessary to identify the indebtedness (referred to in section 545(c)(3)(A)(ii) and paragraph (d)(1)(ii) of this section) incurred for the purpose of making the payments or set-asides which the taxpayer elects to treat as nondeductible, including:

(*a*) The date on which such indebtedness was incurred;

(*b*) The amount of such indebtedness;

(*c*) The person or persons to whom such indebtedness is owed; and

(*d*) A statement that such person or persons do not own more than 10 percent in value of the taxpayer's outstanding stock.

(f) *Limitation on deduction*—(1) *In general.* Section 545(c)(5) provides certain limitations on the deduction otherwise allowed by section 545(c)(1). Such deduction is reduced by the sum of the following amounts:

(i) The amount, if any, by which:

(*a*) The deductions allowed for the taxable year and all preceding taxable years beginning after December 31, 1963, for exhaustion, wear and tear, obsolescence, amortization, or depletion (other than such deductions which are disallowed in computing undistributed personal holding company income under the rule of paragraph (h) of § 1.545–2), exceed

(*b*) Any reduction, by reason of section 545(c)(5)(A) and this subdivision (i), of the deductions otherwise allowed by section 545(c)(1) for such preceding years; and

(ii) The amount, if any, by which:

(*a*) The deductions allowed under section 545(b)(5) (relating to long-term capital gain deduction) in computing undistributed personal holding company income for the taxable year and all preceding taxable years beginning after December 31, 1963, exceed

(*b*) Any reduction, by reason of section 545(c)(5)(B) and this subdivision (ii), of the deductions otherwise allowed by section 545(c)(1) for such preceding years.

(2) *Allocation of reduction.* If the total reduction required by subparagraph (1) of this paragraph is greater than the amount of the payment or set-aside made in respect of qualified indebtedness in a taxable year, then the portion of the reduction which is attributable to either section 545(c)(5)(A) or section 545(c)(5)(B), as the case may be, is that portion which bears the same ratio to the total reduction as the total reduction available under either section 545(c)(5)(A) or section 545(c)(5)(B), respectively, bears to the total reduction available under both such sections.

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

Example. (i) Q Corporation, a calendar year taxpayer, has qualified indebtedness of $400,000 on January 1, 1964, with respect to which payments of $50,000 are made on April 15, 1964, and 1965, and $300,000 on April 15, 1966. In the years 1964 and 1966, Q Corporation is allowed a deduction under section 545(b)(5) of $50,000 for the excess of its net long-term capital gain over its net short-term capital loss, minus the taxes attributable to such excess. Q Corporation is allowed a depreciation deduction of $50,000 for each of its taxable years 1964 through 1966. Q Corporation is a personal holding company with taxable income of $200,000 in each of the years 1964 and 1966.

(ii) For 1964, in computing undistributed personal holding company income, Q Corporation's taxable income is reduced by $50,000 by reason of the deduction under section 545(b)(5). No part of the depreciation deduction is disallowed under the rule of paragraph (h) of § 1.545–2. Q Corporation's deduction for payment of qualified indebtedness otherwise allowable under section 545(c)(1) and this section is reduced to zero by reason of the depreciation deduction and the capital gains deduction. The reduction by reason of section 545(c)(5)(A) and subparagraph (1)(i) of this paragraph (depreciation) is $25,000 [($50,000 ÷ $100,000) × $50,000], and the reduction by reason of section 545(c)(5)(B) and subparagraph (1) (ii) of this paragraph (capital gain) is $25,000 [($50,000 ÷ $100,000) × $50,000].

(iii) For 1966, Q Corporation is allowed a deduction for payment of qualified indebtedness of $100,000 computed as follows:

Amount paid in 1966 to retire qualified indebtedness			$300,000
Less the sum of:			
(*a*) Depreciation deductions allowed for 1964 through 1966 (3 × $50,000)	$150,000		
Reduction of deductions in preceding taxable years (1964)	25,000	$125,000	
(*b*) Deduction allowed under section 545(b)(5) (relating to long-term capital gains) for 1964 through 1966	100,000		
Reduction of deductions in preceding taxable years (1964)	25,000	75,000	200,000
Deduction after reduction			100,000

(iv) If, in the year 1966, Q Corporation's depreciation deduction had been limited for purposes of computing undistributed personal holding company income to $25,000 by reason of section 545(b)(8), then Q Corporation's deduction for payment of qualified indebtedness would be $125,000, computed as follows:

Amounts paid in 1966 to retire qualified indebtedness			$300,000
Less the sum of:			
(*a*) Depreciation deductions allowed for 1964 through 1966	$125,000		
Reduction of deductions in preceding taxable year (1964)	25,000		
	$100,000		
(*b*) Deduction allowed under section 545(b)(5) (relating to long-term capital gains) for 1964 through 1966	100,000		
Reduction of deductions in preceding taxable years (1964)	25,000	75,000	175,000
Deduction after reduction			125,000

(g) *Burden of proof*. The burden of proof rests upon the taxpayer to sustain the deduction claimed under this section. In addition to any information required by this section, the taxpayer must furnish the information required by the return, and such other information as the district director may require in substantiation of the deduction claimed.

(h) *Application of section 381(c)(15)*. Under section 381(c)(15), if an acquiring corporation assumes liability for qualified indebtedness in a transaction to which section 381(a) applies, then the acquiring corporation is considered to be the distributor or transferor corporation for purposes of section 545(c). Paragraph (c)(2) of this section reflects the application of section 381(c)(15) by including an acquiring corporation within the definition of corporation to which this section applies. Thus, the acquiring corporation is not required to meet the requirements of paragraph (c)(1) or paragraph (d)(1) of this section with respect to such acquired qualified indebtedness to which section 381(c)(15) is applicable. All the other provisions of this section apply in full to the acquiring corporation with respect to such acquired indebtedness.

[T.D. 6949, 33 FR 5526, Apr. 9, 1968; 33 FR 6091, Apr. 20, 1968]

§ 1.547–1 General rule.

Section 547 provides a method under which, by virtue of dividend distributions, a corporation may be relieved from the payment of a deficiency in the personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law), or may be entitled to a credit or refund of a part or all of any such deficiency which has been paid. The method provided by section 547 is to allow an additional deduction for a dividend distribution (which meets the requirements of this section) in computing undistributed personal holding company income for the taxable year for which a deficiency in personal holding company tax is determined. The additional deduction for deficiency dividends will not, however, be allowed for the purpose of determining interest, additional amounts, or assessable penalties, computed with respect to the personal holding company tax prior to the allowance of the additional deduction for deficiency dividends. Such amounts remain payable as if section 547 had not been enacted.

§ 1.547–2 Requirements for deficiency dividends.

(a) *In general.* There are certain requirements which must be fulfilled before a deduction is allowed for a deficiency dividend under section 547 and this section. These are:

(1) The taxpayer's liability for personal holding company tax shall be determined only in the manner provided in section 547(c) and paragraph (b)(1) of this section.

(2) The deficiency dividend shall be paid by the corporation on, or within 90 days after, the date of such determination and prior to the filing of a claim under section 547(e) and paragraph (b)(2) of this section for deduction for deficiency dividends. This claim must be filed within 120 days after such determination.

(3) The deficiency dividend must be of such a nature as would have permitted its inclusion in the computation of a deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if it had been distributed during such year. See section 562 and §§ 1.562–1 through 1.562–3. In this connection, it should be noted that under section 316(b)(2), the term *dividend* means (in addition to the usual meaning under section 316(a)) any distribution of property (whether or not a dividend as defined in section 316(a)) made by a corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 and §§ 1.545–1 and 1.545–2 without regard to section 316(b)(2)) for the taxable year in respect of which the distribution is made.

(b) *Special rules*—(1) *Nature and details of determination.* (i) A determination of a taxpayer's liability for personal holding company tax shall, for the purposes of section 547, be established in the manner specified in section 547(c) and this subparagraph.

(ii) The date of determination by a decision of the Tax Court of the United States is the date upon which such decision becomes final, as prescribed in section 7481.

(iii) The slate upon which a judgment of a court becomes final, which is the date of the determination in such cases, must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

(iv) The date of determination by a closing agreement, made under section 7121, is the date such agreement is approved by the Commissioner.

(v) A determination under section 547(c)(3) may be made by an agreement signed by the district director or such other official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall set forth the total amount of the liability for personal holding company tax for the taxable year or years. An agreement under this subdivision which is signed by the district director (or such other official to whom

authority to sign the agreement is delegated) on or after July 15, 1963, shall be sent to the taxpayer at his last known address by either registered or certified mail. For further guidance regarding the definition of last known address, see § 301.6212–2 of this chapter. If registered mail is used for such purpose, the date of registration shall be treated as the date of determination; if certified mail is used for such purpose, the date of the postmark on the sender's receipt for such mail shall be treated as the date of determination. However, if a dividend is paid by the corporation before such registration or postmark date but on or after the date such agreement is signed by the district director or such other official to whom authority to sign the agreement is delegated, the date of determination shall be such date of signing. The date of determination with respect to an agreement which is signed by the district director (or such other official to whom authority to sign the agreement is delegated) before July 15, 1963, shall be the date of the postmark on the cover envelope in which such agreement is sent by ordinary mail, except that if a dividend is paid by the corporation before such postmark date but on or after the date such agreement is signed by the district director or such other official to whom authority to sign the agreement is delegated, the date of determination shall be such date of signing.

(2) *Claim for deduction*—(i) *Contents of claim.* A claim for deduction for a deficiency dividend shall be made with the requisite declaration, on Form 976 and shall contain the following information:

(*a*) The name and address of the corporation;

(*b*) The place and date of incorporation;

(*c*) The amount of the deficiency determined with respect to the tax imposed by section 541 (or a corresponding provision of a prior income tax law) and the taxable year or years involved; the amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof; a statement as to how the deficiency was established, if unpaid; or if paid in whole or in part, how it was established that any portion of the amount paid was a deficiency at the time when paid and, in either case whether it was by an agreement under section 547(c)(3), by a closing agreement under section 7121, or by a decision of the Tax Court or court judgment and the date thereof; if established by a final judgment in a suit against the United States for refund, the date of payment of the deficiency, the date the claim for refund was filed, and the date the suit was brought; if established by a Tax Court decision or court judgment, a copy thereof shall be attached, together with an explanation of how the decision became final; if established by an agreement under section 547(c)(3), a copy of such agreement shall be attached;

(*d*) The amount and date of payment of the dividend with respect to which the claim for the deduction for deficiency dividends is filed;

(*e*) A statement setting forth the various classes of stock outstanding, the name and address of each shareholder, the class and number of shares held by each on the date of payment of the dividend with respect to which the claim is filed, and the amount of such dividend paid to each shareholder;

(*f*) The amount claimed as a deduction for deficiency dividends; and

(*g*) Such other information as may be required by the claim form.

(ii) *Filing of claim and corporate resolution.* The claim together with a certified copy of the resolution of the board of directors or other authority, authorizing the payment of the dividend with respect to which the claim is filed, shall be filed with the district director for the internal revenue district in which the return is filed.

(iii) *Carryover of deficiency dividends paid by acquiring corporation.* In the case of the acquisition of assets of a corporation by another corporation in a distribution or transfer described in section 381(a), the distributor or transferor corporation shall be entitled to a deduction for any deficiency dividends (as defined in section 547(d)) paid by the acquiring corporation with respect

to such distributor or transferor corporation. See section 381(c)(17).

(68A Stat. 192, 917; 26 U.S.C. 547(c), 7805)

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6657, 28 FR 5720, June 12, 1963; T.D. 7604, 44 FR 18661, Mar. 29, 1979; T.D. 8939, 66 FR 2819, Jan. 12, 2001]

§ 1.547–3 Claim for credit or refund.

(a) If a deficiency in personal holding company tax is asserted for any taxable year, and the corporation has paid any portion of such asserted deficiency, it is entitled to a credit or refund of such payment to the extent that such payment constitutes an overpayment as the result of a deduction for a deficiency dividend as provided in section 547 and §§ 1.547–1 through 1.547–7. It should be noted that a *determination* under section 547(c) and paragraph (b)(1) of § 1.547–2, of taxpayer's liability for personal holding company tax may take place subsequent to the time the deficiency was paid. To secure credit or refund of such overpayment, the taxpayer must file a claim on Form 843 in addition to the claim for the deduction for deficiency dividends required under section 547(e) and paragraph (b)(2) of § 1.547–2.

(b) No interest shall be allowed on such credit or refund.

(c) Such credit or refund will be allowed as if, on the date of the determination under section 547(c) and paragraph (b)(1) of § 1.547–2, two years remained before the expiration of the period of limitation on the filing of claim for refund for the taxable year to which the overpayment relates.

§ 1.547–4 Effect on dividends paid deduction.

The deficiency dividends deduction shall be allowed as of the date the claim is filed. No duplication of deductions with respect to any deficiency dividends is permitted. If a corporation claims and receives the benefit of the provisions of section 547 (or the corresponding section 506 of the Internal Revenue Code of 1939, or section 407 of the Revenue Act of 1938 (52 Stat. 447)), based upon a distribution of deficiency dividends, that distribution does not become a part of the dividends paid deduction under section 561. Likewise, it will not be made the basis of a dividends paid deduction under section 561 by reason of the application of section 563(b), relating to dividends paid after the close of the taxable year and on or before the 15th day of the third month following the close of such taxable year.

§ 1.547–5 Deduction denied in case of fraud or wilful failure to file timely return.

No deduction for deficiency dividends shall be allowed under section 547(a) if the determination contains a finding that any part of the deficiency is due to fraud with intent to evade tax, or to wilful failure to file an income tax return within the time prescribed by law or prescribed by the Secretary or his delegate in pursuance of law. See § 1.547–7 for effective date.

§ 1.547–6 Suspension of statute of limitations and stay of collection.

(a) *Statute of limitations.* If the corporation files a claim for a deduction for deficiency dividends under section 547(e) and paragraph (b)(2) of § 1.547–2, the running of the statute of limitations upon assessment, distraint, and collection in court in respect of the deficiency, and all interest, additional amounts, or assessable penalties, shall be suspended for a period of two years after the date of the determination under section 547(c) and paragraph (b)(1) of § 1.547–2.

(b) *Stay of collection.* If a deficiency in personal holding company tax is established by a determination under section 547(c) and paragraph (b)(1) of § 1.547–2, collection by distraint or court proceeding (except in case of jeopardy), of the deficiency and all interest, additional amounts, and assessable penalties, shall be stayed for a period of 120 days after the date of such determination, and, to the extent any part of such deficiency remains after deduction for deficiency dividends, for an additional period until the date the claim is disallowed. After such claim is allowed or rejected, either in whole or in part, the amount of the deficiency which was not eliminated by the application of section 547, together with interest, additional amounts and assessable penalties, will be assessed and collected in the usual manner.

§ 1.547–7 Effective date.

The deduction for deficiency dividends, in computing personal holding company tax for any taxable year, is allowable only with respect to determinations under section 547(c) made after November 14, 1954 (the date falling 90 days after the date of enactment of the Internal Revenue Code of 1954). If the taxable year with respect to which the deficiency is asserted began before January 1, 1954, the deficiency dividends deduction shall include only the amounts which would have been includible in the computation of the basic surtax credit for such taxable year under the Internal Revenue Code of 1939. Section 547(g), relating to the denial of a deficiency dividends deduction if the determination contains a finding that any part of the deficiency is due to fraud, etc., shall apply only if the taxable year with respect to which the deficiency is asserted begins after December 31, 1953.

FOREIGN PERSONAL HOLDING COMPANIES

§ 1.551–1 General rule.

Part III (section 551 and following), subchapter G, chapter 1 of the Code, does not impose a tax on foreign personal holding companies. The undistributed foreign personal holding company income of such companies, however, must be included in the manner and to the extent set forth in section 551, in the gross income of their *United States shareholders,* that is, the shareholders who are individual citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts other than estates or trusts the gross income of which under subtitle A of the Code includes only income from sources within the United States.

§ 1.551–2 Amount included in gross income.

(a) The undistributed foreign personal holding company income is included only in the gross income of the United States shareholders who were shareholders in the company on the last day of its taxable year on which a United States group (as defined in section 552(a)(2)) existed with respect to the company. Such United States shareholders, accordingly, are determined by the stock holdings as of such specified time. This rule applies to every United States shareholder who was a shareholder in the company at the specified time regardless of whether the United States shareholder is included within the United States group. For example, a domestic corporation which is a United States shareholder at the specified time must return its distributive share in the undistributed foreign personal holding company income even though the domestic corporation cannot be included within the United States group since, under section 554, the stock it owns in the foreign corporation is considered as being owned proportionately by its shareholders for the purpose of determining whether the foreign corporation is a foreign personal holding company.

(b) The United States shareholders must include in their gross income their distributive shares of that proportion of the undistributed foreign personal holding company income for the taxable year of the company which is equal in ratio to that which the portion of the taxable year up to and including the last day on which the United States group with respect to the company existed bears to the entire taxable year. Thus, if the last day in the taxable year on which the required United States group existed was also the end of the taxable year, the portion of the taxable year up to and incding such last day would be equal to 100 percent and, in such case, the United States shareholders would be required to return their distributive shares in the entire undistributed foreign personal holding company income. But if the last day on which the required United States group existed was September 30, and the taxable year was a calendar year, the portion of the taxable year up to and including such last day would be equal to nine-twelfths and, in that case, the United States shareholders would be required to return their distributive shares in only nine-twelfths of the undistributed foreign personal holding company income.

(c) The amount which each United States shareholder must return is that amount which he would have received

as a dividend if the above-specified portion of the undistributed foreign personal holding company income had in fact been distributed by the foreign personal holding company as a dividend on the last day of its taxable year on which the required United States group existed. Such amount is determined, therefore, by the interest of the United States shareholder in the foreign personal holding company, that is, by the number of shares of stock owned by the United States shareholder and the relative rights of his class of stock, if there are several classes of stock outstanding. Thus, if a foreign personal holding company has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the common shareholders, then the assumed distribution of the stated portion of the undistributed foreign personal holding company income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.

(d) The assumed distribution of the required portion of the undistributed foreign personal holding company income must be returned as dividend income by the United States shareholders for their respective taxable years in which or with which the taxable year of the foreign personal holding company ends. For example, if the M Corporation, whose taxable year is the calendar year, is a foreign personal holding company for 1954 and if A, one of its United States shareholders, makes returns on a calendar year basis, while B, another United States shareholder, makes returns on the basis of a fiscal year ending November 30, A must return his assumed dividend as income for the taxable year 1954 and B must return his distributive share as income for the fiscal year ending November 30, 1955. In applying this rule, the date as of which the United States group last existed with respect to the company is immaterial. Thus, in the foregoing example, if September 30, 1954, was the last day on which the United States group with respect to the M Corporation existed, B would still be required to return his assumed dividend as income for the fiscal year ending November 30, 1955, even though September 30, 1954, the date as of which the distribution is assumed to have been made, does not fall within such fiscal year.

(e) For the treatment of gain on the sale of certain stock, see section 306(f) and paragraph (h) of § 1.306–3.

§ 1.551–3 Deduction for obligations of the United States and its instrumentalities.

(a) Each United States shareholder required to return his distributive share of undistributed foreign personal holding company income for any taxable year shall take into account in computing the credit against tax under section 35, or the deduction under section 242, whichever is allowable to such shareholder, his proportionate share of whatever interest on obligations of the United States or its instrumentalities (as specified in sections 35 or 242, as the case may be) may be included in the gross income of the company for such taxable year, with the exception of any such interest as may be so included by reason of the application of the provisions of section 555. For reduction of credit for such interest on account of amortizable bond premium, see section 171 and the regulations thereunder.

(b) The rule set forth in paragraph (a) of this section may be illustrated by the following example:

Example. The M Corporation is a foreign personal holding company which owns all the stock of the N Corporation, another foreign personal holding company. Both companies receive interest on obligations of the United States or its instrumentalities as specified in section 35. In determining the amount of the credit allowable under section 35 (if the shareholder is an individual) or the deduction allowable under section 242 (if the shareholder is a corporation), the United States shareholder of the M Corporation would be entitled to a credit or a deduction, as the case may be, only for his proportionate share of the interest received by that Company and not for any part of the interest received by the N Corporation, regardless of whether the interest received by the N Corporation is included in the gross income of the M Corporation as an actual dividend or as a constructive dividend under section 555.

§ 1.551–4 Information in return.

The information required by section 551(d) in the returns of certain United States shareholders relates only to the taxable year of a foreign personal holding company for which any part of such corporation's undistributed foreign personal holding company income must be included in gross income by the United States shareholder of whom the information is required. The information shall be submitted as a part of the income tax return in the form of a statement attached to the return.

§ 1.551–5 Effect on capital account of foreign personal holding company and basis of stock in hands of shareholders.

(a) Sections 551(e) and 551(f) are designed to prevent double taxation with respect to the undistributed foreign personal holding company income.

(b) The application of sections 551(e) and 551(f) may be illustrated by the following examples:

Example 1. The M Corporation is a foreign personal holding company. Seventy-five percent in value of its capital stock is owned by A, a citizen of the United States, and the remainder, or 25 percent, of its stock is owned by B, a nonresident alien individual. For the calendar year 1954 the M Corporation has an undistributed foreign personal holding company income of $100,000. A is required to include $75,000 of such income in gross income as a dividend in his return for the calendar year 1954. The $100,000 is treated as paid-in surplus or as a contribution to the capital of the M Corporation and its accumulated earnings and profits as of the close of the calendar year 1954 are correspondingly reduced. If after treating such $100,000 as paid-in surplus or as a contribution to capital, the M Corporation has no accumulatedearnings and profits at the close of 1954, and if for the calendar year 1955, the M Corporation had no earnings and profits, but distributed $40,000, the amount so distributed would be a nontaxable distribution and would not be included in the gross income of either A or B for the calendar year 1955. If, however, after treating the $100,000 as paid-in surplus or as a contribution to capital, the M Corporation had accumulated earnings and profits of $100,000 at the close of 1954, the facts otherwise being the same, the distributions in 1955 would be taxable to A as a dividend, and the taxability of such distributions to B would depend upon the application of section 861(a)(2), relating to the treatment of dividends from a foreign corporation as income from sources within or without the United States.

Example 2. In example 1 assume the basis of A's stock to be $300,000. If A includes in gross income in his return for the calendar year 1954, $75,000 as a dividend from the M Corporation, the basis of his stock would be $375,000. After the nontaxable distribution of $30,000 to A by the M Corporation in 1955 (75 percent of the $40,000 distribution) the basis of A's stock, assuming no other changes, would be $345,000. If A failed to include the $75,000 as a dividend in gross income in his return for 1954 and his failure was not discovered until after the 6-year period of limitations had expired, the application of the rule would not increase the basis of A's stock. The subsequent nontaxable distribution of $30,000 to A in 1955 would reduce his basis of $300,000 to $270,000, thus tending to compensate for his failure to include the amount of $75,000 as a dividend in his gross income for 1954. If the undistributed foreign personal holding company income of the M Corporation is readjusted within the statutory period of limitations, thus increasing or decreasing the amount A would have to include in his gross income, proper adjustment is required to be made to the basis of A's stock on account of such readjustment.

§ 1.552–1 Definition of foreign personal holding company.

(a) A foreign personal holding company is any foreign corporation, other than a corporation exempt from taxation under subchapter F (section 501 and following), chapter 1 of the Code, and other than certain banking institutions which satisfy the requirements of section 552(b)(2) and paragraph (b) of § 1.552–4 which for the taxable year meets (1) the gross income requirement specified in section 552(a)(1); and (2) the stock ownership requirement specified in section 552(a)(2). Both requirements must be satisfied with respect to each taxable year.

(b) A foreign corporation which comes within the classification of a foreign personal holding company is not subject to taxation either under section 531 or section 541. See sections 532(b)(2) and 542(c)(5). The fact that a foreign corporation is a foreign personal holding company does not relieve the corporation from liability for the taxes imposed generally upon foreign corporations, such as the taxes imposed by sections 881 and 882, since such taxes apply regardless of the classification of the foreign corporation as a foreign personal holding company.

§ 1.552–2 Gross income requirement.

(a) To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year (including the additions to gross income provided in section 555(b) as required by section 555(c)(2)) be foreign personal holding company income as defined in section 553:

(1) 60 percent or more; or

(2) 50 percent or more if the foreign corporation has been classified as a foreign personal holding company for any taxable year ending after August 26, 1937, unless:

(i) A taxable year has intervened since the last taxable year for which it was so classified, during no part of which the stock ownership requirement specified in section 552(a)(2) exists; or

(ii) Three consecutive years have intervened since the last taxable year for which it was so classified, during each of which its foreign personal holding company income was less than 50 percent of its gross income.

(b) In determining whether the foreign personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For meaning of gross income in this part, see section 555 and § 1.555–1.

§ 1.552–3 Stock ownership requirement.

(a) To meet the stock ownership requirement, it is necessary that at some time in the taxable year more than 50 percent in value of the outstanding stock of the foreign corporation be owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, herein referred to as *United States group*. For the purpose of the requirement under section 552(a)(2), section 554 provides that the ownership of the stock must be determined under the rules prescribed by section 544 (relating to rules for determining stock ownership in the case of personal holding companies generally). Accordingly, section 544 and §§ 1.544–1 through 1.544–7 are applicable for purposes of section 552(a)(2) and this section as if each reference in section 544 and §§ 1.544–1 through 1.544–7 to a personal holding company or to part II (section 541 and following), subchapter G, chapter 1 of the Code, was a reference to a foreign personal holding company or to part III (section 551 and following), subchapter G, chapter 1 of the Code, as the case may be.

(b) It is necessary to consider any change in the stock outstanding during the taxable year, whether in the number of shares or classes of stock, or in the ownership thereof, since a corporation comes within the classification if the statutory conditions with respect to stock ownership are present at any time during the taxable year.

(c) In determining whether the statutory conditions with respect to stock ownership are present at any time during the taxable year, the phrase *in value* shall, in the light of all the circumstances, be deemed the value of the corporate stock outstanding at such time (not including treasury stock). This value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock which is used is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein.

§ 1.552–4 Certain excluded banks.

(a) A corporation is excluded from the definition of *foreign personal holding company* if it is organized and doing business under the banking and credit laws of a foreign country and if it establishes to the satisfaction of the Commissioner that it was not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed on its shareholders. If this is established,

the Commissioner, or such other official to whom authority may be delegated, will certify, by letter to the corporation, that it is not a foreign personal holding company.

(b) An application for certification under section 552(b)(2) shall be made in writing to the Commissioner of Internal Revenue, Washington DC 20225, Attention: Director of International Operations. A separate application shall be filed for each taxable year for which certification is requested, and the application shall be accompanied by a completed Form 958 for the taxable year. See section 6035. The following information shall be set forth in, or submitted with, the application:

(1) A complete reference to the banking or credit laws of the foreign country under which the corporation operates;

(2) A statement as to the extent of the corporation's business in receiving deposits and making loans and discounts and similar banking and credit operations;

(3) A statement as to the extent of the operations of the corporation other than such banking and credit operations;

(4) A statement as to whether the banking and credit operations of the corporation are customary for it;

(5) A statement setting forth the degree and manner of supervision exercised over it by the foreign government under its banking and credit laws; a copy (in English) of the corporation's last annual financial statement, as submitted to the Government authority having jurisdiction over it, shall be submitted with the application;

(6) A statement setting forth the business reasons of the corporation for not distributing the amount which would be its undistributed foreign personal holding company income if the corporation were not excluded under section 552(b);

(7) A statement setting forth the extent of the corporation's profits which must be retained as reserves under the foreign law;

(8) A statement setting forth the date or dates when the corporation reasonably expects to distribute is undistributed foreign personal holding company income for the taxable year;

(9) A statement setting forth the name and address of each of the individuals described in section 552(a)(2), the extent of their stock ownership in the corporation, and the amount of distributions or other payments to such stockholders, including, but not limited to, dividends, compensation, interest, and rents; and

(10) Any other facts or information the corporation may wish to submit to show that it was not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed on its shareholders

The corporation shall also furnish such other information requested as necessary by the Director of International Operations. The application for certification, together with the information required by this paragraph, should be filed within 60 days after the close of the taxable year of the corporation or before November 9, 1958, whichever is later. However, if the corporation is unable, for good cause, to submit the application for certification within such 60-day period, additional time may be granted by the Director of International Operations upon receipt of a request from the corporation setting forth the reasons for such request.

§ 1.552–5 United States shareholder of excluded bank.

A copy of the certification issued to an excluded bank under section 552(b)(2) and § 1.552–4 shall be filed with, and made a part of, the income tax return for the taxable year of each United States shareholder of such foreign corporation, if he has been a shareholder of such corporation for any part of such year. If the certificate has not been issued at the time the return of the United States shareholder is filed, the shareholder shall compute the tax on his return by treating the bank as a foreign personal holding company. If a certificate is issued after the return is filed, the United States shareholder may file a claim for refund or an amended return, and shall attach thereto a copy of the certification.

§ 1.553–1 Foreign personal holding company income.

Foreign personal holding company income shall consist of the items defined under section 543 and §§ 1.543–1 and 1.543–2, relating to personal holding company income, with the following exceptions:

(a) The entire amount received as *interest*, whether or not treated as rent, shall be considered to be foreign personal holding company income. Thus, the exception in the second sentence of section 543(a)(1) and paragraph (b)(2) of § 1.543–1 (relating to interest treated as rent under section 543(a)(7) and paragraph (b)(10) of § 1.543–1), is inapplicable for the purpose of determining foreign personal holding company income. Similarly, section 543(a)(7) and paragraph (b)(10) of § 1.543–1 are applied for this purpose without regard to the interest described in that section.

(b)(1) The entire amount received as *royalties*, whether or not mineral, oil, or gas royalties, or copyright royalties, shall be considered to be foreign personal holding company income. Thus, subparagraphs (A) and (B) of section 543(a)(8) and paragraph (b)(11)(i) (*a*) and (*b*) of § 1.543–1 (relating to mineral, oil, or gas royalties), and subparagraphs (A), (B), and (C) of section 543(a)(9) and paragraph (b) (12)(ii) of § 1.543–1 (relating to copyright royalties), are inapplicable for the purpose of determining foreign personal holding company income.

(2) In computing foreign personal holding company income, the first sentence of paragraph (b)(11)(ii) of § 1.543–1 shall apply to overriding royalties received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid, and to mineral, oil, or gas production payments, only with respect to amounts received after September 30, 1958.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7715, June 17, 1964]

§ 1.554–1 Stock ownership.

For regulations under section 554, see § 1.552–3.

§ 1.555–1 General rule.

The gross income of a foreign corporation which is a foreign personal holding company is computed the same as if the foreign corporation were a domestic corporation which is a personal holding company. See section 542(a)(1) and § 1.542–2. The gross income of a foreign personal holding company thus includes income from all sources, whether within or without the United States, which is not specifically excluded from gross income under any other provisions of the Code. For example, the gross income of a foreign personal holding company includes all income from sources outside the United States even though the foreign personal holding company is a foreign corporation not engaged in trade or business within the United States. However, the gross income of a foreign corporation which is a foreign personal holding company shall not include, with respect to a United States shareholder described in section 951(b), dividends received by such corporation which are excluded under section 959(b) from the income of such corporation with respect to such shareholder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6795, 30 FR 934, Jan. 29, 1965]

§ 1.555–2 Additions to gross income.

(a) If, for any taxable year:

(1) A foreign corporation meets the stock ownership requirement specified in section 552(a)(2) and § 1.552–3, regardless of whatever day in its taxable year is the last day on which the required United States group exists, and

(2) Such foreign corporation is a shareholder in a foreign personal holding company on any day of a taxable year of the second company which ends with or within the taxable year of the first company and such day is the last day in the taxable year of the second company in which the United States group exists with respect to the second company, then for the purpose of:

(i) Determining whether the first company meets the specified gross income requirement so as to come within the classification of a foreign personal holding company, and

(ii) Determining the undistributed foreign personal holding company income of the first company which (in the event the first company is a foreign personal holding company) is to be included, in whole or in part, in the gross income of its shareholders, whether United States shareholders or other foreign personal holding companies

there shall be included as a dividend in the gross income of the first company for the taxable year in which or with which the taxable year of the second company ends, the amount the first company would have received as a dividend, if on the last day referred to in this subparagraph there had been distributed by the second company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the second company for its taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year. The foregoing rules apply to any chain of foreign corporations regardless of the number of corporations included in the chain.

(b) The application of section 555(b) may be illustrated by the following examples:

Example 1. The X Corporation is a foreign corporation whose stock is owned by A, a United States citizen. The X Corporation owns the entire stock of the Y Corporation, another foreign corporation. The taxable year of the X Corporation is the calendar year and the taxable year of the Y Corporation is the fiscal year ending June 30. For the fiscal year ending June 30, 1955, more than the required percentage of the Y Corporation's gross income consists of foreign personal holding company income and no part of the earnings for such year is distributed as dividends. On the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1955. The X Corporation meets the stock ownership requirement and constitutes a foreign personal holding company for 1955, if it also meets the gross income requirement. For the purpose of determining whether the X Corporation meets the gross income requirements, the entire undistributed foreign personal holding company income of the Y Corporation for the fiscal year ending June 30, 1955, must be included as a dividend in the gross income of the X Corporation for 1955, since:

(1) The X Corporation was a shareholder in the Y Corporation on a day (June 30, 1955) in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation, which day was the last day in the taxable year of the Y Corporation on which the United States group required with respect to the Y Corporation existed,

(2) Such last day was also the end of the Y Corporation's taxable year so that the portion of the taxable year of the Y Corporation up to and including such last day is equal to 100 percent of the taxable year of the Y Corporation, and, therefore, the portion of the undistributed foreign personal holding company income of the Y Corporation includible in the gross income of its shareholders is likewise equal to 100 percent, and

(3) The X Corporation being the sole shareholder of the Y Corporation must include such portion in its gross income for 1955, the taxable year in which or with which the taxable year of the Y Corporation ends. If, after the inclusion of the presumptive dividend in its gross income, the X Corporation is a foreign personal holding company for 1955, then the undistributed foreign personal holding company income of the Y Corporation must also be included as a dividend in the gross income of the X Corporation in determining its undistributed foreign personal holding company income which is to be included in the gross income of A, the sole shareholder in the X Corporation. On the other hand, if, after including such presumptive dividend, the X Corporation does not constitute a foreign personal holding company, the undistributed foreign personal holding company income of the Y Corporation is not includible in the gross income of the X Corporation.

Example 2. The X Corporation referred to in example 1 sold the stock in the Y Corporation to other interests on September 30, 1955, so that after that date no United States group existed with respect to the Y Corporation. For the fiscal year ending June 30, 1956, more than the required percentage of the gross income of the Y Corporation consists of foreign personal holding company income. The taxable income of the Y Corporation for such fiscal year amounts to $1,000,000, of which $900,000 is distributed in dividends after September 30, 1955. The undistributed foreign personal holding company income of the Y Corporation for such fiscal year amounts to $100,000. Upon the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1956, since at one time in such fiscal year, or from July 1 to and including September 30, 1955, it meets the stock ownership requirement, and the gross income requirement is also satisfied. In determining whether the X Corporation constitutes a foreign personal holding company for 1956, a portion of the undistributed foreign personal holding company income of the Y Corporation for the fiscal year ending June 30, 1956 (three-

twelfths of $100,000, or $25,000), must be included as a dividend in the gross income of the X Corporation, since:

(1) The X Corporation was a shareholder in the Y Corporation on September 30, 1955, or on a day in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation which day was the last day in the Y Corporation's taxable year on which the United States group required with respect to the Y Corporation existed.

(2) The portion of the taxable year of the Y Corporation up to and including such day is three-twelfths of the entire taxable year of the Y Corporation and, therefore, the portion of the undistributed foreign personal holding company income of the Y Corporation includible in the gross income of its shareholders also is equal to three-twelfths, and

(3) The X Corporation, being the sole shareholder of the Y Corporation at the time the United States group with respect to the Y Corporation last existed, must include all of such portion in its gross income for 1956, the taxable year of the X Corporation in which or with which the taxable year of the Y Corporation ends

It is to be observed that three-twelfths of the undistributed foreign personal holding company income of the Y Corporation for the entire taxable year and not the earnings realized by the Y Corporation up to and including September 30, 1955, the last day on which the United States group with respect to the Y Corporation existed, must be included in the gross income of the X Corporation.

Example 3. The X Corporation referred to in example 1 sold the stock in the Y Corporation to other interests on September 30, 1955, so that after that date a different United States group existed with respect to the Y Corporation. Assuming that the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1956, no part of the undistributed foreign personal holding company income of the Y Corporation for such fiscal year would, in this instance, be includible in the gross income of the X Corporation for the year 1956, in determining whether the X Corporation is a foreign personal holding company for that year. In such case, the undistributed foreign personal holding company income of the Y Corporation is includible in the gross income of the other foreign personal holding companies, if any, and of the United States shareholders who are shareholders in the Y Corporation the day after September 30, 1955, which was the last day in the taxable year of the Y Corporation on which the United States group withrespect to the Y Corporation existed. If, however, the X Corporation sells 90percent of its stock in the Y Corporation and thus is a minority shareholder in the Y Corporation on the last day of the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation exists, the portion of the undistributed foreign personal holding company income allocable to the minority interests of the X Corporation would be includible in the gross income of the X Corporation, even though on such last day the United States group is not the same with respect to both corporations.

Example 4. If the Y Corporation in example 1 owns all of the stock of the Z Corporation, another foreign corporation, there would be a chain of three foreign corporations. In such case, assuming that the Z Corporation is a foreign personal holding company for a taxable year ending with or within the taxable year of the Y Corporation, the undistributed foreign personal holding company income of the Z Corporation would be included in the gross income of the Y Corporation for the purpose of determining whether the Y Corporation comes within the classification of a foreign personal holding company. If, after the inclusion of such presumptive dividend, the Y Corporation is a foreign personal holding company, the undistributed foreign personal holding company income of the Z Corporation would be included in the gross income of the Y Corporation in determining the undistributed foreign personal holding company income of the Y Corporationwhich is includible in the gross income of its shareholder, the X Corporation. The same process would be repeated with respect to determining whether the X Corporation is a foreign personal holding company and in determining its undistributed foreign personal holding company income. If all three corporations are foreign personal holding companies, the undistributed foreign personal holding company income of each would, in this manner, be reflected as a dividend in the gross income of A, the ultimate beneficial shareholder of the chain. In the event that after the inclusion of the undistributed foreign personal holding company income of the Z Corporation in the gross income of the Y Corporation, the Y Corporation is not a foreign personal holding company, then no part of the income of either the Z Corporation or the Y Corporation would be includible in the gross income of the X Corporation. In that event, whether the X Corporation is a foreign personal holding company, and its undistributed foreign personal holding company income, would be determined independently of the income of the Y Corporation and the Z Corporation.

§ 1.556–1 Definition.

Undistributed foreign personal holding company income is the amount which is to be included in the gross income of the United States shareholders

under section 551(b) and § 1.551–2. Undistributed foreign personal holding company income is the taxable income of the foreign personal holding company, as defined in section 63(a) (computed without regard to subchapter N, chapter 1 of the Code), and adjusted in the manner described in section 556(b) and § 1.556–2, less the deduction for dividends paid (§§ 1.561–1 through 1.565–6). See § 1.556–3 for an illustration of the computation of undistributed foreign personal holding company income.

§ 1.556–2 Adjustments to taxable income.

(a) *Taxes*—(1) *General rule.* (i) In computing undistributed foreign personal holding company income for any taxable year, there shall be allowed as a deduction the Federal income and excess profits taxes accrued during the taxable year except that no deduction shall be allowed for (*a*) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (*b*) the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (c) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940. The deduction is for taxes for the taxable year determined under the accrual method of accounting, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursements method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(ii) However, the corporation shall deduct taxes paid, rather than taxes accrued, if it used that method with respect to Federal taxes for each taxable year for which it was subject to the provisions of supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, unless an election is made under subparagraph (2) of this paragraph to deduct taxes accrued.

(2) *Election by corporation which deducted taxes paid.* (i) If the corporation was subject to supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, and, for the purpose of computing undistributed supplement P net income under such Code, deducted Federal taxes paid, rather than such taxes accrued, for each taxable year for which it was subject to supplement P of the 1939 Code, the corporation may elect for any taxable year ending after August 16, 1954, to deduct taxes accrued, rather than taxes paid, for the purpose of computing its undistributed foreign personal holding company income. The election shall be made by deducting such taxes accrued in the return (Form 958) required to be filed for such taxable year. The return shall, in addition, contain a statement that the corporation has made such election and shall set forth the year to which such election was first applicable. The deduction of taxes accrued in the year of election precludes the deduction of taxes paid during such year. The election, if made, shall be irrevocable and the deduction for taxes accrued shall be allowed for the year of election and for all subsequent taxable years. See section 6035 and the regulations thereunder for rules relative to the filing of returns of officers, directors, and shareholders of foreign personal holding companies.

(ii) Pursuant to section 7851(a)(1)(C), the election provided for in subdivision (i) of this subparagraph may be made with respect to a taxable year ending after August 16, 1954, even though such taxable year is subject to the Internal Revenue Code of 1939.

(3) *Taxes of foreign countries and United States possessions.* In computing taxable income, a foreign personal holding company is allowed a deduction under section 164 for income, war profits, and excess-profits taxes paid or accrued during the taxable year to foreign countries or possessions of the United States, but is not allowed the foreign tax credit under section 901. Therefore, in computing undistributed foreign personal holding company income for any taxable year, no adjustment under section 556(b)(1) is allowed for such taxes.

(b) *Charitable contributions*—(1) *Taxable years beginning before January 1, 1970.* (i) Section 556(b)(2) provides that, in computing the deduction for charitable contributions for purposes of determining the undistributed foreign

personal holding company income of a corporation for taxable years beginning before January 1, 1970, the limitations in section 170(b)(1)(A) and (B), relating to charitable contributions by individuals, shall apply and section 170(b)(2) and (5), relating to charitable contributions by corporations and carryover of certain excess charitable contributions made by individuals, respectively, shall not apply.

(ii) Although the limitations of section 170(b)(1)(A) and (B) are 10 and 20 percent, respectively, of the individual's adjusted gross income, the limitations are applied for purposes of section 556(b)(2) by using 10 and 20 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applied. Thus, the term *adjusted gross income* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in the first sentence of section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 556(b)(5), relating to expenses and depreciation applicable to property of the taxpayer, and section 556(b)(6), relating to taxes and contributions to pension trusts, and without the inclusion of the amounts includible as dividends under section 555(b), relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(2) and, with respect to contributions paid in taxable years beginning after December 31, 1963, in section 170(b)(5), shall not be allowed as a deduction in computing undistributed foreign personal holding company income for any taxable year.

(iii) See §1.170–2 with respect to the charitable contributions to which the 10-percent limitation is applicable and the charitable contributions to which the 20-percent limitation is applicable.

(2) *Taxable years beginning after December 31, 1969.* (i) Section 556(b)(2) provides that, in computing the deduction allowable for charitable contributions for purposes of determining the undistributed foreign personal holding company income of a corporation for taxable years beginning after December 31, 1969, the limitations in section 170(b)(1)(A), (B), and (D)(i) (relating to charitable contributions by individuals) shall apply, and section 170(b)(1)(D)(ii) (relating to excess charitable contributions by individuals of certain capital gain property), section 170(b)(2) (relating to the 5-percent limitation on charitable contributions by corporations), and section 170(d) (relating to carryovers of excess contributions of individuals and corporations) shall not apply.

(ii) Although the limitations of section 170(b)(1) (A), (B), and (D)(i) are 50, 20, and 30 percent, respectively, of an individual's contribution base, these limitations are applied for purposes of section 556(b)(2) by using 50, 20, and 30 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applies. Thus, the term *contribution base* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 556(b)(5), relating to expenses and depreciation applicable to property of the taxpayer, and section 556(b)(6), relating to taxes and contributions to pension trusts, and without the inclusion of the amounts includible as dividends under section 555(b), relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in

computing taxable income to the extent provided in section 170(b)(1) (D) (ii) and (d), shall not be allowed as a deduction in computing undistributed foreign personal holding company income for any taxable year.

(iii) See §1.170A–8 for the rules with respect to the charitable contributions to which the 50-, 20-, and 30-percent limitations apply.

(c) *Special deductions disallowed.* Part VIII, subchapter B, chapter 1 of the Code allows corporations special deductions in computing taxable income for such matters as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, organizational expenses, etc. See section 241. For purposes of computing undistributed foreign personal holding company income, such special deductions, except the deduction provided by section 248 (relating to organizational expenditures) and, with respect to such a computation for a taxable year ending before January 1, 1958, the deduction provided by section 242 (relating to partially tax-exempt interest), shall be disallowed.

(d) *Net operating loss.* The net operating loss deduction provided in section 172 is not allowed for purposes of the computation of undistributed foreign personal holding company income. For purposes of such a computation, however, there is allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year, except that, in computing undistributed foreign personal holding company income for a taxable year ending after December 31, 1957, the amount of such net operating loss shall be computed without the deductions provided in part VIII (section 241 and following) except section 248, relating to organizational expenditures, subchapter B, chapter 1 of the Code.

(e) *Expenses and depreciation applicable to property of the corporation.* (1) Section 556(b)(5) provides a specific limitation in computing undistributed foreign personal holding company income, with respect to the allowance of deductions for trade or business expenses and depreciation which are allocable to the operation and maintenance of property owned or operated by a foreign personal holding company. Under this limitation these deductions shall not be allowed in excess of the aggregate amount of the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner:

(i) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(ii) That the property was held in the course of a business carried on bona fide for profit; and

(iii) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(2) The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If a United States shareholder, in computing his distributive share of undistributed foreign personal holding company income to be included in gross income in his individual return (see section 551, and §§1.551–1 and 1.551–2), claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, he shall attach to his income tax return a statement setting forth his claim for allowance of the additional deductions, together with a complete statement of the facts and circumstances pertinent to his claim and the arguments on which he relies. Such statement shall set forth:

(i) A description of the property;

(ii) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(iii) The name and address of the person from whom the property was acquired and the date the property was acquired;

(iv) The name and address of the person to whom the property is leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(v) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(vi) Evidence that the rent or other compensation was the highest obtainable, or, if none was received, a statement of the reasons therefor;

(vii) In the case of a return for a taxable year beginning before January 1, 2003, a copy of the contract, lease, or rental agreement;

(viii) The purpose for which the property was used;

(ix) The business carried on by the corporation with respect to which the property was held and the gross income, expenses, and taxable income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(x) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(xi) Any other information pertinent to the taxpayer's claim.

(3) If the statement described in §1.556–2(e)(2) is attached to a taxpayer's income tax return for a taxable year beginning after December 31, 2002, a copy of the applicable contract, lease or rental agreement is not required to be submitted with the return, but must be retained by the taxpayer and kept available for inspection in the manner required by §1.6001–1(e).

(f) *Taxes and contributions to pension trusts.* Section 164(e) provides for deduction by a corporation for taxes of a shareholder paid by it; section 404 provides for deduction by an employer for its contributions to an employees' trust, etc. For the purpose of computing undistributed foreign personal holding company income, neither of these deductions is allowable.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7207, 37 FR 20796, Oct. 5, 1972; T.D. 9100, 68 FR 70704, Dec. 19, 2003; T.D. 9300, 71 FR 71042, Dec. 8, 2006]

§1.556–3 Illustration of computation of undistributed foreign personal holding company income.

The method of computation of the undistributed foreign personal holding company income may be illustrated by the following example:

Example. (a) The following facts exist with respect to the M Corporation, a foreign personal holding company, for the calendar year 1954:

(1) The gross income of the corporation as defined in section 555 amounts to $300,000, of which $85,000 represents its distributive share of the undistributed foreign personal holding company income of another foreign personal holding company in which it is a shareholder, $200,000 consists of dividends, $10,000 consists of fully taxable interest, and the remainder ($5,000) consists of rent received from the principal shareholder of the corporation for the use of property owned by the corporation.

(2) The expenses of the corporation amount to $85,000, of which $75,000 is allocable to the maintenance and operation of the property used by the principal shareholder and $10,000 consists of ordinary and necessary office expenses allowable as a deduction. The claim for deduction for the expenses of, and depreciation on, the rented property in excess of the rent received for its use is not established as provided in section 556(b)(5). The yearly depreciation on the rented property amounts to $30,000.

(3) Federal income tax withheld at the source on the income of the corporation from sources within the United States amounts to $59,125.

(4) No gain from the sale or exchange of stock or securities is realized during the taxable year, but losses in the amount of $10,000 are sustained from the sale of stock or securities which constitute capital assets. Such losses are not allowed as a deduction in any amount. See section 1211(a).

(5) Contributions, payment of which is made to or for the use of donees described in section 170(b)(1)(A) for the purposes therein specified, amount to $15,000, of which $5,000 is deductible in computing taxable income under section 63.

(6) Dividends paid by the corporation to its shareholders during the taxable year amount to $50,000.

(b) The taxable income of the corporation (including the distributive share of the undistributed foreign personal holding company income of the other foreign personal holding company) is $180,000, computed as follows (assuming for the purposes of this example only that the expenses of, and depreciation on, the rental property are deductible under sections 162 and 167):

Income (Section 61)	
Dividends	$200,000
Interest	10,000
Rent	5,000
Gross income as defined in section 61	215,000
Add:	
Distributive share of undistributed income of the other foreign personal holding company (considered as a dividend)	85,000
Gross income as defined in section 555	300,000
Deductions (Section 161)	
Expenses allocable to operation of the rented property	$75,000
Depreciation of the rented property	30,000
Ordinary and necessary expenses (office)	10,000
Contributions (within the 5-percent limitation specified in section 170(b) (2)	5,000
	120,000
Taxable income for purposes of computing undistributed foreign personal holding company income	180,000

(c) The undistributed foreign personal holding company income of the corporation is $160,875, computed as follows:

Taxable income for purposes of computing undistributed foreign personal holding company income	$180,000
Add (see section 556(b)):	
Contributions deductible in computing taxable income under section 63	5,000
Excess property expenses and depreciation over amount of rent received for use of property ($105,000 – $5,000)	100,000
Total	105,000
Deduct (see section 556(b)):	
Federal income taxes	59,125
Contributions (within the percentage limitations specified in section 170(b)(1) (A) and (B), determined under the rules provided in section 556(b)(2))	15,000
Total	74,125
Net additions under section 556(b)	30,875
Taxable income, as adjusted under section 556(b)	210,875
Less: Deduction for dividends paid (see section 561)	50,000
Undistributed foreign personal holding company income	160,875

DEDUCTION FOR DIVIDENDS PAID

§ 1.561–1 Deduction for dividends paid.

(a) The deduction for dividends paid is applicable in determining accumulated taxable income under section 535, undistributed personal holding company income under section 545, undistributed foreign personal holding company income under section 556, investment company taxable income under section 852, and real estate investment trust taxable income under section 857. The deduction for dividends paid includes:

(1) The dividends paid during the taxable year;

(2) The consent dividends for the taxable year, determined as provided in section 565; and

(3) In the case of a personal holding company, the dividend carryover computed as provided in section 564.

(b) For dividends for which the dividends paid deduction is allowable, see section 562 and § 1.562–1. As to when dividends are considered paid, see § 1.561–2.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4093, Apr. 28, 1962]

§ 1.561–2 When dividends are considered paid.

(a) *In general.* (1) A dividend will be considered as paid when it is received by the shareholder. A deduction for dividends paid during the taxable year will not be permitted unless the shareholder receives the dividend during the taxable year for which the deduction is claimed. See section 563 for special rule with respect to dividends paid after the close of the taxable year.

(2) If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mails, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by the shareholder within the taxable year, a presumption arises that the dividend was paid to the shareholder in such year.

(3) The payment of a dividend during the taxable year to the authorized agent of the shareholder will be

deemed payment of the dividend to the shareholder during such year.

(4) If a corporation, instead of paying the dividend directly to the shareholder, credits the account of the shareholder on the books of the corporation with the amount of the dividend, the deduction for a dividend paid will not be permitted unless it be shown to the satisfaction of the Commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year.

(5) A deduction will not be permitted for the amount of a dividend credited during the taxable year upon an obligation of the shareholder to the corporation unless it is shown to the satisfaction of the Commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year.

(6) If the dividend is payable in obligations of the corporation, they should be entered or registered in the taxable year on the books of the corporation, in the name of the shareholder (or his nominee or transferee), and, in the case of obligations payable to bearer, should be received in the taxable year by the shareholder (or his nominee or transferee) to constitute payment of the dividend within the taxable year.

(7) In the case of a dividend from which the tax has been deducted and withheld as required by chapter 3 (section 1441 and following), of the Code the dividend is considered as paid when such deducting and withholding occur.

(b) *Methods of accounting.* The determination of whether a dividend has been paid to the shareholder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books or upon the method of accounting upon the basis of which the taxable income of the corporation is computed.

(c) *Records.* Every corporation claiming a deduction for dividends paid shall keep such permanent records as are necessary (1) to establish that the dividends with respect to which such deduction is claimed were actually paid during the taxable year and (2) to supply the information required to be filed with the income tax return of the corporation. Such corporation shall file with its return (i) a copy of the dividend resolution; and (ii) a concise statement of the pertinent facts relating to the payment of the dividend, clearly specifying (*a*) the medium of payment and (*b*) if not paid in money, the fair market value and adjusted basis (or face value, if paid in its own obligations) on the date of distribution of the property distributed and the manner in which such fair market value and adjusted basis were determined. Canceled dividend checks and receipts obtained from shareholders acknowledging payment of dividends paid otherwise than by check need not be filed with the return but shall be kept by the corporation as a part of its records.

§ 1.562–1 Dividends for which the dividends paid deduction is allowable.

(a) *General rule.* Except as otherwise provided in section 562 (b) and (d), the term *dividend,* for purposes of determining dividends eligible for the dividends paid deduction, refers only to a dividend described in section 316 (relating to definition of dividends for purposes of corporate distributions). No distribution, however, which is preferential within the meaning of section 562(c) and § 1.562–2 shall be eligible for the dividends paid deduction. Moreover, when computing the dividends paid deduction with respect to a U.S. person (as defined in section 957(d)), no distribution which is excluded from the gross income of a foreign corporation under section 959(b) with respect to such person or from gross income of such person under section 959(a) shall be eligible for suchdeduction. Further, for purposes of the dividends paid deduction, the term *dividend* does not include a distribution in liquidation unless the distribution is treated as a dividend under section 316(b)(2) and paragraph (b)(2) of § 1.316–1, or under section 333(e)(1) and paragraph (c) of § 1.333–4 or paragraph (c)(2), (d)(1)(ii), or (d)(2) of § 1.333–5, or qualifies under section 562(b) and paragraph (b) of this section. If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the

time of the distribution. See paragraph (b)(2) of this section for special rules with respect to liquidating distributions by personal holding companies occurring during a taxable year of the distributing corporation beginning after December 31, 1963. Also see section 563 for special rules with respect to dividends paid after the close of the taxable year.

(b) *Distributions in liquidation*—(1) *General rule*—(i) *In general.* In the case of amounts distributed in liquidation by any corporation during a taxable year of such corporation beginning before January 1, 1964, or by a corporation other than a personal holding company (as defined in section 542) or a foreign personal holding company (as defined in section 552) during a taxable year of such a corporation beginning after December 31, 1963, section 562(b) makes an exception to the general rule that a deduction for dividends paid is permitted only with respect to dividends described in section 316. In order to qualify under that exception, the distribution must be one either in complete or partial liquidation of a corporation pursuant to sections 331, 332, or 333. See subparagraph (2) of this paragraph for rules relating to the treatment of distributions in complete liquidation made by a corporation which is a personal holding company to corporate shareholders during a taxable year of such distributing corporation beginning after December 31, 1963. As provided by section 346(a), for the purpose of section 562(b), a partial liquidation includes a redemption of stock to which section 302 applies. Amounts distributed in liquidation in a transaction which is preceded, or followed, by a transfer to another corporation of all or part of the assets of the liquidating corporation, may not be eligible for the dividends paid deduction.

(ii) *Amount of dividends paid deduction allowable—(a) General rule.* In the case of distributions in liquidation with respect to which a deduction for dividends paid is permissible under subdivision (i) of this subparagraph, the amount of the deduction is equal to the part of such distribution which is properly chargeable to the earnings and profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings and profits accumulated after February 28, 1913, there must be deducted from the amount of the distribution that part allocable to capital account. The capital account, for the purposes of this subdivision, includes not only amounts representing the par or stated value of the stock with respect to which the liquidation distribution is made, but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which, for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings and profits accumulated after February 28, 1913. Thus, if there is a deficit in earnings and profits on the first day of a taxable year, and the earnings and profits for such taxable year do not exceed such deficit, no dividends paid deduction would be allowed for such taxable year with respect to a distribution in liquidation; if the earnings and profits for such taxable year exceed the deficit in earnings and profits which existed on the first day of such taxable year, then a dividends paid deduction would be allowed to the extent of such excess.

(*b*) *Special rule.* Section 562(b)(1)(B) provides that in the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation the amount of the deduction is equal to the earnings and profits for each taxable year in which distributions are made. Thus, if there is a distribution in liquidation pursuant to section 333, or a distribution in complete liquidation pursuant to section 331(a)(1) or 332 which occurs within a 24-month period after the adoption of a plan of liquidation, a dividends paid deduction will be allowable to the extent of the current earnings and profits for the taxable year or years even though there was a deficit in earnings and profits on the first day of such taxable year or years. In computing the earnings and profits for the taxable year in

which the distributions are made, computation shall be made with the inclusion of capital gains and without any deduction for capital losses.

(*c*) *Examples*. The application of this subparagraph may be illustrated by the following examples:

Example 1. The Y Corporation, which makes its income tax returns on the calendar year basis, was organized on January 1, 1910, with an authorized and outstanding capital stock of 2,000 shares of common stock of a par value of $100 each and 1,000 shares of participating preferred stock of a par value of $100 each. The preferred stock was to receive annual dividends of $7 per share and $100 per share on complete liquidation of the corporation in priority to any payments on common stock, and was to participate equally with the common stock in either instance after the common stock had received a similar amount. However, the preferred stock was redeemable in whole or in part at the option of the board of directors at any time at $106 per share plus its proportion of the earnings of the company at the time of such redemption. In 1910 the preferred stock was issued at $106 per share, for a total of $106,000 and the common stock was issued, at $100 per share, for a total of $200,000. On July 15, 1954, the company had a paid-in surplus of $6,000, consisting of the premium received on the preferred stock; earnings and profits of $30,000 accumulated prior to March 1, 1913; and earnings and profits accumulated since February 28, 1913, of $75,000. On July15, 1954, the option with respect to the preferred stock was exercised and the entire amount of such stock was redeemed at $141 per share or a total of $141,000 in a transaction upon which gain or loss to the distributees resulting from the exchange was determined and recognized under section 302(a). The amount of the distribution allocable to capital account was $116,000 ($100,000 attributable to par value, $6,000 attributable to paid-in surplus, and $10,000 attributable to earnings and profits accumulated prior to March 1, 1913). The remainder, $25,000 ($141,000, the amount of the distribution, less $116,000, the amount allocable to capital account) is properly chargeable to the earnings and profits accumulated since February 28, 1913, and is deductible as dividends paid.

Example 2. The M Corporation, a calendar year taxpayer, is completely liquidated on November 1, 1955, pursuant to a plan of liquidation adopted April 1, 1955. On January 1, 1955, the M Corporation has a deficit in earnings and profits of $100,000. During the period January 1, 1955, to the date of liquidation, November 1, 1955, it has earnings and profits of $10,000. The M Corporation is entitled to a dividends paid deduction in the amount of $10,000 as a result of its distribution in complete liquidation on November 1, 1955.

Example 3. The N Corporation, a calendar year taxpayer, is completely liquidated on July 1, 1958, pursuant to a plan of liquidation adopted February 1, 1955. No distributions in liquidation were made pursuant to the plan of liquidation adopted February 1, 1955, until the distribution in complete liquidation on July 1, 1958. On January 1, 1958, N Corporation had a deficit in earnings and profits of $30,000. During the period January 1, 1958, to the date of liquidation, July 1, 1958, the N Corporation has earnings and profits of $5,000. The N Corporation is not entitled to any deduction for dividends paid as a result of the distribution in complete liquidation on July 1, 1958. If the earnings and profits for the period January 1, 1958, to July 1, 1958, had been $32,000, the N Corporation would have been entitled to a deduction for dividends paid in the amount of $2,000.

(2) *Special rule*—(i) *Distributions to corporate shareholders*. In the case of amounts distributed in complete liquidation of a personal holding company (as defined in section 542) within 24 months after the adoption of a plan of liquidation, section 562(b)(2) makes a further exception to the general rule that a deduction for dividends paid is permitted only with respect to dividends described in section 316. The exception referred to in the preceding sentence applies only to distributions made in any taxable year of the distributing corporation beginning after December 31, 1963. Under the exception, the amount of any distribution within the 24-month period pursuant to the plan shall be treated as a dividend for purposes of computing the dividends paid deduction, but:

(*a*) Only to the extent that such amount is distributed to corporate distributees, and

(*b*) Only to the extent that such amount represents such corporate distributees' allocable share of undistributed personal holding company income for the taxable year of such distribution (computed without regard to section 316(b)(2)(B) and section 562(b)(2))

Amounts distributed in liquidation in a transaction which is preceded, or followed, by a transfer to another corporation of all or part of the assets of the liquidating corporation, may not be eligible for the dividends paid deduction.

(ii) *Corporate distributees' allocable share.* For purposes of subdivision (i)(*b*) of this subparagraph:

(*a*) Except as provided in (*b*) of this subdivision, the corporate distributees' allocable share of undistributed personal holding company income for the taxable year of the distribution (computed without regard to sections 316(b)(2)(B) and 562(b)(2)) shall be determined by multiplying such undistributed personal holding company income by the ratio which the aggregate value of the stock held by all corporate shareholders immediately before the record date of the last liquidating distribution in such year bears to the total value of all stock outstanding on such date. For rules applicable in a case where the distributing corporation has more than one class of stock, see (*c*) of this subdivision (ii).

(*b*) If more than one liquidating distribution was made during the year, and if, after the record date of the first distribution but before the record date of the last distribution, there was a change in the relative shareholdings as between corporate shareholders and noncorporate shareholders, then the corporate distributees' allocable share of undistributed personal holding company income for the taxable year of the distributions (computed without regard to sections 316(b)(2)(B) and 562(b)(2)) shall be determined as follows:

(*1*) First, allocate the corporation's undistributed personal holding company income for the taxable year among the distributions made during such year by reference to the ratio which the aggregate amount of each distribution bears to the total amount of all distributions during such year;

(*2*) Second, determine the corporate distributees' allocable share of the corporation's undistributed personal holding company income for each distribution by multiplying the amount determined under (*1*) of this subdivision (*b*) for each distribution by the ratio which the aggregate value of the stock held by all corporate shareholders immediately before the record date of such distribution bears to the total value of all stock outstanding on such date; and

(*3*) Last, determine the sum of the corporate distributees' allocable share of the corporation's undistributed personal holding company income for all such distributions

For rules applicable in a case where the distributing corporation has more than one class of stock, see (*c*) of this subdivision (ii).

(*c*) Where the distributing corporation has more than one class of stock:

(*1*) The undistributed personal holding company income for the taxable year in which, or in respect of which, the distribution was made shall be treated as a fund from which dividends may properly be paid and shall be allocated between or among the classes of stock in a manner consistent with the dividend rights of such classes under local law and the pertinent governing instruments, such as, for example, the distributing corporation's articles or certificate of incorporation and bylaws;

(*2*) The corporate distributees' allocable share of the undistributed personal holding company income for each class of stock shall be determined separately in accordance with the rules set forth in (*a*) and (*b*) of this subdivision (ii) as if each class of stock were the only class of stock outstanding; and

(*3*) The sum of the corporate distributees' allocable share of the undistributed personal holding company income for the taxable year in which, or in respect of which, the distribution was made shall be the sum of the corporate distributees' allocable share of the undistributed personal holding company income for all classes of stock.

(*d*) For purposes of this subdivision (ii), in any case where the record date of a liquidating distribution cannot be ascertained, the record date of the distribution shall be the date on which the liquidating distribution was actually made.

(iii) *Example.* The application of this subparagraph may be illustrated by the following example:

Example. O Corporation, a calendar year taxpayer is completely liquidated on December 31, 1964, pursuant to a plan of liquidation adopted July 1, 1964. No distributions in liquidation were made pursuant to the plan of liquidation adopted July 1, 1964, until the distribution in complete liquidation on December 31, 1964. O Corporation has undistributed personal holding company income of

$300,000 for the year 1964 (computed without regard to section 316(b)(2)(B) and section 562(b)(2)). On December 31, 1964, immediately before the record date of the distribution in complete liquidation, P Corporation owns 100 shares of O Corporation's outstanding stock and individual A owns the remaining 200 shares. All shares are equal in value. The amount which represents P Corporation's allocable share of undistributed personal holding company income is $100,000(100 shares ÷ 300 shares × $300,000), and for purposes of computing the dividends paid deduction, such amount is treated as a dividend under section 562(b)(2) provided that the liquidating distribution to P Corporation equals or exceeds $100,000. P Corporation does not treat the $100,000 distributed to it as a dividend to which section 301 applies. For an example of the treatment of the distribution to individual A see example 5 of paragraph (e) of § 1.316–1.

(iv) *Distributions to noncorporate shareholders.* For the rules for determining the extent to which distributions in complete liquidation made to noncorporate shareholders by a personal holding company are dividends within the meaning of section 562(a), see section 316(b)(2)(B) and paragraph (b)(2) of § 1.316–1.

(c) *Special definition of dividend for nonliquidating distributions by personal holding companies.* Section 316(b)(2)(A) provides that in the case of a corporation which, under the law applicable to the taxable year in which or in respect of which a distribution is made, is a personal holding company, the term *dividend* (in addition to the general meaning set forth in section 316(a)) also means a nonliquidating distribution to its shareholders to the extent of the corporation's undistributed personal holding company income (determined under section 545 without regard to such distributions) for the taxable year in which or in respect of which the distribution is made. See paragraph (b)(1) of § 1.316–1.

[T.D. 6949, 33 FR 5529, Apr. 9, 1968, as amended by T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.562–2 Preferential dividends.

(a) Section 562(c) imposes a limitation upon the general rule that a corporation is entitled to a deduction for dividends paid with respect to all dividends which it actually pays during the taxable year. Before a corporation may be entitled to any such deduction with respect to a distribution regardless of the medium in which the distribution is made, every shareholder of the class of stock with respect to which the distribution is made must betreated the same as every other shareholder of that class, and no class of stock may be treated otherwise than in accordance with its dividend rights as a class. The limitation imposed by section 562(c) is unqualified, except in the case of an actual distribution made in connection with a consent distribution (see section 565), if the entire distribution composed of such actual distribution and consent distribution is not preferential. The existence of a preference is sufficient to prohibit the deduction regardless of the fact (1) that such preference is authorized by all the shareholders of the corporation or (2) that the part of the distribution received by the shareholder benefited by the preference is taxable to him as a dividend. A corporation will not be entitled to a deduction for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Nor will a corporation be entitled to a deduction for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock. A preference exists if any rights to preference inherent in any class of stock are violated. The disallowance, where any preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution. As used in this section, the term *distribution* includes a dividend as defined in subchapter C, chapter 1 of the Code, and a distribution in liquidation referred to in section 562(b).

(b) The application of the provisions of section 562(c) may be illustrated by the following examples:

Example 1. A, B, C, and D are the owners of all the shares of class A common stock in the M Corporation, which makes its income tax returns on a calendar year basis. With

the consent of all the shareholders, the M Corporation on July 15, 1954, declared a dividend of $5 a share payable in cash on August 1, 1954, to A. On September 15, 1954, it declared a dividend of $5 a share payable in cash on October 1, 1954, to B, C, and D. No allowance for dividends paid for the taxable year 1954 is permitted to the M Corporation with respect to any part of the dividends paid on August 1, 1954, and October 1, 1954.

Example 2. The N Corporation, which makes its income tax returns on the calendar year basis, has a capital of $100,000 (consisting of 1,000 shares of common stock of a par value of $100) and earnings or profits accumulated after February 28, 1913, in the amount of $50,000. In the year 1954, the N Corporation distributes $7,500 in cancellation of 50 shares of the stock owned by three of the four shareholders of the corporation. No deduction for dividends paid is permissible under section 562(c) and paragraph (a) of this section with respect to such distribution.

Example 3. The P Corporation has two classes of stock outstanding, 10 shares of cumulative preferred, owned by E, entitled to $5 per share and on which no dividends have been paid for two years, and 10 shares of common, owned by F. On December 31, 1954, the corporation distributes a dividend of $125, $50 to E, and $75 to F. The corporation is entitled to no deduction for any part of such dividend paid, since there has been a preference to F. If, however, the corporation had distributed $100 to E and $25 to F, it would have been entitled to include $125 as a dividend paid deduction.

§ 1.562–3 Distributions by a member of an affiliated group.

A personal holding company which files or is required to file a consolidated return with other members of an affiliated group may be required to file a separate personal holding company schedule by reason of the limitations and exceptions provided in section 542(b) and § 1.542–4. Section 562(d) provides that in such case the dividends paid deduction shall be allowed to the personal holding company, with respect to a distribution made to any member of the affiliated group, if such distribution would constitute a dividend if it were made to a shareholder which is not a member of the affiliated group.

§ 1.563–1 Accumulated earnings tax.

In the determination of the dividends paid deduction for purposes of the accumulated earnings tax imposed by section 531, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall be considered as paid during such taxable year, and shall not be included in the computation of the dividends paid deduction for the year of payment. However, the rule provided in section 563(a) is not applicable to dividends paid during the first two and one-half months of the first taxable year of the corporation subject to tax under chapter 1 of the Internal Revenue Code of 1954.

§ 1.563–2 Personal holding company tax.

In the case of a personal holding company subject to the provisions of section 541, dividends paid after the close of the taxable year and before the 15th day of the third month thereafter shall be included in the computation of the dividends paid deduction for the taxable year only if the taxpayer so elects in its return for such taxable year. The election shall be made by including such dividends in computing its dividends paid deduction. The amount of such dividends which may be included in computing the dividends paid deduction for the taxable year shall not exceed either:

(a) The undistributed personal holding company income of the corporation for the taxable year, computed without regard to this section, or

(b) In the case of a taxable year beginning after December 31, 1969, 20 percent (10 percent, in the case of a taxable year beginning before Jan. 1, 1970) of the sum of the dividends paid during the taxable year (not including consent dividends), computed without regard to this section

In computing the amount of the dividends paid deduction allowable for any taxable year, the amount allowed by reason of section 563(b) for any preceding taxable year is considered a dividend paid in such preceding taxable year and not in the year of actual distribution. Thus, a double deduction is not allowable.

[T.D. 7079, 35 FR 18587, Dec. 8, 1970]

§ 1.563–3 Dividends considered as paid on last day of taxable year.

(a) *General rule*. Where a distribution made after the close of the taxable year is considered as paid during such taxable year, for purposes of applying section 562(a) the distribution shall be considered as made on the last day of such taxable year.

(b) *Personal holding company tax*. In the case of a corporation which under the law applicable to the taxable year in respect of which a distribution is made under section 563(b) and § 1.563–2 is a personal holding company under the law applicable to such taxable year, section 316(b)(2) provides that the term dividend means (in addition to the general rule under section 316(a)) any distribution to the extent of the corporation's undistributed personal holding company income (determined under section 545 without regard to distributions under section 316(b)(2)) for such year. See paragraph (b) of § 1.316–1.

(c) *Dividends paid on or before December 15, 1955*. The Act of June 15, 1955 (Public Law 74, 84th Cong., 69 Stat. 136), repealed sections 452 and 462 of the Code, relating to prepaid income and reserve for estimated expenses. Under section 4(c)(4) of that Act, dividends paid after the 15th day of the third month following the close of the taxable year and on or before December 15, 1955, may be treated as having been paid on the last day of the taxable year for purposes of the accumulated earnings tax or the personal holding company tax and in the case of regulated investment companies, but only to the extent that such dividends are attributable to an increase in taxable income for the taxable year by reason of the repeal of sections 452 and 462. See paragraph (b) of § 1.9000–8, relating to treatment of certain dividends, prescribed pursuant to section 4(c)(4) of the Act of June 15, 1955.

§ 1.564–1 Dividend carryover.

(a) *General rule*. The dividend carryover from the two preceding years, allowable only to personal holding companies, is includible in the dividends paid deduction under section 561. It is computed as follows:

(1) If, for each of the preceding two years, the deduction for dividends paid under section 561 (determined without regard to the dividend carryover to each such year) exceeds the taxable income (adjusted as provided in section 545 for purposes of determining undistributed personal holding company income) then the dividend carryover to the taxable year is the sum of both such excess amounts.

(2) If the deduction for dividends paid under section 561 for the second preceding year (determined without regard to the dividend carryover to such year) exceeds the taxable income for such year (adjusted as provided in section 545), and if the taxable income for the first preceding year (as so adjusted) exceeds the dividends paid deduction for such first preceding year (as so determined), then the dividend carryover to the taxable year shall be such excess amount for the second preceding year, less such excess amount for the first preceding year.

(3) If for the first preceding year the deduction for dividends paid under section 561 (determined without regard to the dividend carryover to such year) exceeds the taxable income (adjusted as provided in section 545) for such year, and such excess is not present in the second preceding year, then the dividend carryover to the taxable year shall be such excess amount for the first preceding year.

(b) *Dividend carryover from year in which taxpayer was not a personal holding company*. In computing the dividend carryover, the taxable income as adjusted under section 545 of any preceding taxable year shall be determined as if the corporation was, under the law applicable to such taxable year, a personal holding company.

(c) *Dividend carryover from year in which taxpayer was subject to 1939 Code*. In a case where the first or the second preceding taxable year began before the taxpayer's first taxable year under the Internal Revenue Code of 1954, the amount of the dividend carryover shall be determined under the Internal Revenue Code of 1939.

(d) *Statement to be filed with return*. Every corporation claiming a dividend carryover for any taxable year shall

file with its return for such year a concise statement setting forth the amount of the dividend carryover claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the dividend carryover claimed.

(e) *Computation of dividend carryover.* The computation of the dividend carryover may be illustrated by the following examples:

Example 1. The X Corporation, which files its income tax returns on the calendar year basis, has taxable income, adjusted as required by section 545, in the amount of $110,000 and has a dividends paid deduction of $150,000 for the year 1954. For 1955, its taxable income, adjusted as required by section 545, is $200,000 and its dividends paid deduction is $300,000. The dividend carryover to the year 1956 is $140,000, computed as follows:

Dividends paid deduction for 1954	$150,000
Taxable income for 1954	110,000
Dividend carryover from 1954	40,000
Dividends paid deduction for 1955	300,000
Taxable income for 1955	200,000
Dividend carryover from 1955	100,000
Dividend carryover for 2 preceding taxable years, allowable as a deduction for the year 1956	140,000

Example 2. The Y Corporation, which files its income tax returns on the calendar year basis, has taxable income, adjusted as required by section 545, in the amount of $100,000 and has a dividends paid deduction of $150,000 for the year 1954. For 1955, its taxable income, adjusted as required by section 545, is $200,000 and its dividends paid deduction is $170,000. The dividend carryover to the year 1956 is $20,000 computed as follows:

Dividends paid deduction for 1954	$150,000
Taxable income for 1954	100,000
Dividend carryover from 1954	50,000
Taxable income for 1955	200,000
Dividends paid deduction for 1955	170,000
Excess of taxable income over dividends paid deduction	30,000
Dividend carryover for second preceding taxable year, allowable as a deduction for the year 1956	20,000

§ 1.565–1 General rule.

(a) *Consent dividends.* The dividends paid deduction, as defined in section 561, includes the consent dividends for the taxable year. A consent dividend is a hypothetical distribution (as distinguished from an actual distribution) made by:

(1) A corporation that has a reasonable basis to believe that it is subject to the accumulated earnings tax imposed in part I of subchapter G, chapter 1 of the Code, or

(2) A corporation described in part II (personal holding companies or a corporation with adjusted income from rents described in section 543(a)(2)(A) which utilizes the consent dividends described in section 543(a)(2)(B)(iii) to avoid personal holding company status) or part III (foreign personal holding companies) of subchapter G or in part I (regulated investment companies) or part II (real estate investment trusts) of subchapter M, chapter 1 of the Code.

A consent dividend may be made by a corporation described in this paragraph to any person who owns consent stock on the last day of the taxable year of such corporation and who agrees to treat the hypothetical distribution as an actual dividend, subject to the limitations in section 565, § 1.565–2, and paragraph (c)(2) of this section, by filing a consent at the time and in the manner specified in paragraph (b) of this section.

(b) *Making and filing of consents.* (1) A consent shall be made on Form 972 in accordance with this section and the instructions on the form issued therewith. It may be made only by or on behalf of a person who was the actual owner on the last day of the corporation's taxable year of any class of consent stock, that is, the person who would have been required to include in gross income any dividends on such stock actually distributed on the last day of such year. Form 972 shall contain or be verified by a written declaration that it is made under the penalties of perjury. In the consent such person must agree to include in gross income for his taxable year in which or with which the taxable year of the corporation ends a specific amount as a taxable dividend.

(2) See paragraph (c) of this section and § 1.565–2 for the rules as to when all or a portion of the amount so specified will be disregarded for tax purposes.

(3) A consent may be filed at any time not later than the due date (including extensions) of the corporation's income tax return for the taxable year for which the dividends paid deduction is claimed. With such return, and not later than the due date (including extensions) thereof, the corporation must file Forms 972 for each consenting shareholder, and a return on Form 973 showing by classes the stock outstanding on the first and last days of the taxable year, the dividend rights of such stock, distributions made during the taxable year to shareholders, and giving all the other information required by the form. For taxable years beginning before January 1, 2003, the Form 973 filed with the corporation's income tax return shall contain or be verified by a written declaration that is made under the penalties of perjury and the Forms 972 filed with the return must be duly executed by the consenting shareholders. For taxable years beginning after December 31, 2002, the Form 973 filed with the corporation's income tax return shall be verified by signing the return and the Forms 972 filed with the return must be duly executed by the consenting shareholders or, if unsigned, must contain the same information as the duly executed originals. If the corporation submits unsigned Forms 972 with its return for a taxable year beginning after December 31, 2002, the duly executed originals are records that the corporation must retain and keep available for inspection in the manner required by §1.6001–1(e).

(c) *Taxability of amounts specified in consents.* (1) The filing of a consent is irrevocable, and except as otherwise provided in section 565(b), §1.565–2, and paragraph (c)(2) of this section, the full amount specified in a consent filed by a shareholder of a corporation described in paragraph (a) of this section shall be included in the gross income of the shareholder as a taxable dividend. Where the shareholder is taxable on a dividend only if received from sources within the United States, the amount specified in the consent of the shareholder shall be treated as a dividend from sources within the United States in the same manner as if the dividend has been paid in money to the shareholder on the last day of the corporation's taxable year. See paragraph (b) of this section relating to the making and filing of consents, and section 565(e) and §1.565–5, with respect to the payment requirement in the case of nonresident aliens and foreign corporations.

(2) To the extent that the Commissioner determines that the corporation making a consent dividend is not a corporation described in paragraph (a) of this section, the amount specified in the consent is not a consent dividend and the amount specified in the consent will not be included in the gross income of the shareholder. In addition, where a corporation is described in paragraph (a)(1) but not paragraph (a)(2) of this section, to the extent that the Commissioner determines that the amount specified in a consent is larger than the amount of earnings subject to the accumulated earnings tax imposed by part I of subchapter G, such excess is not a consent dividend under paragraph (a) of this section and will not be included in the gross income of the shareholder.

(3) Except as provided in section 565(b), §1.565–2 and paragraph (c)(2) of this section, once a shareholder's consent is filed, the full amount specified in such consent must be included in the shareholder's gross income as a taxable dividend, and the ground upon which a deduction for consent dividends is denied the corporation does not affect the taxability of a shareholder whose consent has been filed for the amount specified in the consent. For example, although described in part I, II, or III of subchapter G, or part I or II of subchapter M, chapter 1 of the Code, the corporation's taxable income (as adjusted under section 535(b), 545(b), 556(b), 852(b)(2), or 857(b)(2), as appropriate) may be less than the total of the consent dividends.

(4) A shareholder who is a nonresident alien or a foreign corporation is taxable on the full amount of the consent dividend that otherwise qualifies under this section even though that payment has not been made as required by section 565(e) and §1.565–5.

(5) Income of a foreign corporation is not subject to the tax on accumulated earnings under part I of subchapter G,

chapter 1 of the Code except to the extent of U.S. source income, adjusted as permitted under section 535. See section 535 (b) and (d) and §1.535–1(b). Therefore, foreign source earnings (other than those distributions subject to resourcing under section 535(d)) of a foreign corporation that is not described in paragraph (a)(2) of this section cannot qualify for consent dividend treatment. Accordingly, a consent dividend made by a foreign corporation described in paragraph (a)(1) of this section shall not be effective with respect to all of the corporation's earnings, but shall relate solely to earnings which would have been, in the absence of the consent dividend, subject to the accumulated earnings tax.

[T.D. 8244, 54 FR 10538, Mar. 14, 1989, as amended by T.D. 9100, 68 FR 70705, Dec. 19, 2003; T.D. 9300, 71 FR 71042, Dec. 8, 2006]

§ 1.565–2 Limitations.

(a) *General rule.* Amounts specified in consents filed by shareholders or other beneficial owners of a corporation described in §1.565–1(a) are not treated as consent dividends to the extent that—

(1) They would constitute a preferential dividend or

(2) They would not constitute a dividend (as defined in section 316),

if distributed in money to shareholders on the last day of the taxable year of the corporation. If any portion of any amount specified in a consent filed by a shareholder of a corporation described in the preceding sentence is not treated as a consent dividend under section 565(b) and this section, it is disregarded for all tax purposes. For example, it is not taxable to the consenting shareholder, and paragraph (c) of §1.565–1 is not applicable to this portion of the amount specified in the consent.

(b) *Preferential Distribution.* (1) A preferential distribution is an actual distribution, or a consent distribution, or a combination of the two, which involves a preference to one or more shares of stock as compared with other shares of the same class or to one class of stock as compared with any other class of stock. See section 562(c) and §1.562–2.

(2) The application of section 565 (b)(1) and §1.565–2 (b) may be illustrated by the following examples:

Example 1. The X Corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has 200 shares of stock outstanding, owned by A and B in equal amounts. On December 15, 1987, the corporation distributes $600 to B and $100 to A. As a part of the same distribution, A executes a consent to include $500 in his gross income as a taxable dividend although such amount is not distributed to him. The X Corporation, assuming the other requirements of section 565 have been complied with, is entitled to a consent dividends deduction of $500. Although the consent dividend is deemed to have been paid on December 31, 1987, the last day of the taxable year of the corporation, the total amount of all distributions constitutes a single nonpreferential distribution of $1200.

Example 2. The Y corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has one class of consent stock outstanding, owned in equal amounts by A, B, and C. If A and B each receive a distribution in cash of $5,000 and C consents to include $3,000 in gross income as a taxable dividend, the combined actual and consent distribution of $13,000 is preferential. See section 562 (c) and §1.562–2 (a). Similarly, if no one receives a distribution in cash, but A and B each consents to include $5,000 as a taxable dividend in gross income and C agrees to include only $3,000, the entire consent distribution is preferential.

Example 3. The Z Corporation, which makes its income tax returns on the calendar year basis and is subject, for the taxable year in question, to the accumulated earnings tax, has only two classes of stock outstanding, each class being consent stock and consisting of 500 shares. Class A, with a par value of $40 per share, is entitled to two-thirds of any distribution of earnings and profits. Class B, with a par value of $20 per share, is entitled to one-third of any distribution of earnings and profits. On December 15, 1987, there is distributed on the class B stock $2 per share, or $1,000, and shareholders of the class A stock consent to include in gross income amounts equal to $2 per share, or $1,000. The entire distribution of $2,000 is preferential, inasmuch as the class B stock has received more than its pro rata share of the combined amounts of the actual distributions and the consent distributions.

(c) *Section 316 Limitation.* (1) An additional limitation under section 565 (b) is that the amounts specified in consents which may be treated as consent dividends cannot exceed the amounts

which would constitute a dividend (as defined in section 316) if the corporation had distributed the total specified amounts in money to shareholders on the last day of the taxable year of the corporation. If only a portion of such total would constitute a dividend, then only a corresponding portion of each specified amount is treated as a consent dividend.

(2) The application of section 565 (b)(2) and § 1.565–2 (c) may be illustrated by the following example:

Example. The X Corporation, a corporation described in § 1.565–(a) (1) or (2), which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year 1987. Its earnings and profits for the calendar year 1987 amount to $8,000, there being at the beginning of such year no accumulated earnings or profits. A and B execute proper consents to include $5,000 each in their gross income as a dividend received by them on December 31, 1987. The sum of the amounts specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X corporation on December 31, 1987, only $8,000 would have constituted a dividend under section 316 (a). The amount which could be considered as consent dividends in computing the dividends paid deduction for purposes of the accumulated earnings tax is limited to $8,000, or $4,000 of the $5,000 specified in each consent. The remaining $1,000 in each consent is disregarded for all tax purposes. (In the case of a personal holding company, see also the example in § 1.565–3(b).)

[T.D. 8244, 54 FR 10539, Mar. 14, 1989]

§ 1.565–3 Effect of consent.

(a) *General Rule*. The amount of the consent dividend that is described in paragraph (a) of § 1.565–1 shall be considered, for all purposes of the Code, as if it were distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation, received by the shareholder on such day, and immediately contributed by the shareholder as paid-in capital to thecorporation on such day. Thus, the amount of the consent dividend will be treated by the shareholder as a dividend. The shareholder will be entitled to the dividends received deduction under section 243 or 245 with respect to such consent dividend. The basis of the shareholder's consent stock in a corporation will be increased by the amount thus treated in his hands as a dividend which he is considered as having contributed to the corporation as paid-in capital. The amount of the current dividend will also be treated as a dividend received from sources within the United States in the same manner as if the dividend had been paid in money to the shareholders. Among other effects of the consent dividend, the earnings and profits of the corporation will be decreased by the amount of the consent dividends. Moreover, if the shareholder is a corporation, its accumulated earnings and profits will be increased by the amount of the consent dividend with respect to which it makes a consent.

(b) *Example*. The application of section 565 (c) may be illustrated by the following example:

Example. Corporation A, a personal holding company and a calendar year taxpayer, has one shareholder, individual B, whose consent to include $10,000 in his gross income for the calendar year 1987 has been timely filed. A has $8,000 of earnings and profits at the beginning of 1987. A has $10,000 of undistributed personal holding company income (determined without regard to distributions under section 316(b)(2)) for 1987. B must include $10,000 in his gross income as a taxable income and is treated as having immediately contributed $10,000 to A as paid-in capital. See section 316(b)(2).

[T.D. 8244, 54 FR 10540, Mar. 14, 1989]

§ 1.565–4 Consent dividends and other distributions.

Section 565(d) provides a rule applicable where a distribution is made in part in consent dividends and in part in money or other property. With respect to such a distribution the entire amount specified in the consents and the amount of such money or other property shall be considered together. Thus, if as a part of the same distribution consents are filed by some of the shareholders and cash is distributed to other shareholders, for example, those who may be unwilling to sign consents, the total amount of the cash and the amounts specified in the consents will be viewed as a single distribution to determine the tax effects of such distribution. For example, the total of such amounts must be considered to

determine whether the distribution (including the amounts specified in the consents) is preferential and whether any part of such distribution would not be dividends if the total amounts specified in the consents were distributed in cash. See paragraph (b)(2) of § 1.565–2 for examples illustrating the treatment of distributions which consist in part of consent dividends and in part of other property.

§ 1.565–5 Nonresident aliens and foreign corporations.

(a) *Withholding*. In the event that a corporation makes a consent dividend, as described in § 1.565–1 (a), to a shareholder that is subject to a withholding tax under section 1441 or 1442 on a distribution of cash or other property, the corporation must remit an amount of tax equal to the withholding tax that would be imposed under section 1441 or 1442 if an actual cash distribution equal to the consent dividend had been paid to the shareholder on the last day of the corporation's taxable year. Such payment must be in one of the following forms:

(1) Cash,

(2) United States postal money order,

(3) Certified check drawn on a domestic bank, provided that the law of the place where the bank is located does not permit the certification to be rescinded prior to presentation,

(4) A cashier's check of a domestic bank, or

(5) A draft on a domestic bank or a foreign bank maintaining a United States agency or branch and payable in United States funds.

The amount of such payment shall be credited against the tax imposed on the shareholder.

[T.D. 8244, 54 FR 10540, Mar. 14, 1989]

§ 1.565–6 Definitions.

(a) *Consent stock*. (1) The term *consent stock* includes what is generally known as common stock. It also includes participating preferred stock, the participation rights of which are unlimited.

(2) The definition of consent stock may be illustrated by the following example:

Example. If in the case of the X Corporation, a personal holding company, there is only one class of stock outstanding, it would all be consent stock. If, on the other hand, there were two classes of stock, class A and class B, and class A was entitled to 6 percent before any distribution could be made on class B, but class B was entitled to everything distributed after class A had received its 6 percent, only class B stock would be consent stock. Similarly, if class A, after receiving its 6 percent, was to participate equally or in some fixed proportion with class B until it had received a second 6 percent, after which class B alone was entitled to any further distributions, only class B stock would be consent stock. The same result would follow if the order of preferences were class A 6 percent, then class B 6 percent, then class A a second 6 percent, either alone or in conjunction with class B, then class B the remainder. If, however, class A stock is entitled to ultimate participation without limit as to amount, then it, too, may be consent stock. For example, if class A is to receive 3 percent and then share equally or in some fixed proportion with class B in the remainder of the earnings or profits distributed, both class A stock and class B stock are consent stock.

(b) *Preferred dividends*. (1) The term *preferred dividends* includes all fixed amounts (whether determined by percentage of par value, a stated return expressed in a certain number of dollars per share, or otherwise) the distribution of which on any class of stock is a condition precedent to a further distribution of earnings or profits (not including a distribution in partial or complete liquidation). A distribution, though expressed in terms of a fixed amount, is not a preferred dividend, however, unless it is preferred over a subsequent distribution within the taxable year upon some class or classes of stock other than one on which it is payable.

(2) The definition of preferred dividends may be illustrated by the following example:

Example. If, in the case of the X Corporation, there are only two classes of stock outstanding, class A and class B, and class A is entitled to a distribution of 6 percent of par, after which the balance of the earnings and profits are distributable on class B exclusively, class A's 6 percent is a preferred dividend. If the order of preferences is class A $6 per share, class B $6 per share, then class A and class B in fixed proportions until class A receives $3 more per share, then class B the remainder, all of class A's $9 per share and $6 per share of the amount distributable on class B are preferred dividends. The amount

which class B is entitled to receive in conjunction with the payment to class A of its last $3 per share is not a preferred dividend, because the payment of such amount is preferred over no subsequent distribution except one made on class B itself. Finally, if a distribution must be $6 on class A, $6 on class B, then on class A and class B share and share alike, the distribution on class A of $6 and the distribution on class B of $6 are both preferred dividends.

[54 FR 10540, Mar. 14, 1989]

BANKING INSTITUTIONS

Rules of General Application to Banking Institutions

§ 1.581–1 Banks.

(a) In order to be a bank as defined in section 581, an institution must be a corporation for federal tax purposes. See § 301.7701–2(b) of this chapter for the definition of a corporation.

(b) This section is effective as of January 1, 1997.

[T.D. 8697, 61 FR 66588, Dec. 18, 1996]

§ 1.581–2 Mutual savings banks, building and loan associations, and cooperative banks.

(a) While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, and a cooperative bank not having capital stock represented by shares, there are certain exceptions and special rules governing the computation in the case of such institutions. See section 593 for special rules concerning reserves for bad debts. See section 591 and § 1.591–1, relating to dividends paid by banking corporations, for special rules concerning deductions for amounts paid to, or credited to the accounts of, depositors or holders of withdrawable accounts as dividends. See also section 594 and § 1.594–1 for special rules governing the taxation of a mutual savings bank conducting a life insurance business.

(b) For the purpose of computing the net operating loss deduction provided in section 172, any taxable year for which a mutual savings bank, building and loan association, or a cooperative bank not having capital stock represented by shares was exempt from tax shall be disregarded. Thus, no net operating loss carryover shall be allowed from a taxable year beginning before January 1, 1952, and, in the case of any taxable year beginning after December 31, 1951, the amount of the net operating loss carryback or carryover from such year shall not be reduced by reference to the income of any taxable year beginning before January 1, 1952.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8697, 61 FR 66588, Dec. 18, 1996]

§ 1.581–3 Definition of bank prior to September 28, 1962.

Prior to September 28, 1962, for purposes of sections 582 and 584, the term *bank* means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act (38 Stat. 262; 12 U.S.C. 248(k)), and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

[T.D. 6651, 28 FR 4950, May 17, 1963]

§ 1.582–1 Bad debts, losses, and gains with respect to securities held by financial institutions.

(a) *Bad debt deduction for banks.* A bank, as defined in section 581, is allowed a deduction for bad debts to the extent and in the manner provided by subsections (a), (b), and (c) of section 166 with respect to a debt which has become worthless in whole or in part and which is evidenced by a security (a bond, debenture, note, certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money) issued by any corporation (including governments and their political subdivisions), with interest coupons or in registered form.

(b) *Worthless stock in affiliated bank.* For purposes of section 165(g)(1), relating to the deduction for losses involving worthless securities, if the taxpayer is a bank (as defined in section 581) and owns directly at least 80 percent of each class of stock of another bank, stock in such other bank shall not be treated as a capital asset.

(c) *Pre-1970 sales and exchanges of bonds, etc., by banks.* For taxable years beginning before July 12, 1969, with respect to the taxation under subtitle A of the Code of a bank (as defined in section 581), if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset.

(d) *Post-1969 sales and exchanges of securities by financial institutions.* For taxable years beginning after July 11, 1969, the sale or exchange of a security is not considered the sale or exchange of a capital asset if such sale or exchange is made by a financial institution to which any of the following sections applies: Section 585 (relating to banks), 586 (relating to small business investment companies and business development corporations), or 593 (relating to mutual savings banks, domestic building and loan associations, and cooperative banks). This paragraph shall apply to determine the character of gain or loss from the sale or exchange of a security notwithstanding any other provision of subtitle A of the Code, such as section 1233 (relating to short sales). However, this paragraph shall have no effect in the determination of whether a security is a capital asset under section 1221 for purposes of applying any other provision of the Code, such as section 1232 (relating to original issue discount). For purposes of this paragraph, a security is a bond, debenture, note, or certificate or other evidence of indebtedness, issued by any person. See paragraphs (e) and (f) of this section for special transitional rules applicable, respectively, to banks and to small business investment companies and business development corporations.

(e) *Transition rule for qualifying securities held by banks*—(1) *In general.* Notwithstanding the provisions of paragraph (d) of this section, if the net long-term capital gain from sales and exchanges of qualifying securities exceeds the net short-term capital loss from such sales and exchanges in any taxable year beginning after July 11, 1969, such excess shall be treated as long-term capital gain, but in an amount not to exceed the net gain from sales and exchanges of securities in such year. For purposes of computing such net gain, a capital loss carried to the taxable year under section 1212 shall not be taken into account. See section 1222 and the regulations thereunder for definitions of the terms *net long-term capital gain* and *net short-term capital loss.* For purposes of this paragraph:

(i) The term *security* means a security within the meaning of paragraph (d) of this section.

(ii) The term *qualifying security* means a security which is held by the bank on July 11, 1969, and continuously thereafter until it is first sold or exchanged by the bank

See also subparagraph (4) of this paragraph for rules under which the time certain securities are held is deemed to include a period of time determined under section 1223 (1) and (2) with respect to such security.

(2) *Computation of capital gain or loss.* For purposes of this paragraph, the amount of gain or loss from the sale or exchange of a qualifying security treated as capital gain or loss is determined by multiplying the amount of gain or loss recognized from such sale or exchange by a fraction the numerator of which is the number of days before July 12, 1969, that such security was held by the bank and the denominator of which is the sum of the number of days included in the numerator and the number of days the security was held by the bank after July 11, 1969.

(3) *Special rules.* For purposes of subparagraphs (1) and (2) of this paragraph, the following items are not taken into account:

(i) Any amount treated as original issue discount under section 1232, and

(ii) Any amount which, without regard to section 582(c) and this section, would be treated as gain or loss from the sale or exchange of property which is not a capital asset, such as an amount which is realized from the sale or exchange of a security which is held by a bank as a dealer in securities.

(4) *Holding period in certain cases.* For purposes of this paragraph:

(i) The time a security received in an exchange is deemed to have been held by a bank includes a period of time determined under section 1223(1) with respect to such security.

(ii) The time a security transferred to a bank from another bank is deemed to have been held by the transferee bank includes a period of time determined under section 1223(2) with respect to such security

For example, if a bank on December 3, 1972, surrendered an obligation of the United States which it held as a capital asset on July 11, 1969, in a transaction to which section 1037 applied, the time during which the newly received obligation is deemed to have been held includes the time during which the surrendered obligation was deemed to have been held by the bank. Because the surrendered obligation was held on July 11, 1969, the newly acquired obligation is deemed to have been held on that date and is a qualifying security. The period during which the surrendered obligation is deemed to have been held is taken into account in computing the fraction determined under subparagraph (2) of this paragraph with respect to the newly received obligation.

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

Example 1. Bank A, a calendar year taxpayer, purchased a qualifying security on July 14, 1968, and held it to maturity on August 20, 1970, when it was redeemed. The redemption resulted in a taxable gain of $10,000. The security was held by the bank for 363 days before July 12, 1969, and for a total of 768 days. During the taxable year, the bank had no other gains and no losses from sales or exchanges of qualifying securities, but had a net loss of $4,000 from sales of securities other than qualifying securities. The portion of the gain from the redemption of the qualifying security treated as capital gain under subparagraph (2) of this paragraph is $4,726.56 (363/768 × $10,000). Because the net gain of the taxable year from sales and exchanges of securities, $6,000 ($10,000 − $4,000), exceeds the portion of the gain on the sale of the qualifying security treated as capital gain under this paragraph, $4,726.56 is treated as long-term capital gain on the sale of the qualifying security for the taxable year.

Example 2. Assume the same facts as in example 1, except that the bank's net loss of the taxable year from the sale of securities other than qualifying securities was $7,000. The amount considered as long-term capital gain under this paragraph is limited by the amount of gain on the sale of securities to $3,000 ($10,000 − $7,000).

(f) *Small business investment companies and business development corporations*—(1) *Election.* In the case of a small business investment company or a business development corporation, described in section 586(a), section 582(c) does not apply for taxable years beginning after July 11, 1969, and before July 11, 1974, unless the taxpayer elects that such section shall apply. In the case of a small business investment company, see paragraph (a)(1) of § 1.1243–1 if such an election is made, but see paragraph (a)(2) of § 1.1243–1 if such an election is not made. Such election applies to all such taxable years and, except as provided in subparagraph (3) of this paragraph, is irrevocable. Such election must be made not later than (i) the time, including extensions thereof, prescribed by law for filing the taxpayer's income tax return for its first taxable year beginning after July 11, 1969, or (ii) June 8, 1970, whichever is later.

(2) *Manner of making election.* An election pursuant to the provisions of this paragraph is made by the taxpayer by a written statement attached to the taxpayer's income tax return (or an amended return) for its first taxable year beginning after July 11, 1969. Such statement shall indicate that the election is made pursuant to section 433(d) of the Tax Reform Act of 1969 (83 Stat. 624). The taxpayer shall attach to its income tax return for each subsequent taxable year to which such election is applicable a statement indicating that the election has been made and the amount to which it applies for such year.

(3) *Revocation of election.* An election made pursuant to subparagraph (2) of

this paragraph shall be irrevocable unless:

(i) A written application for consent to revoke the election, setting forth the reasons therefor, is filed with the Commissioner within 90 days after the permanent regulations relating to section 433(d)(2) of the Tax Reform Act of 1969 (83 Stat. 624) are filed with the Office of the Federal Register, and

(ii) The Commissioner consents to the revocation.

The revocation is effective for all taxable years to which the election applied.

[T.D. 7171, 37 FR 5620, Mar. 17, 1972; 37 FR 6400, Mar. 29, 1972]

§ 1.584–1 Common trust funds.

(a) *Method of taxation.* A common trust fund maintained by a bank is not subject to taxation under this chapter and is not considered a corporation. Its participants are taxed on their proportionate share of income from the common trust fund.

(b) *Conditions for qualification.* (1) For a fund to be qualified as a common trust fund it must be maintained by a bank (as defined in section 581) in conformity with the rules and regulations of the Comptroller of the Currency, exclusively for the collective investment and reinvestment of contributions to the fund by the bank. The bank may either act alone or with one or more other fiduciaries, but it must act solely in its capacity as one or a combination of the following: (i) As a trustee of a trust created by will, deed, agreement, declaration of trust, or order of court; (ii) as an executor of a will or as an administrator of an estate; (iii) as a guardian (by whatever name known under local law) of the estate of an infant, of an incompentent individual, or of an absent individual; or (iv) on or after October 3, 1976, as a custodian of a UniformGifts to Minors account. A Uniform Gifts to Minors account is an account established pursuant to a State law substantially similar to the Uniform Gifts to Minors Act. (*See* the Uniform Gifts to Minors Act of 1956 or the Uniform Gifts to Minors Act of 1966, as published by the National Conference of Commissioners on Uniform State Laws.) The Commissioner will publish a list of the States whose laws he determines to be substantially similar to such uniform acts. A bank that maintains a Uniform Gifts to Minors Act account must establish, to the satisfaction of the Commissioner or his delegate, that with respect to the account the bank has duties and responsibilities similar to the duties and responsibilities of a trustee or guardian.

(2) A common trust fund may be a participant in another common trust fund.

(c) *Affiliated groups.* For taxable years beginning after December 31, 1975, two or more banks that are members of the same affiliated group (within the meaning of section 1504) are treated, for purposes of section 584, as one bank for the period of their affiliation. A common trust fund may be maintained by one or by more than one member of an affiliated group. Any member of the group may, but need not, contribute to the fund. Further, for purposes of this paragraph, members of an affiliated group may be, but need not be, co-trustees of the common trust fund.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7935, 49 FR 1694, Jan. 13, 1984]

§ 1.584–2 Income of participants in common trust fund.

(a) Each participant in a common trust fund is required to include in computing its taxable income for its taxable year within which or with which the taxable year of the fund ends, whether or not distributed and whether or not distributable:

(1) Its proportionate share of short-term capital gains and losses, computed as provided in § 1.584–3;

(2) Its proportionate share of long-term capital gains and losses, computed as provided in § 1.584–3; and

(3) Its proportionate share of the ordinary taxable income or the ordinary net loss of the common trust fund, computed as provided in § 1.584–3.

(b) Any tax withheld at the source from income of the fund (*e.g.,* under section 1441) is deemed to have been withheld proportionately from the participants to whom such income is allocated.

(c)(1) The proportionate share of each participant's short-term capital gains and losses, long-term capital gains and

losses, ordinary taxable income or ordinary net loss, dividends and interest received, and tax withheld at the source shall be determined under the method of accounting adopted by the bank in accordance with the written plan by which the common trust fund is established and administered, provided such method clearly reflects the income of each participant.

(2) Items of income and deductions shall be allocated to the periods between valuation dates established by the plan within the taxable year in which they were realized. Ordinary taxable income or ordinary net loss, short-term capital gains and losses, long-term capital gains and losses, and tax withheld at the source shall be computed for each period. The participants' proportionate shares of income and losses for each period shall then be determined.

(3) For taxable years beginning on or after September 22, 1980, any amount of income or loss of the common trust fund which is included in the computation of a participant's taxable income for the taxable year shall be treated as income or loss from an unrelated trade or business to the extent that such amount would have been income or loss from an unrelated trade or business if such participant had made directly the investments of the common trust fund.

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

Example. (i) The plan of a common trust fund provides for quarterly valuation dates and for the computation and the distribution of the income upon a quarterly basis, except that there shall be no distribution of capital gains. The participants are as follows: Trusts A, B, C, and D for the first quarter; Trusts A, B, C, and E for the second quarter; and Trusts A, B, F, and G for the third and fourth quarters, the participants having equal participating interests. As computed upon the quarterly basis, the ordinary taxable income, the short-term capital gain, and the long-term capital loss for the taxable year were as follows:

	First quarter	Second quarter	Third quarter	Fourth quarter	Total
Ordinary taxable income	$200	$300	$200	$400	$1,100
Short-term capital gain	200	100	200	100	600
Long-term capital loss	100	200	100	200	600

(ii) The participants' shares of ordinary taxable income are as follows:

PARTICIPANTS' SHARES OF ORDINARY TAXABLE INCOME

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$75	$50	$100	$275
B	50	75	50	100	275
C	50	75	.....	.....	125
D	50	.....	.....	.....	50
E	.....	75	.....	.....	75
F	.....	.....	50	100	150
G	.....	.....	50	100	150
Total	200	300	200	400	1,100

(iii) The participants' shares of the short-term capital gain are as follows:

PARTICIPANTS' SHARES OF SHORT-TERM CAPITAL GAIN

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$25	$50	$25	$150
B	50	25	50	25	150
C	50	25	.....	.....	75
D	50	.....	.....	.....	50
E	.....	25	.....	.....	25
F	.....	.....	50	25	75
G	.....	.....	50	25	75
Total	200	100	200	100	600

(iv) The participants' shares of the long-term capital loss are as follows:

PARTICIPANTS' SHARES OF LONG-TERM CAPITAL LOSS

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$25	$50	$25	$50	$150
B	25	50	25	50	150
C	25	50	.....	.....	75
D	25	.....	.....	.....	25
E	.....	50	.....	.....	50
F	.....	.....	25	50	75
G	.....	.....	25	50	75
Total	100	200	100	200	600

(v) If in the above example the common trust fund also had short-term capital losses and long-term capital gains, the treatment

of such gains or losses would be similar to that accorded to the short-term capital gains and long-term capital losses in the above example.

(vi) Assume in the above example that participant Trust A qualified as a trust forming part of a pension, profit sharing, or stock bonus plan under section 401(a). Assume further that 20 percent of the ordinary taxable income of the common trust fund would be unrelated business taxable income (as defined under section 512(a)(1)) if received directly by Trust A. Under paragraph (c)(3), participant Trust A, for purposes of computing its taxable income, must treat its proportionate share of the common trust fund's ordinary taxable income as income from an unrelated trade or business to the extent such amount would have been income from an unrelated trade or business if Trust A had directly made the investments of the common trust fund. Therefore, participant Trust A must take into account 20 percent of its proportionate share of the common trust fund's ordinary taxable income as income from an unrelated trade or business.

(d) The provisions of part I, subchapter J, chapter 1 of the Code, or, as the case may be, the provisions of subchapters D, F, or H of chapter 1 of the Code, are applicable in determining the extent to which each participant's proportionate share of any income or loss of the common trust fund is taxable to the participant, or to a person other than the participant.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7935, 49 FR 1694, Jan. 13, 1984; T.D. 8662, 61 FR 19546, May 2, 1996]

§ 1.584–3 Computation of common trust fund income.

The taxable income of the common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that:

(a) No deduction shall be allowed under section 170 (relating to charitable, etc., contributions and gifts);

(b) The gains and losses from sales or exchanges of capital assets of the common trust fund are required to be segregated. A common trust fund is not allowed the benefit of the capital loss carryover provided by section 1212; and

(c) The ordinary taxable income (the excess of the gross income over deductions) or the ordinary net loss (the excess of the deductions over the gross income) shall be computed after excluding all items of gain and loss from sales or exchanges of capital assets.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7935, 49 FR 1694, Jan. 13, 1984]

§ 1.584–4 Admission and withdrawal of participants in the common trust fund.

(a) *Gain or loss.* The common trust fund realizes no gain or loss by the admission or withdrawal of a participant, and the basis of the assets and the period for which they are deemed to have been held by the common trust fund for the purposes of section 1202 are unaffected by such an admission or withdrawal. For taxable years of participants ending after April 7, 1976, and for transfers occurring after that date, the transfer of property by a participant to a common trust fund is treated as a sale or exchange of the property transferred. If a participant withdraws the whole or any part of its participating interest from the common trust fund, such withdrawal shall be treated as a sale or exchange by the participant of the participating interest or portion thereof which is so withdrawn. A participant is not deemed to have withdrawn any part of its participating interest in the common trust fund so as to have completed a closed transaction by reason of the segregation and administration of an investment of the fund, pursuant to the provisions of 12 CFR 9.18(b)(7) (or, for periods before September 28, 1962, 12 CFR206.17(c)(7)), for the benefit of all the then participants in the common trust fund. Such segregated investment shall be considered as held by, or on behalf of, the common trust fund for the benefit ratably of all participants in the common trust fund at the time of segregation, and any income or loss arising from its administration and liquidation shall constitute income or loss to the common trust fund apportionable among the participants for whose benefit the investment was segregated. When a participating interest is transferred by a bank, or by two or more banks that are members of the same affiliated group (within the meaning of section 1504), as a result of the combination of two or more common trust funds or the division of a single common trust fund,

the transfer to the surviving or divided fund is not considered to be an admission or a withdrawal if the combining, dividing, and resulting common trust funds have diversified portfolios. For purposes of this paragraph (a), a common trust fund has a diversified portfolio if it satisfies the 25 and 50-percent tests of section 368(a)(2)(F)(ii), applying the relevant provisions of section 368(a)(2)(F). However, Government securities are included in total assets for purposes of the denominator of the 25 and 50-percent tests (unless the Government securities are acquired to meet the 25 and 50-percent tests), but are not treated as securities of an issuer for purposes of the numerator of the 25 and 50-percent tests. In addition, for a transfer of a participating interest in a division of a common trust fund not to be considered an admission or withdrawal, each participant's pro ratainterest in each of the resulting common trust funds must be substantially the same as was the participant's pro rata interest in the dividing fund. However, in the case of the division of a common trust fund maintained by two or more banks that are members of the same affiliated group resulting from the termination of such affiliation, the division will be treated as meeting the requirements of the preceding sentence if the written plans of operation of the resulting common trust funds are substantially identical to the plan of operation of the dividing common trust fund, each of the assets of the dividing common trust fund are distributed substantially pro rata to each of the resulting common trust funds, and each participant's aggregate interest in the assets of the resulting common trust funds of which he or she is a participant is substantially the same as was the participant's pro rata interest in the assets of the dividing common trust fund. The plan of operation of a resulting common trust fund will not be considered to be substantially identical to that of the dividing common trust fund where, for example, the plan of operation of the resulting common trust fund contains restrictions as to the types of participants that may invest in the common trust fund where such restrictions were not present in the plan of operation of the dividing common trust fund.

(b) *Basis for gain or loss upon withdrawal.* The participant's gain or loss upon withdrawal of its participating interest or portion thereof shall be measured by the difference between the amount received upon such withdrawal and the adjusted basis of the participating interest or portion thereof withdrawn plus the additions prescribed in paragraph (c) of this section and minus the reductions prescribed in paragraph (d) of this section. The amount received by the participant shall be the sum of any money plus the fair market value of property (other than money) received upon such withdrawal. The basis of the participating interest or portion thereof withdrawn shall be the sum of any money plus the fair market value of any property (other than money) contributed by the participant to the common trust fund to acquire the participating interest or portion thereof withdrawn. Such basis shall not be reduced on account of the segregation of any investment in the common trust fund pursuant to the provisions of 12 CFR 9.18(b)(7) (or, for periods before September 28, 1962, 12 CFR 206.17(c)(7)). For the purpose of making the adjustments, additions, and reductions with respect to basis as prescribed in this paragraph, the ward, rather than the guardian, shall be deemed to be the participant; and the grantor, rather than the trust, shall be deemed to be the participant, to the extent that the income of the trust is taxable to the grantor under subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code.

(c) *Additions to basis.* As prescribed in paragraph (b) of this section, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, there shall be added to the basis of the participating interest or portion thereof withdrawn an amount equal to the aggregate of the following items (to the extent that they were properly allocated to the participant for a taxable year of the common trust fund and were not distributed to the participant prior to withdrawal):

(1) Wholly exempt income of the common trust fund for any taxable year,

(2) Net income of the common trust fund for the taxable years beginning after December 31, 1935, and prior to January 1, 1938,

(3) Net short-term capital gain of the common trust fund for each taxable year beginning after December 31, 1937,

(4) The excess of the gains over the losses recognized to the common trust fund upon sales or exchanges of capital assets held (i) for more than 18 months for taxable years beginning after December 31, 1937, and before January 1, 1942, (ii) for more than 6 months for taxable years beginning after December 31, 1941, and before January 1, 1977, (iii) for more than 9 months for taxable years beginning in 1977, and (iv) for more than 1 year for taxable years beginning after December 31, 1977, and

(5) Ordinary net or taxable income of the common trust fund for each taxable year beginning after December 31, 1937.

(d) *Reductions in basis.* As prescribed in paragraph (b) of this section, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, the basis of the participating interest or portion thereof withdrawn shall be reduced by such portions of the following items as were allocable to the participant with respect to the participating interest or portion thereof withdrawn:

(1) The amount of the excess of the allowable deductions of the common trust fund over its gross income for the taxable years beginning after December 31, 1935, and before January 1, 1938, and

(2) The amount of the net short-term capital loss, net long-term capital loss, and ordinary net loss of the common trust fund for each taxable year beginning after December 31, 1937.

(e) *Effective date.* The eighth sentence of paragraph (a) of this section is effective for combinations and divisions of common trust funds completed on or after May 2, 1996.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6651, 28 FR 4950, May 17, 1963; T.D. 7935, 49 FR 1695, Jan. 13, 1984; T.D. 8662, 61 FR 19546, May 2, 1996; 61 FR 39072, July 26, 1996]

§ 1.584–5 Returns of banks with respect to common trust funds.

For rules applicable to filing returns of common trust funds, see section 6032 and the regulations thereunder.

§ 1.584–6 Net operating loss deduction.

The net operating loss deduction is not allowed to a common trust fund. Each participant in a common trust fund, however, will be allowed the benefits of such deduction. In the computation of such deduction, a participant in a common trust fund shall take into account its pro rata share of items of income, gain, loss, deduction, or credit of the common trust fund. The character of any such item shall be determined as if the participant had realized such item directly from the source from which realized by the common trust fund, or incurred such item in the same manner as incurred by the common trust fund.

§ 1.585–1 Reserve for losses on loans of banks.

(a) *General rule.* As an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, a financial institution to which section 585 and this section apply shall be allowed a deduction under section 585(a) (or, for taxable years beginning before January 1, 1987, section 166(c)), for a reasonable addition to a reserve for bad debts provided such financial institution has adopted or adopts the reserve method of treating bad debts in accordance with paragraph (b) of § 1.166–1. In the case of such a taxpayer the amount of the reasonable addition to such reserve for a taxable year beginning after July 11, 1969, shall be an amount determined by the taxpayer which does not exceed the amount computed under § 1.585–2. Such reasonable addition for the taxable year shall be an amount at least equal to the amount provided by § 1.585–2(a)(2). For each taxable year the taxpayer must include in its income tax return (or amended return) for that year a computation of the amount of the addition determined under this section showing the method used to determine that amount. The use of a particular method in the return for a taxable year is not a binding election by

the taxpayer to apply such method either for such taxable year or for subsequent taxable years. A financial institution to which section 585 and this section apply which adopts the reserve method is not entitled to charge off any bad debts pursuant to section 166(a) with respect to a loan (as defined in §1.585–2(e)(2). Except as provided by §1.585–3, the reserve for bad debts of a financial institution to which section 585 and this section apply shall be established and maintained in the same manner as is provided by section 585 (or, for taxable years beginning before January 1, 1987, section 166(c)) and theregulations under section 166 with respect to reserves for bad debts. Except as provided by this section, no deduction is allowable for an addition to a reserve for losses on loans as defined in §1.585–2(e)(2) of a financial institution to which section 585 and this section apply. For rules relating to deduction with respect to debts which are not loans (as defined in §1.585–2(e)(2)), see section 166(a) and the regulations thereunder. For rules relating to a debt evidenced by a security (as defined in section 165(g)(2)(C), see sections 166 and 582(a) and the regulations thereunder. For the definition of certain terms, see paragraph (e) of §1.585–2. For rules relating to a transaction to which section 381(a) applies, see §1.585–4. For rules relating to large banks, see §§1.585–5 through 1.585–8.

(b) *Application of section*—(1) *In general*. Except as provided in paragraph (b)(2) of this section, section 585 and this section apply to the following financial institutions—

(i) Any bank (as defined in section 581 and the regulations thereunder) other than a mutual savings bank, domestic building and loan association, or cooperative bank, to which section 593 applies; and

(ii) Any corporation to which paragraph (b)(1)(i) of this section would apply except for the fact that it is a foreign corporation and in the case of any such foreign corporation, the rules provided by section 585(a) and (b), this section, §§1.585–2, 1.585–3, and 1.585–4 apply only with respect to loans outstanding the interest on which is effectively connected with the conduct of a banking business within the United States.

(2) *Exception*. For taxable years beginning after December 31, 1986, section 585(a) and (b) and this section do not apply to any large bank (as defined in §1.585–5(b)). For these years, a large bank may not deduct any amount under section 585 or any other section for an addition to a reserve for bad debts.

(Sec. 585(b)(4), of the Internal Revenue Code of 1954 (83 Stat. 618; (26 U.S.C. 585(b)(4))))

[T.D. 7532, 43 FR 3109, Jan. 23, 1978, as amended by T.D. 8513, 58 FR 68757, Dec. 29, 1993; 59 FR 15502, Apr. 1, 1994]

§1.585–2 Addition to reserve.

(a) *In general*—(1) *Maximum addition*. For taxable years beginning before January 1, 1988, the maximum reasonable addition to the reserve for losses on loans as defined in paragraph (e)(2) of this section is the amount allowable under the percentage method provided by paragraph (b) of this section or the experience method provided by paragraph (c) of this section, whichever is greater. For taxable years beginning after December 31, 1987, the maximum reasonable addition to the reserve for losses on loans is the amount determined under the experience method provided by paragraph (c) of this section.

(2) *Minimum addition*. For taxable years beginning after December 31, 1976, and before January 1, 1988, a taxpayer to which this section applies shall make a minimum addition to the reserve for losses on loans as defined in paragraph (e)(2) of this section. For purposes of this subparagraph, the term *minimum addition* means an addition to the reserve for losses on loans in an amount equal to the lesser of (i) the amount allowable under section 585 (b)(3)(A) and paragraph (c)(1)(ii) of this section, or (ii) the maximum amount allowable under section 585 (b)(2) and paragraph (b) of this section. For taxable years beginning after December 31, 1987, a taxpayer to which this section applies shall make a minimum addition to the reserve for losses on loans for each taxable year in an amount equal to the amount allowable under section 585 (b)(3)(A) and paragraph (c)(1)(ii) of this section.

(b) *Percentage method*—(1) *In general*—(i) *Maximum addition*. Except as limited under subparagraph (2) of this paragraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method for a taxable year is the amount determined under paragraph (b)(1) (ii), (iii), or (iv) of this section, whichever is applicable. For purposes of this paragraph, the term *allowable percentage* means 1.8 percent for taxable years beginning before 1976; 1.2 percent for taxable years beginning after 1975 but before 1982; 1.0 percent for taxable years beginning in 1982; and 0.6 percent for taxable years beginning after 1982 and before 1988. This paragraph does not apply for taxable years beginning after 1987.

(ii) *Reserve less than allowable percentage of eligible loans*. (A) If the reserve for losses on loans as of the close of the base year is less than the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of the base year, the amount determined under this subdivision for the taxable year is the amount necessary to increase the balance of the reserve for losses on loans as of the close of the taxable year to an amount equal to the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of that year, except that the amount determined with respect to the reserve deficiency shall not exceed one-fifth of the reserve deficiency. For purposes of this section, the term *reserve deficiency* means the excess of the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of the base year over the reserve forlosses on loans as of the close of the base year. Where a taxpayer has recoveries of bad debts for a taxable year which exceed the bad debts sustained for such year, the taxpayer is not required to reduce its otherwise permissible current addition by the amount of the net recovery. A reasonable addition attributable to an increase in eligible loans outstanding at the close of the taxable year over eligible loans outstanding at the close of the base year may be made only for the portion of such increase which does not exceed the excess of eligible loans outstanding at the close of the taxable year over the sum of the amount of eligible loans outstanding at the close of the base year and the amount of previous increases in such loans for which an addition was made in taxable years ending after the close of the base year. For purposes of this subdivision, the order in which the factors which make up the annual reserve addition shall be claimed is:

(*1*) An amount equal to one-fifth of the reserve deficiency;

(*2*) Net bad debts charged to the reserve; and

(*3*) An amount attributable to an increase in the amount of eligible loans outstanding.

(B) For its first taxable year, a newly organized financial institution to which § 1.585–1 and this section apply shall be considered to have no reserve deficiency. For example, a new financial institution would compute its annual reserve addition by including in such addition an amount not in excess of the sum of (*1*) the amount of its net bad debts charged to the reserve for the taxable year, and (*2*) the allowable percentage of the increase in its eligible loans outstanding at the close of the taxable year over the amount of its loans outstanding (zero) at the end of the year preceding its first taxable year. Such amount would be subject to the 0.6 percent limitations provided in subparagraph (2) of the paragraph.

(C) The application of the rules provided by this subdivision may be illustrated by the following example:

Example. The X Bank is a commercial bank which has a calendar year as its taxable year. X adopted the reserve method of accounting for bad debts in 1950. On December 31, 1969, X has $1,000,000 of outstanding eligible loans and a balance of $13,000 in its reserve for losses on loans. The base year is 1969 and, consequently, X has a reserve deficiency of $5,000 ((1.8% × $1,000,000) − $13,000).

(a) During 1970, X has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1970, X has $1,050,000 of outstanding eligible loans. The maximum reasonable addition under the percentage method is $2,900 which consists of $1,000 of reserve deficiency (⅕ × $5,000), the $1,000 in net bad debts charged to the reserve for losses on loans, and $900 attributable to the increase in the balance of eligible loans (1.8% × ($1,050,000 − $1,000,000)). Assuming that X makes an addition to the reserve for losses on loans of $2,900 for the year, the balance of

the reserve as of December 31, 1970 is $14,900 ($13,000 − $1,000 + $2,900).

(b) During 1971, X has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1971, X has $800,000 of outstanding eligible loans. The allowable percentage of eligible loans is $14,400 (1.8% × $800,000). The maximum reasonable addition under the percentage method is $500 which is a portion of one-fifth of the reserve deficiency. Assuming that X makes an addition to the reserve for losses on loans of $500 for the year, the balance of the reserve as of December 31, 1971, is $14,400 ($14,900 − $1,000 + $500).

(c) During 1972, X has net bad debts of $600 charged to the reserve for losses on loans. On December 31, 1972, X has $850,000 of outstanding eligible loans. The allowable percentage of eligible loans is $15,300 (1.8% × $850,000). The maximum reasonable addition under the percentage method is $1,500 which consists of $1,000 of reserve deficiency (⅕ × $5,000) and $500 of the net bad debts charged to the reserve for losses on loans in 1971. Even though the full addition with respect to the reserve deficiency in 1971 was not made, the amount of the addition that can be made in 1972 with respect to the reserve deficiency is limited to one-fifth of such deficiency. Assuming that X makes an addition to the reserve for losses on loans of $1,500 for the year, the balance of the reserve as of December 31, 1972, is $15,300 ($14,400 − $600 + $1,500).

(d) During 1973, X did not have any net bad debts charged to the reserve for losses on loans. On December 31, 1973, X has $1,000,000 of outstanding eligible loans. The allowable percentage of eligible loans is $18,000 (1.8% × $1,000,000). The maximum reasonable addition under the percentage method is $2,100 which consists of $1,000 of reserve deficiency (⅕ × $5,000), $500 of net bad debts charged to the reserve for losses in 1971, and $600 of net bad debts charged to the reserve in 1972. Although outstanding eligible loans increased from $850,000 in 1972 to $1,000,000 in 1973, no addition is permitted with respect to the increase because the amount of eligible loans outstanding at the close of 1973 ($1,000,000) does not exceed the sum of the amount of such loans at the close of the base year ($1,000,000) and the amount of previous increases in such loans for which an addition was made in taxable years ending after the close of the base year ($50,000 loan increase in 1970). Assuming that X makes an addition to the reserve for losses on loans of $2,100, the balance of the reserve as of December 31, 1973, is $17,400 ($15,300 + $2,100).

(iii) *Reserve equal to or greater than allowable percentage and eligible loans have not declined.* If the reserve for losses on loans as of the close of the base year is equal to or greater than the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of the base year and if the amount of eligible loans outstanding at the close of the taxable year is equal to or greater than the amount of eligible loans outstanding at the close of the base year, the amount determined under this subdivision is the amount necessary to increase the reserve to the greater of (A) the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of the year, or (B) the balance of the reserve as of the close of the base year. The application of the rule provided by this subdivision may be illustrated by the following example:

Example. The M Bank is a commercial bank which has a calendar year as its taxable year. M adopted the reserve method of accounting for bad debts in 1950. On December 31, 1969, M has $1,000,000 of outstanding eligible loans and a balance of $20,000 in its reserve for losses on loans.

(a) During 1970, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1970, M has $1,100,000 of outstanding eligible loans. The allowable percentage of eligible loans is $19,800 (1.8% × $1,100,000). The maximum reasonable addition under the percentage method is $1,000 which is the amount sufficient to increase the balance of the reserve as of the close of the taxable year to the balance of the reserve as of the close of the 1969 base year ($20,000). Assuming that M makes an addition to the reserve for losses on loans of $1,000 for the year, the balance of the reserve as of December 31, 1970, is $20,000 ($20,000 − $1,000 + $1,000).

(b) During 1971, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1971, M has $1,300,000 of outstanding eligible loans. The allowable percentage of eligible loans is $23,400 (1.8% × $1,300,000). The maximum reasonable addition under the percentage method is $4,400 which is the amount sufficient to increase the balance of the reserve to the allowable percentage of eligible loans outstanding at the close of the taxable year. Assuming that M makes an addition to the reserve for losses on loans of $4,400 for the year, the balance of the reserve as of December 31, 1971, is $23,400 ($20,000 − $1,000 + $4,400).

(c) During 1972, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1972, M has $1,200,000 of outstanding eligible loans. The allowable percentage of eligible loans is $21,600 (1.8% × $1,200,000). No reasonable addition may be made under the percentage method because

the reserve for losses on loans ($22,400, i.e., $23,400 – $1,000) is greater than the allowable percentage of eligible loans outstanding at the close of the taxable year ($21,600) and the balance of the reserve as of the close of the base year ($20,000). Assuming that no amount is added under the experience method provided by paragraph (c) of this section, the balance of the reserve for losses on loans as of December 31, 1972, is $22,400 ($23,400 – $1,000).

(d) During 1973, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1973, M has $1,200,000 of outstanding eligible loans. The allowable percentage of eligible loans is $21,600 (1.8% × $1,200,000). The maximum reasonable addition under the percentage method is $200 which is the amount sufficient to increase the reserve for losses on loans to the allowable percentage of eligible loans outstanding at the close of the taxable year. Assuming that M makes an addition to the reserve for losses on loans of $200 for the year, the balance of the reserve as of December 31, 1973, is $21,600 ($22,400 – $1,000 + $200).

(iv) *Reserve greater than allowable percentage and eligible loans have declined.* If the reserve for losses on loans as of the close of the base year is equal to or greater than the allowable percentage of eligible loans outstanding at such time and if the amount of eligible loans at the close of the taxable year is less than the amount of eligible loans outstanding at the close of the base year, the amount determined under this subdivision is the amount necessary to increase the balance of the reserve to the amount which bears the same ratio to eligible loans outstanding at the close of the taxable year as the balance of the reserve as of the close of the base year bears to the amount of eligible loans outstanding at the close of the base year. The application of the rule provided by this subdivision may be illustrated by the following example:

Example. The N Bank is a commercial bank which has a calendar year as its taxable year. N adopted the reserve method of accounting for bad debts in 1950. On December 31, 1969, N has $1,000,000 of outstanding eligible loans and a balance of $20,000 in its reserve for losses on loans.

(a) During 1970, N has net bad debts of $3,000 charged to the reserve for losses on loans. On December 31, 1970, N has $900,000 of outstanding eligible loans. The maximum reasonable addition under the percentage method is $1,000, which is the amount necessary to increase the balance of the reserve to the amount ($18,000) which bears the same ratio to eligible loans outstanding at the close of the taxable year ($900,000) as the balance of the reserve as of the close of the base year ($20,000) bears to the amount of the eligible loans outstanding at the close of the base year ($1,000,000). Assuming that N makes an addition to the reserve for losses on loans of $1,000 for the year, the balance of the reserve as of December 31, 1970, is $18,000 ($20,000 – $3,000 + $1,000).

(b) During 1971, N has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1971, N has $1,100,000 of outstanding eligible loans. The maximum reasonable addition under the percentage method, determined under subdivision (iii) of this subparagraph, is $3,000 which is the amount necessary to increase the balance of the reserve to the greater of the allowable percentage of eligible loans outstanding at the close of the taxable year ($19,800) or the balance of the reserve at the close of the base year ($20,000). Assuming that N makes an addition to the reserve for losses on loans of $3,000 for the year, the balance of the reserve as of December 31, 1971 is $20,000 ($18,000 – $1,000 + $3,000).

(2) *Limitations.* Notwithstanding any other provision of this paragraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method shall not exceed the greater of:

(i) Six-tenths of 1 percent of the eligible loans outstanding at the close of the taxable year, or

(ii) An amount sufficient to increase the reserve for losses on loans at the close of the taxable year to six-tenths of 1 percent of the eligible loans outstanding at the close of the taxable year.

The application of the rules provided by this subparagraph may be illustrated by the following example:

Example. The Y Bank begins business as a commercial bank on July 1, 1974. Y adopts the calendar year as its taxable year and the reserve method of accounting for bad debts.

(a) During 1974, Y has net bad debts of $1,000. On December 31, 1974, Y has $1,000,000 of outstanding eligible loans. Under subparagraph (1)(ii)(B) of this paragraph, because Y is a newly-organized financial institution, there is no reserve deficiency. Except for the limitations of this subparagraph, the maximum reasonable addition under subparagraph (1)(ii)(A) of this paragraph would be the amount of net bad debts charged to the reserve for losses ($1,000) plus the allowable percentage of outstanding eligible loans at the close of the taxable year $18,000 (1.8% ×

$1,000,000). However, because of the limitations of this subparagraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method is an amount sufficient to increase the balance of the reserve for losses on loans to $6,000 which is 0.6 percent of the eligible loans outstanding at the close of the taxable year. Assuming that Y makes an addition to the reserve for losses on loans of $7,000 for the year, the balance of the reserve as of December 31, 1974, is $6,000 ($7,000 − $1,000). The $7,000 consists of the $1,000 in net bad debts and $6,000 attributable to the increase in eligible loans outstanding.

(b) During 1975, Y has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1975, Y has $1,000,000 of outstanding eligible loans. Except for the limitations of this subparagraph, the maximum reasonable addition under subparagraph (1)(ii)(A) of this paragraph would be the amount of net bad debts charged to the reserve for losses ($1,000) plus an amount attributable to the increase in the amount of eligible loans outstanding with respect to which no reasonable addition was allowed in 1974 ($12,000, *i.e.*, $18,000 − $6,000). However, because of the limitations of this paragraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method is $6,000 which is an amount equal to 0.6 percent of the eligible loans outstanding at the close of the taxable year. This amount consists of net bad debts of $1,000 and $5,000 attributable to a portion of the increase in eligible loans in 1974 with respect to which no reasonable addition was allowable for 1974. Assuming that Y makes an addition to the reserve for losses on loans of $6,000 for the year, the balance of the reserve as of December 31, 1975, is $11,000 ($6,000 − $1,000 + $6,000).

(c) During 1976, Y has net bad debts charged to the reserve for losses on loans of $1,000. On December 31, 1976, Y has $1,000,000 in outstanding eligible loans. At the close of 1975 (Y's base year for 1976), the amount of outstanding eligible loans was also $1,000,000. Consequently, there is a reserve deficiency of $1,000 ((1.2% × $1,000,000)—$11,000). The maximum reasonable addition to the reserve for losses under subparagraph (1)(ii)(A) of this paragraph is $1,200 which consists of one-fifth of the reserve deficiency ($1,000 × ⅕ = $200) and the net bad debts charged to the reserve for losses on loans for the year ($1,000). Because that amount is less than 0.6 percent of the eligible loans outstanding at the close of the taxable year (0.6% × $1,000,000 = $6,000), the limitations of this subparagraph do not apply. Assuming that Y makes an addition to the reserve for losses on loans of $1,200 for the year, the balance of the reserve as of December 31, 1976, is $11,200 ($11,000 − $1,000 + $1,200).

(c) *Experience method*—(1) *In general*—(i) *Maximum addition*. The amount determined under this paragraph for a taxable year is the amount necessary to increase the balance of the reserve for losses on loans (as of the close of the taxable year) to the greater of the amount determined under subdivision (ii) or (iii) of this subparagraph. For special rules for a new financial institution, see subparagraph (2) of this paragraph.

(ii) *Six-year moving average amount*. The amount determined under this subdivision is the amount which bears the same ratio to loans outstanding at the close of the taxable year as (A) the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (B) the sum of the loans outstanding at the close of such 6 (or fewer) taxable years. For purposes of applying this subdivision, a period shorter than 6 years generally would be appropriate only where there is a change in the type of a substantial portion of the loans outstanding such that the risk of loss is substantially increased. For example, if the major portion of a bank's portfolio of loans changes fromagricultural loans to industrial loans which results in a substantial increase in the risk of loss, a period shorter than 6 years may be appropriate. Similarly, a bank which has recently altered its lending practices to include in its portfolio of loans consumer-installment loans, when it had previously made only commercial loans, may also qualify to use a period shorter than six years. A decline in the general economic conditions in the area, which substantially increase the risk of loss, is a relevant factor which may be considered. In any case, however, approval to use a shorter period will not be granted unless the taxpayer supplies specific evidence that the loans outstanding at the close of the taxable years for the shorter period requested are not comparable in nature and risk to loans outstanding at the close of the six taxable years. The fact that a bank's bad debt experience has shown a substantial increase is not, by itself, sufficient to justify use of a

shorter period. If approval is granted to use a shorter period, the experience for those taxable years which are excluded shall not be used for any subsequent year. A request for approval to exclude the experience of a prior taxable year shall not be considered unless it is sent to the Commissioner at least 30 days before the close of the first taxable year for which such approval is requested.

(iii) *Base year amount.* The amount determined under this subdivision is the lower of (A) the balance of the reserve as of the close of the base year, or (B) if the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the base year, the amount which bears the same ratio to loans outstanding at the close of the taxable year as the balance of the reserve as of the close of the base year bears to the amount of loans outstanding at the close of the base year.

(2) *Special rules for new financial institutions*—(i) *In general.* In the case of any taxable year preceded by less than 5 authorization years (as defined in paragraph (e)(5) of this section), subparagraph (1) of this paragraph shall be applied with the adjustments provided by subdivision (ii) of this subparagraph.

(ii) *Adjustments.* (A) The total bad debts for the 6-year period computed under subparagraph (1)(ii)(A) of this paragraph shall be the sum of:

(*1*) The bad debts sustained by the taxpayer during its authorization years, adjusted for recoveries of bad debts for such years, and

(*2*) That fraction of the total bad debts sustained by a comparable bank (as defined in paragraph (e)(7) of this section) during the comparison years (as defined in paragraph (e)(6) of this section), adjusted for recoveries of bad debts for such years, which bears the same ratio to such total as the average loans outstanding of the taxpayer during the authorization years bears to the average loans outstanding of the comparable bank during the comparison years.

(B) The total amount of loans outstanding during the 6-year period computed under subparagraph (1)(ii)(B) of this paragraph shall be six times the average loans outstanding of the taxpayer during the authorization years.

(d) *Change in accounting method from specific charge-off method to reserve method of treating bad debts*—(1) *In general.* If a bank is granted permission in accordance with § 1.446–1(e)(3) to change its method of accounting for bad debts from a method under which specific bad debt items are deducted to the reserve method of treating bad debts, the taxpayer shall effect the change as provided in subparagraphs (2) and (3) of this paragraph.

(2) *Initial balance of the reserve.* The initial balance of the reserve at the close of the year of change shall be no less than the minimum addition as described in paragraph (a)(2) of this section and shall be no larger than the greater of:

(i) The allowable percentage of eligible loans outstanding at the close of the taxable year of change, or

(ii) The amount which bears the same ratio to loans outstanding at the close of the taxable year as the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to the sum of the loans outstanding at the close of such 6 or fewer taxable years.

In the case of taxable years beginning after 1987, the initial balance of the reserve at the end of the year of change shall be the amount specified in subdivision (ii) of this subparagraph.

(3) *Deduction with respect to initial balance.* The deduction with respect to the initial balance of the reserve at the close of the taxable year of change, determined under subparagraph (2) of this paragraph, is allowable ratably over a period of 10 years commencing with the taxable year of change (or a shorter period as may be approved by the Commissioner). Thus, the bad debt deduction under section 166 for the taxable year of change will consist of the amount of debts determined to be wholly or partially worthless and charged-off during such taxable year plus one-tenth (if a 10-year period is used) of the amount of the reserve determined under subparagraph (2) of this paragraph. For each of the 9 taxable

years following the taxable year of change, the bad debt deduction will consist of the reasonable addition to the reserve for bad debts for each such year as provided by section 585, as otherwise determined, plus one-tenth of the amount determined to be theinitial balance of the reserve under subparagraph (2) of this paragraph. The amount established as a bad debt reserve for the taxable year of change under subparagraph (2) of this paragraph shall be considered as the balance of the reserve for purposes of determining the amount of subsequent additions to such reserve, even though the entire amount of the reserve may not have been deducted under section 585(a)(1) or former section 166(c) because of the requirement that it be deducted over a number of years.

(e) *Definitions*—(1) *Base year*—(i) *Percentage method*. For purposes of paragraph (b) of this section (relating to the percentage method), the term *base year* means: For years beginning before 1976, the last taxable year beginning on or before July 11, 1969; for taxable years beginning after 1975 but before 1983, the last taxable year beginning before 1976; and, for taxable years beginning after 1982, the last taxable year beginning before 1983. However, for purposes of section 585(b)(2)(A) the term *base year* means the last taxable year before the most recent adoption of the percentage method, if later than the base year as determined under the preceding sentence.

(ii) *Experience method*. For purposes of paragraph (c) of this section (relating to the experience method), the term *base year* means (A) the last taxable year before the most recent adoption of the experience method, or (B) the last taxable year beginning on or before July 11, 1969, which ever is later; and for taxable years beginning after 1987, the last taxable year beginning before 1988.

(iii) *Example*. The application of the rules provided by this subparagraph may be illustrated by the following example:

Example. The T Bank is a commercial bank which has a calendar year as its taxable year. T adopted the reserve method of accounting for bad debts in 1950. On December 31, 1969, T has $1,000,000 of outstanding eligible loans and a balance of $19,300 in its reserve for losses on loans.

(a) During 1970, T has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1970, T has $1,050,000 of outstanding eligible loans. T elects the percentage method. The base year is 1969. The maximum reasonable addition under the percentage method of $1,000 which is the amount sufficient to increase the balance of the reserve as of the close of the taxable year to the balance of the reserve as of the close of the base year 1969 ($19.300). Assuming that T makes an addition to the reserve for losses on loans of $1,000 for the year, the balance of the reserve for losses on loans as of December 31, 1970, is $19,300 ($19,300 − $1,000 + $1,000).

(b) During 1971, T has net bad debts of $8,000 charged to the reserve for losses on loans. On December 31, 1971, T has $1,100,000 of outstanding eligible loans. T elects the experience method. The base year is 1970. The maximum reasonable addition under the experience method is $8,000 which is the amount sufficient to increase the balance of the reserve as of the close of the taxable year to the balance of the reserve as of the close of the 1970 base year ($19,300). Assuming that T makes an addition to the reserve for losses on loans of $8,000 for the year, the balance of the reserve for losses on loans as of December 31, 1971, is $19,300, ($19,300 − $8,000 + $8,000).

(c) During 1972, T has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1972, T has $1,200,000 of outstanding eligible loans. T elects the percentage method. The base year is 1971 and there is a reserve deficiency of $500 ((1.8% × $1,100,000) − $19,300). The maximum reasonable addition under the percentage method is $2,900 which consists of $100 of reserve deficiency (⅕ × $500), the $1,000 in net bad debts charged to the reserve for losses on loans, and $1,800 attributable to the increase in the balance of eligible loans (1.8% × ($1,200,000 − $1,100,000)). Assuming that T makes an addition to the reserve for losses on loans of $2,900 for the year, the balance of the reserve for losses on loans as of December 31, 1972, is $21,200 ($19,300 − $1,000 + $2,900).

(2) *Loan*—(i) *General rule*. For purposes of this section and §§ 1.585–1, 1.585–3, and 1.585–4, the term *loan* means debt as the term *debt* is used in section 166 and the regulations thereunder. The term *loan* includes (but is not limited to) the following items:

(A) An overdraft in one or more deposit accounts by a customer in good faith whether or not other deposit accounts of the same customer have balances in excess of the overdraft;

(B) A bankers acceptance purchased or discounted by a bank; and

(C) A loan participation to the extent that the taxpayer bears a risk of loss.

For purposes of (B) of this subdivision (i), a bankers acceptance shall be considered as a loan made by the bank which purchased or discounted the bankers acceptance and not a loan made by the originating bank.

(ii) *Exceptions.* Notwithstanding the provisions of subdivision (i) of this subparagraph, the term *loan* does not include the following items:

(A) Discount or interest receivable reflected in the face amount of an outstanding loan, which discount or interest has not been included in gross income;

(B) For taxable years beginning after December 31, 1976, commercial paper, however acquired by the bank, including, for example, short-term promissory notes which may be purchased on the open market;

(C) For taxable years beginning after December 31, 1976, a debt evidenced by a security (as defined in section 165(g)(2)(C) and the regulations thereunder);

(D) Any loan which is entered into or acquired for the primary purpose of enlarging the otherwise available bad debt deduction;

(E) Loans which have been contractually committed to the extent that funds have not been disbursed to the borrower or disbursed on behalf of the borrower; and

(F) Any transaction which is in violation of a Federal or State statute that governs the activities of the financial institution.

(3) *Eligible loan*—(i) *General rule.* For purposes of this section and §§ 1.585–3 and 1.585–4, the term *eligible loan* means a loan (as defined in subparagraph (2) of this paragraph) which is incurred in the course of the normal customer loan activities of a financial institution and which is not a loan described in subdivision (ii) of this subparagraph. Nothing within the preceding sentence will be construed to exclude from the term *eligible loan* a bona fide loan in a new market or under a novel repayment arrangement if the likelihood of nonrepayment is at least as great as that of other customer loans of the financial institution.

(ii) *Exceptions.* Loans which do not constitute eligible loans include:

(A) A loan to a bank (as defined in section 581 and the regulations thereunder) or to a domestic branch of a foreign corporation to which § 1.585–1 applies, including a repurchase transaction or other similar transaction;

(B) Bank funds on deposit in any bank (foreign or domestic) such as a deposit represented by a certificate of deposit or any other form of instrument evidencing the deposit of a sum of money with the issuing bank that will be available on or after a stated date or period of time;

(C) A sale or loan of Federal funds irrespective of the purchaser or borrower;

(D) A loan, to the extent that it is directly or indirectly made to, guaranteed by, or insured by the United States, a possession or instrumentality thereof, or a State or political subdivision thereof; and

(E) A loan which is secured by a deposit in the lending financial institution or in a bank as defined in section 581 or a domestic branch of a foreign corporation to which this section applies to the extent that the financial institution has control over withdrawal of such deposit.

(iii) *Definition of loan which is secured by a deposit.* For purposes of subdivision (ii)(E) of this subparagraph:

(A) A loan is considered secured if the loan is on the security of any instrument which makes the deposit specific security for the payment of the loan, provided that such instrument is of such a nature that in the event of default the deposit could be subjected to the satisfaction of the loan;

(B) A deposit includes a guarantee deposit in the form of a *holdback*, pledged collateral that has been reduced to cash, and loan payments that are maintained in a separate account; and

(C) Control over the withdrawal of a deposit is evidenced by possession of a passbook, certificate of deposit, note, or other similar instrument the possession of which is normally required to permit withdrawal. The lending financial institution does not have control over withdrawal of the deposit if the

deposit can be withdrawn without consent of the lending financial institution. Thus, the lending financial institution normally does not have control over the withdrawal of a deposit in an account merely because the borrower agrees to maintain a minimum, average, or compensating balance.

(4) *Predecessor*. For purposes of this section, the term *predecessor* means (i) any taxpayer which transferred more than 50 percent of the total amount of its assets to the taxpayer and is described in §1.585–1, or (ii) any predecessor of such predecessor.

(5) *Authorization years*. For purposes of this section, the term *authorization years* means the number of years, containing 12 complete months, between (i) the first day of the first full taxable year of the taxpayer for which it (or any predecessor) was authorized to do business as a financial institution described in §1.585–1, and (ii) the taxable year.

(6) *Comparison years*. For purposes of this section, the term *comparison years* means those consecutive taxable years containing 12 complete months of a comparable bank, the last of which ends within 12 months immediately preceding the beginning of the first taxable year of the taxpayer, which are equal in number to six minus the number of authorization years of the taxpayer.

(7) *Comparable bank*. For purposes of this section, the term *comparable bank* means all the financial institutions described in §1.585–1 located within the same Federal Reserve district.

(8) *Average loans outstanding*. For purposes of this section, the term *average loans outstanding* means the sum of the loans outstanding at the close of each taxable year of a period divided by the number of taxable years in such period.

(9) *Adjusted for recoveries of bad debts*. For purposes of this section, the term *adjusted for recoveries of bad debts* means an adjustment for the full amount recovered with respect to bad debts previously charged to the reserve during any of the applicable taxable years.

(Sec. 585(b)(4), of the Internal Revenue Code of 1954 (83 Stat. 618; (26 U.S.C. 585(b)(4))))

[T.D. 7532, 43 FR 3109, Jan. 23, 1978, as amended by T.D. 7835, 47 FR 42342, Sept. 27, 1982; T.D. 8513, 58 FR 68757, Dec. 29, 1993]

§ 1.585–3 Special rules.

(a) *Treatment of reserve*. For taxable years beginning after July 11, 1969, if a financial institution to which section 585 and §1.585–1 apply establishes a reserve pursuant to section 585(a) (or, for taxable years beginning before January 1, 1987, section 166(c)), any bad debt in respect of a loan (whether or not such loan is an eligible loan) must be charged to the reserve for losses on loans provided for by §1.585–1 for the taxable year in which the bad debt occurs. For such a year, any recovery of a bad debt previously charged to the reserve account in respect of a loan (whether or not such loan is an eligible loan) must be credited to such reserve in the taxable year of recovery regardless of whether such credit causes the reserve to exceed the permissible amount. If, as a result of net recoveries during the taxable year, the reserve balance exceeds the permissible amount, a taxpayer is not required to report the excess as taxable income. In such a case, the excess over the otherwise permissible amount in the reserve account precludes current reasonable additions to the reserve and may affect future reasonable additions. Recoveries of bad debts which were not charged to the reserve shall not be credited to such reserve, but shall be treated as taxable income subject to the provisions of section 111. No item other than a loan as defined in §1.585–2 (e)(2) shall be charged to the reserve for losses on loans.

(b) *Accounting for reserve*. A financial institution to which section 585 and §1.585–1 apply which establishes a reserve pursuant to section 585(a) (or, for taxable years beginning before January 1, 1987, section 166(c)) shall establish and maintain a permanent record of such reserve. Copies of Federal income tax returns and amended returns with attached schedules satisfy the requirements of this paragraph provided that such returns are permanently maintained by the financial institution and the balance of the reserve for losses on loans established pursuant to section 585(a) (or former section 166(c)) can be readily reconciled with the reservefor losses on loans maintained by the financial institution for financial statement purposes. The requirements of

this paragraph would also be satisfied if a financial institution establishes and maintains a permanent subsidiary ledger reflecting an account for the reserve for losses on loans established pursuant to section 585(a) (or former section 166(c)) provided the balance in such account can be readily reconciled with the balance of the reserve for losses on loans for financial statement purposes maintained in any other ledger. The permanent records maintained pursuant to this section must reflect any changes in the amount initially added to the reserve for losses on loans and the amount finally determined by the taxpayer to be a reasonable addition to the reserve for losses on loans.

(Sec. 585(b)(4), of the Internal Revenue Code of 1954 (83 Stat. 618; (26 U.S.C. 585(b)(4))))

[T.D. 7532, 43 FR 3114, Jan. 23, 1978, as amended by T.D. 8513, 58 FR 68757, Dec. 29, 1993]

§ 1.585–4 Reorganizations and asset acquisitions.

(a) *In general*. In computing a reasonable addition to the reserve for losses on loans for the first taxable year ending after a transaction to which section 381(a) applies and for subsequent taxable years, the separate reserves for losses on loans, the amount of loans outstanding, the total bad debts sustained (adjusted for recoveries), and the amount of eligible loans outstanding of the distributor or transferor corporation and the acquiring corporation (or, in the case of a consolidation, the transferor corporations) shall be combined for all applicable years. Thus, for example, in applying § 1.585–2(c)(1)(i) for the first taxable year ending after the distribution or transfer, the total bad debts sustained during the 5 preceding taxable years are the sum of the bad debts sustained by the acquiring corporation for the 5 preceding taxable years and bad debts sustained by the distributor or transferor corporation for the taxable year ending on the date of distribution or transfer and the 4 preceding taxable years.

(b) *Base year and base year amounts of acquiring corporation*—(1) *Base year*. For transactions to which section 381(a) applies, the base year of the acquiring corporation for the first taxable year ending after the date of distribution or transfer shall be the last taxable year ending on or before the date of distribution or transfer. The balance of the reserve, the amount of loans outstanding, and the amount of eligible loans outstanding at the close of such base year shall be determined in accordance with the provisions of subparagraph (2)(i) of this paragraph. For taxable years subsequent to the first taxable year ending after the date of distribution or transfer, the base year of the acquiring corporation shall be the more recent of the base year provided by the first sentence of this subparagraph or the base year provided by § 1.585–2(e)(1). If § 1.585–2(e)(1) provides the more recent base year, the balance of the reserve for losses on loans, the amount of loans outstanding, and the amount of eligible loans outstanding shall be determined at the close of such base year without regard to this paragraph.

(2) *Base year amounts*—(i) *Method of determination*. The balance of the reserve for losses on loans, the amount of loans outstanding, and the amount of eligible loans outstanding at the close of the base year provided by the first sentence of subparagraph (1) of this paragraph shall be the total of such amounts of the distributor or transferor corporation and the acquiring corporation (or, in the case of a consolidation, the transferor corporations) at the close of what would have been their respective base years determined under § 1.585–2(e)(1) if the distribution or transfer to which section 381(a) applies had not occurred, except that the method (experience or percentage) used or adopted by the acquiring corporation to determine its reasonable addition to a reserve for losses on loans for the first taxable year ending after the date of the distribution or transfer shall be considered to be the method that the distributor or transferor corporation (or, in the case of a consolidation, that the transferor corporation) would have used or adopted for its first taxable year ending after the date of distribution or transfer if the distribution or transfer had not occurred.

(ii) *Examples*. The application of the rule provided by this subparagraph may be illustrated by the following examples:

Example 1. The X Corporation and the Y Corporation are commercial banks both of which have a calendar year as a taxable year. Both X and Y adopted the reserve method of accounting for bad debts prior to July 11, 1969. For the taxable year 1970 through 1973, X and Y determined their reasonable additions to a reserve for losses on loans as defined in §1.585–2(e)(2) under the percentage method. On June 30, 1974, the X Bank is merged into the Y Bank; for its short taxable year ending on June 30, 1974, X determines its reasonable addition under the percentage method. If, for the taxable year ending on December 31, 1974 (the first taxable year ending after the date of distribution or transfer), Y determines its reasonable addition to a reserve for losses on loans under the percentage method, then at the close of the base year the reserve balance, the amount of outstanding loans, and the amount of eligible loans outstanding are the sum of X's and Y's respective amounts at the close of the taxable year endingDecember 31, 1969 (the base year of both X and Y determined under §1.585–2(e)(1) as if the distribution or transfer had not taken place). If, instead of the above, Y adopts the experience method of determining its reasonable addition to a reserve for losses for the taxable year 1974, than at the close of the base year (1973) the reserve balances, the amount of loans outstanding, and the amount of eligible loans outstanding are the sum of X's respective amounts at the close of its short taxable year ending on June 30, 1974 (X's last taxable year before its (Y's) most recent adoption of the experience method) and of Y's respective amounts at the close of its taxable year 1973 (Y's last taxable year before its most recent adoption of the experience method).

Example 2. The M Corporation and the N Corporation are commercial banks. M has a fiscal year ending September 30, as its taxable year and N has a calendar year as its taxable year. Both M and N adopted the reserve method of accounting for bad debts prior to July 11, 1969. For the taxable years ending in 1970, 1971, and 1972, M determined its reasonable addition to a reserve for losses under the percentage method; for the taxable year ending in 1973 M adopted the experience method. For the taxable years 1970 through 1973 N determined its reasonable addition under the percentage method. M is merged into N on June 30, 1974, and for its short taxable year ending on June 30, 1974, M determines its reasonable addition under the experience method. If, for the taxable year ending on December 31, 1974 (thefirst taxable year ending after the date of distribution or transfer), N determines its reasonable addition to a reserve for losses under the percentage method, then at the close of the base year (1973) the reserve balance, the amount of loans outstanding, and the amount of eligible loans outstanding are the sum of M's respective amounts at the close of (a) if M had a reserve deficiency as of June 30, 1974, its short taxable year ending on June 30, 1974 (M's last taxable year before its (N's) most recent adoption of the percentage method), or (b) if M did not have a reserve deficiency, the taxable year ending on September 30, 1969, and N's respective amounts at the close of its taxable year 1979. If, instead of the above, N adopts the experience method for the taxable year 1974, then at the close of the base year the reserve balance, the amount of outstanding loans, and the amount of eligible loans outstanding are the sum of M's respective amounts at the close of its taxable year ending on September 30, 1972 (the last taxable year before M's most recent adoption of the experience method), and N's respective amounts at the close of the taxable year 1973 (the last taxable year ending before N's most recent adoption of the experience method).

(Sec. 585(b)(4), of the Internal Revenue Code of 1954 (83 Stat. 618; (26 U.S.C. 585(b)(4))))

[T.D. 7532, 43 FR 3114, Jan. 23, 1978]

§1.585–5 Denial of bad debt reserves for large banks.

(a) *General rule.* For taxable years beginning after December 31, 1986, a large bank (as defined in paragraph (b) of this section) may not deduct any amount under section 585 or any other section for an addition to a reserve for bad debts. However, for these years, except as provided in §1.585–7, a large bank may deduct amounts allowed under section 166(a) for specific debts that become worthless in whole or in part. Any large bank that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year (as defined in paragraph (d)(1) of this section) must follow the rules prescribed by §1.585–6 or §1.585–7 for changing from the reserve method of accounting for bad debts that is allowed by section 585, to the specific charge-off method of accounting for bad debts, in its disqualification year. However, except as may be provided otherwise in regulations prescribed under section 593, the rules prescribed by §§1.585–6 and 1.585–7 do not apply to a large bank that maintained a reserve for bad debts under section 593 for the taxable year immediately preceding its disqualification year.

(b) *Large bank*—(1) *General definition.* For purposes of this section, a large

bank is any institution described in §1.585–1(b)(1) (i) or (ii) if, for the taxable year (or for any preceding taxable year beginning after December 31, 1986)—

(i) The average total assets of the institution (determined under paragraph (c) of this section) exceed $500,000,000; or

(ii) The institution is a member of a parent-subsidiary controlled group (as defined in paragraph (d)(2) of this section) and the average total assets of the group exceed $500,000,000.

(2) *Large bank resulting from transfer by large bank*—(i) *In general*. If a corporation acquires the assets of a large bank (as defined in this paragraph (b)) in an acquisition to which paragraph (b)(2) (ii), (iii) or (iv) of this section applies, the acquiring corporation (the acquiror) is treated as a large bank for any taxable year ending after the date of the acquisition in which it is an institution described in §1.585–1(b)(1) (i) or (ii).

(ii) *Transfer of significant portion of assets where control is retained*. This paragraph (b)(2)(ii) applies to any direct or indirect acquisition of a significant portion of a large bank's assets if, after the acquisition, the transferor large bank owns more than 50 percent (by vote or value) of the outstanding stock of the acquiror. For this purpose, stock of an acquiror is considered owned by a transferor bank if the stock is owned by any member of a parent-subsidiary controlled group (as defined in paragraph (d)(2) of this section) of which the bank is a member, by any related party within the meaning of section 267(b) or 707(b), or by any person that received the stock in a transaction to which section 355 applies.

(iii) *Transfer to which section 381 applies*. This paragraph (b)(2)(iii) applies to any acquisition to which section 381(a) applies if, immediately after the acquisition, the acquiror's principal method of accounting for bad debts (determined under §1.381(c)(4)–1(c)(2)) with respect to its banking business is the specific charge-off method. In applying §1.381(c)(4)–1(c)(2) for this purpose, the following rules apply: A transferor large bank is considered to use the specific charge-off method for all of its loans immediately before the acquisition; an acquiror is considered to use a reserve method for all of its loans immediately before the acquisition; and all banking businesses of the acquiror immediately after the acquisition are treated as one integrated business. See §§1.585–6(c)(3) and 1.585–7(d)(2) for rules on the treatment of assets acquired from large banks in section 381(a) transactions.

(iv) *Transfer of substantially all assets to related party*. This paragraph (b)(2)(iv) applies to any direct or indirect acquisition of substantially all of a large bank's assets if the transferor large bank and the acquiror are related parties before or after the acquisition and a principal purpose of the acquisition is to avoid treating the acquired assets as those of a large bank. A transferor bank and an acquiror are considered to be related parties for this purpose if they are members of the same parent-subsidiary controlled group (as defined in paragraph (d)(2) of this section) or related parties within the meaning of section 267(b) or 707(b).

(3) *Examples*. The following examples illustrate the principles of this paragraph (b):

Example 1. Bank M, a calendar year taxpayer, is an institution described in §1.585–1(b)(1)(i). For its taxable year beginning on January 1, 1987, M has average total assets of $600 million. Since M's average total assets for 1987 exceed $500 million, M is a large bank for that year. Pursuant to §1.585–5(d)(1), 1987 is M's disqualification year. If M maintained a bad debt reserve under section 585 for its immediately preceding taxable year (1986), M must change in 1987 to the specific charge-off method of accounting for bad debts, in accordance with §1.585–6 or §1.585–7.

Example 2. Assume the same facts as in Example 1. Also assume that in 1988 M disposes of a portion of its assets and, as a result, M's average total assets for taxable year 1988 fall to $400 million. M remains a large bank for taxable year 1988 and succeeding taxable years, since its average total assets for a preceding taxable year (1987) beginning after December 31, 1986, exceeded $500 million.

Example 3. Bank P, a calendar year taxpayer, is an institution described in §1.585–1(b)(1)(i). P has average total assets of $300 million for its taxable year beginning on January 1, 1988. For the same year, P is a member of a parent-subsidiary controlled group (within the meaning of §1.585–5(d)(2)) that has average total assets of $800 million. In February 1989, the group sells its stock in P to several individual investors. P is a large

bank for taxable year 1988 because it is a member of a group described in §1.585–5(b)(1)(ii) for that year. P also is a large bank for taxable year 1989 and succeeding taxable years because it was a member of a group described in §1.585–5(b)(1)(ii) for a preceding taxable year (1988) beginning after December 31, 1986.

Example 4. Assume the same facts as in Example 3, except that P's stock is purchased by a corporation that is not a large bank under §1.585–5(b). Also assume that the purchasing corporation elects under section 338 to treat the stock purchase as an asset acquisition. Under section 338, P is considered to have sold all of its assets on the purchase date and is treated as a new corporation that purchased these assets on the next day. Since P is treated as a new corporation, its prior membership in a group described in §1.585–5(b)(1)(ii) does not cause it to be treated as a large bank for taxable years ending after the date of its sale by the group. However, P may be treated as a large bank because of new membership in such a group or pursuant to §1.585–5(b)(1)(i) or (b)(2).

Example 5. Bank Q is a large bank, within the meaning of §1.585–5(b)(1), for its taxable year beginning on January 1, 1988, and hence for all later years. On March 1, 1989, Q transfers $200 million of its $600 million of assets to Bank R, a newly created subsidiary, in a transaction to which section 351 applies; these assets are R's only assets. On the same day, Q then spins off R in a transaction to which section 355 applies. After these transactions, the shareholders of Q own more than 50 percent of R's outstanding stock. Although R's average total assets do not exceed $500 million, R becomes a large bank on March 1, 1989, pursuant to §1.585–5(b)(2)(ii). These transactions do not affect Q's status as a large bank.

Example 6. Bank S is a large bank, within the meaning of §1.585–5(b)(1)(ii), for its taxable year beginning on January 1, 1987. As a result, S changes to the specific charge-off method of accounting for bad debts in that year. Bank T, which is not a large bank under §1.585–5(b), uses the reserve method of accounting for bad debts. On June 30, 1988, T acquires substantially all of S's assets in a transaction to which section 381(a) applies. Immediately before the acquisition, S's banking business has total assets of $200 million, and T's has total assets of $250 million. To determine whether T is a large bank under §1.585–5(b)(2)(iii) for taxable years ending after the acquisition, it is necessary to determine T's principal method of accounting for bad debts with respect to its banking business immediately after the acquisition. This determination requires an application of §1.381(c)(4)–1(c)(2). For this purpose, T's original and acquired banking businesses are treated as an integrated business. Applying §1.381(c)(4)–1(c)(2), it is determined that the business's principal method of accounting for bad debts immediately after the acquisition is the reserve method. Hence, the acquisition does not cause T to become a large bank under §1.585–5(b)(2)(iii).

(c) *Average total assets*—(1) *In general.* For purposes of paragraph (b)(1) of this section, and except as otherwise provided in paragraph (c)(3)(ii) of this section, the average total assets of an institution or group for any taxable year are determined by—

(i) Computing, for each report date (as defined in paragraph (c)(2) of this section) within the taxable year, the amount of total assets (as defined in paragraph (c)(3) of this section) held by the institution or group as of the close of business on the report date;

(ii) Adding these amounts; and

(iii) Dividing the sum of these amounts by the number of report dates within the taxable year.

(2) *Report date*—(i) *Institutions*—(A) *In general.* A report date for an institution generally is the last day of the regular period for which the institution must report to its primary Federal regulatory agency. However, an institution that is required to report to its primary Federal regulatory agency more frequently than quarterly may choose the last day of the calendar quarter as its report date, and an institution that is required to report to its primary Federal regulatory agency less frequently than quarterly must choose the last day of the calendar quarter as its report date. If an institution does not have a Federal regulatory agency, its primary State regulatory agency is considered its primary Federal regulatory agency for purposes of this paragraph (c)(2)(i)(A). In the case of a short taxable year that does not otherwise include a report date, the first or last day of the taxable year is the institution's report date for the year.

(B) *Alternative report date.* In lieu of the report date prescribed by paragraph (c)(2)(i)(A) of this section, for any taxable year an institution may choose as its report date the last day of any regular interval in the taxable year that is more frequent than quarterly (such as bi-monthly, monthly, weekly, or daily).

(ii) *Groups.* If all members of a parent-subsidiary controlled group have

the same taxable year, a report date for the group is the report date, determined under paragraph (c)(2)(i) of this section, for any one member of the group that is an institution described in §1.585–1(b)(1) (i) or (ii). The same report date must be used in applying paragraph (b)(1)(ii) of this section to all members of the group for a taxable year. If all members of a parent-subsidiary controlled group do not have the same taxable year, a report date for the group must be determined under similar principles.

(iii) *Member of group for only part of taxable year*. If an institution is a member of a parent-subsidiary controlled group for only part of a taxable year, paragraph (b)(1)(ii) of this section is applied to the institution for that year on the basis of the group's average total assets for the portion of the year that the institution is a member of the group. Thus, only the group's report dates (as determined under paragraph (c)(2)(ii) of this section) that are included in that portion of the year are taken into account in determining the group's average total assets for purposes of applying paragraph (b)(1)(ii) of this section to the institution. If no report date of the group is included in that portion of the year, the first or last day of that portion of the year must be treated as the group's report date for purposes of this paragraph (c)(2)(iii).

(3) *Total assets*—(i) *All corporations*. The amount of total assets held by an institution or group is the amount of cash, plus the sum of the adjusted bases of all other assets, held by the institution or group. For this purpose, the adjusted basis of an asset generally is its basis for Federal income tax purposes, determined under sections 1012, 1016 and other applicable sections of the Internal Revenue Code. In determining the amount of total assets held by a group, any asset of a member of the group that is an interest in another member of the group is not to be counted.

(ii) *Foreign corporations*. In determining the amount of total assets held by a foreign corporation, all of the corporation's assets are taken into account, including those that are not effectively connected with the conduct of a banking business within the United States. In the case of a foreign corporation that is not engaged in a trade or business in the United States, the adjusted basis of an asset must be determined substantially in accordance with United States tax principles as provided in regulations under section 964. In the case of a foreign corporation that is engaged in a trade or business in the United States, the amount of its average total assets for a taxable year (within the meaning of paragraph (c)(1) of this section) is the amount of the corporation's average worldwide assets used for purposes of computing the interest expense deduction allowable under section 882 and §1.882–5 for the taxable year.

(4) *Estimated adjusted tax bases*—(i) *In general*. The amount of the adjusted Federal income tax bases (tax bases) of assets held on a report date may be estimated, for purposes of applying paragraph (c)(3) of this section. This estimate must be based on the adjusted bases of the assets on that date as determined by reference to the asset holder's books and records maintained for financial reporting purposes (book bases). The estimate must reflect any change in the ratio between the asset holder's tax and book bases of assets that occurs during the taxable year, and the estimate must assume that this change occurs ratably. If an institution or group member estimates the tax bases of assets held on any report date during a taxable year, it must do so for all assets (other than cash) held on that report date, and it must do so for all other report dates during the year. However, the tax bases of assets may not be estimated for any report date that is the first or last day of the taxable year or that is determined under paragraph (c)(2)(i)(B) of this section.

(ii) *Formulas*. The estimated amount of the tax bases of assets held on any report date during a taxable year is based on the following variables: The total book bases of the assets on the report date (B); the asset holder's *tax/book ratio* as of the close of the preceding taxable year (R); and the result (whether positive or negative) obtained when R is subtracted from the asset holder's *tax/book ratio* as of the close of

the current taxable year (Y). For purposes of determining R and Y, an asset holder's *tax/book ratio* is the ratio of the total tax bases of all of the holder's assets (other than cash), to the total book bases of those assets. If an asset holder's taxable year is the calendar year and its report date is the last day of the calendar quarter, its estimated tax bases of assets held on the first three report dates of the year are determined under the following formulas:

1st Report Date = B × (R + ¼Y)
2nd Report Date = B × (R + ½Y)
3rd Report Date = B × (R + ¾Y)

(5) *Examples*. The following examples illustrate the principles of this paragraph (c):

Example 1. Bank U is a fiscal year taxpayer, and its fiscal year ends on January 31. U reports to its primary Federal regulatory agency as of the last day of the calendar quarter. U does not choose under §1.585–5(c)(2)(i)(B) a report date more frequent than quarterly. Thus, U's report dates under §1.585–5(c)(2)(i)(A) are March 31, June 30, September 30, and December 31. For its taxable year beginning on February 1, 1987, U has total assets (within the meaning of §1.585–5(c)(3)) of $480 million on March 31, $490 million on June 30, $510 million on September 30, and $540 million on December 31. Thus, pursuant to §1.585–5(c)(1), U's average total assets for its taxable year beginning on February 1, 1987, are $505 million.

Example 2. Bank W is a calendar year taxpayer, and its report date (within the meaning of §1.585–5(c)(2)(i)(A)) is the last day of the calendar quarter. Pursuant to §1.585–5(c)(4), W chooses to estimate the tax bases of its assets for 1990. Therefore, W must estimate the tax bases of all of its assets (other than cash) for its first three report dates in 1990. Since W's fourth report date (December 31) is the last day of its taxable year, the tax bases of its assets may not be estimated for this date. The adjusted tax bases ofall of W's assets (other than cash) are $450z on December 31, 1989, and $480z on December 31, 1990. The book bases of those assets are $500z on December 31, 1989; $520z on March 31, 1990; $540z on June 30, 1990; $560z on September 30, 1990; and $600z on December 31, 1990. Applying the formulas provided in §1.585–5(c)(4)(ii), W's tax/book ratio as of the close of 1989 (R), is 0.9 (450z/500z). W's tax/book ratio as of the close of 1990 is 0.8 (480z/600z). Thus, Y is −0.1. The estimated adjusted tax bases of all of W's assets (other than cash) on the first three report dates of 1990 are as follows:

$$\begin{aligned} 1st &= B \times (R + 1/4Y) \\ &= \$520z \times [0.9 + 1/4(-0.1)] \\ &= \$455z \\ 2nd &= B \times (R + 1/2Y) \\ &= \$540z \times [0.9 + 1/2(-0.1)] \\ &= \$459z \\ 3rd &= B \times (R + 3/4Y) \\ &= \$560z \times [0.9 + 3/4(-0.1)] \\ &= \$462z \end{aligned}$$

(d) *Definitions*. The following definitions apply for purposes of this section and §§1.585–6, 1.585–7 and 1.585–8:

(1) *Disqualification year*. A bank's disqualification year is its first taxable year beginning after December 31, 1986, for which the bank is a large bank within the meaning of paragraph (b) of this section.

(2) *Parent-subsidiary controlled group*. A parent-subsidiary controlled group includes all of the members of a controlled group of corporations described in section 1563(a)(1). The members of such a group are determined without regard to whether any member is an *excluded member* described in section 1563(b)(2), a foreign entity, or a commercial bank.

(3) *Example*. The following example illustrates the principles of this paragraph (d):

Example. Bank X is a large bank within the meaning of §1.585–5(b)(1)(i). Bank Y is not a large bank under §1.585–5(b), and it maintains a bad debt reserve under section 585. In 1988, X purchases all of the stock of Y. If the acquisition causes Y to become a member of a parent-subsidiary controlled group described in §1.585–5(b)(1)(ii), Y is a large bank beginning in its first taxable year that ends after the date of the acquisition. Pursuant to §1.585–5(d)(1), this year is Y's disqualification year. Y must change in this year to the specific charge-off method of accounting for bad debts, in accordance with §1.585–6 or §1.585–7.

[T.D. 8513, 58 FR 68757, Dec. 29, 1993; 59 FR 15502, Apr. 1, 1994]

§1.585–6 Recapture method of changing from the reserve method of section 585.

(a) *General rule*. This section applies to any large bank (as defined in §1.585–5(b)) that maintained a reserve for bad debts under section 585 for the taxable

year immediately preceding its disqualification year (as defined in § 1.585–5(d)(1)) and that does not elect the cut-off method set forth in § 1.585–7. Except as otherwise provided in paragraphs (c) and (d) of this section, any bank to which this section applies must include in income the amount of its net section 481(a) adjustment (as defined in paragraph (b)(3) of this section) over the four-year period beginning with the bank's disqualification year. If a bank follows the rules prescribed by thissection, its change to the specific charge-off method of accounting for bad debts in its disqualification year will be treated as a change in accounting method that is made with the consent of the Commissioner. Paragraph (b) of this section specifies the portion of the net section 481(a) adjustment to be included in income in each year of the recapture period; paragraph (c) of this section provides rules on the effect of disposing of loans; and paragraph (d) of this section provides rules on the suspension of recapture by financially troubled banks.

(b) *Four-year spread of net section 481(a) adjustment*—(1) *In general*. If a bank to which this section applies does not make the election allowed by paragraph (b)(2) of this section, the bank must include in income the following portions of its net section 481(a) adjustment in each year of the four-year recapture period: 10 percent in the bank's disqualification year; 20 percent in its first taxable year after its disqualification year; 30 percent in its second taxable year after its disqualification year; and 40 percent in its third taxable year after its disqualification year.

(2) *Election to include more than 10 percent in disqualification year*. A bank to which this section applies may elect to include in income, in its disqualification year, any percentage of its net section 481(a) adjustment that is larger than 10 percent. Any such election must be made at the time and in the manner prescribed by § 1.585–8. If a bank makes such an election, the bank must include in income the remainder, if any, of its net section 481(a) adjustment in the following portions: 2/9 of the remainder in the bank's first taxable year after its disqualification year; 1/3 of the remainder in its second taxable year after its disqualification year; and 4/9 of the remainder in its third taxable year after its disqualification year. For this purpose, the remainder of a bank's net section 481(a) adjustment is any portion of the adjustment that the bank does not elect to include in income in its disqualification year.

(3) *Net section 481(a) adjustment*. For purposes of this section, the amount of a bank's net section 481(a) adjustment is the amount of the bank's reserve for bad debts as of the close of the taxable year immediately preceding its disqualification year. Since the change from the reserve method of section 585 is initiated by the taxpayer, the amount of the bank's bad debt reserve for this purpose is not reduced by amounts attributable to taxable years beginning before 1954.

(4) *Examples*. The following examples illustrate the principles of this paragraph (b):

Example 1. Bank M is a large bank within the meaning of § 1.585–5(b). M's disqualification year is its taxable year beginning on January 1, 1989, and M maintained a bad debt reserve under section 585 for the preceding taxable year. Pursuant to § 1.585–5(a), M must change from the reserve method of accounting for bad debts to the specific charge-off method in its disqualification year. M does not elect the cut-off method set forth in § 1.585–7. Thus, M must follow the recapture method set forth in this § 1.585–6. M's net section 481(a) adjustment, as defined in § 1.585–6(b)(3), is $2 million. M does not make the election allowed by § 1.585–6(b)(2). Pursuant to § 1.585–6(b)(1), M must include the following amounts in income: $200,000 in taxable year 1989; $400,000 in 1990; $600,000 in 1991; and $800,000 in 1992.

Example 2. Assume the same facts as in Example 1, except that M elects under § 1.585–6(b)(2) to recapture 55 percent of its net section 481(a) adjustment in its disqualification year. Pursuant to § 1.585–6(b)(2), M must include the following amounts in income: $1,100,000 in taxable year 1989; $200,000 in 1990; $300,000 in 1991; and $400,000 in 1992.

(c) *Effect of disposing of loans*—(1) *In general*. Except as provided in paragraphs (c)(2) and (c)(3) of this section, if a bank to which this section applies sells or otherwise disposes of any of its outstanding loans on or after the first day of its disqualification year, the disposition does not affect the bank's obligation under this section to include in

income the amount of its net section 481(a) adjustment, and the disposition does not affect the amount of this adjustment.

(2) *Cessation of banking business*—(i) *In general*. If a bank to which this section applies ceases to engage in the business of banking before it is otherwise required to include in income the full amount of its net section 481(a) adjustment, the bank must include in income the remaining amount of the adjustment in the taxable year in which it ceases to engage in the business of banking. For this purpose, and except as provided in paragraph (c)(2)(ii) of this section, whether a bank ceases to engage in the business of banking is determined under the principles of §1.446–1(e)(3)(ii) and its administrative procedures.

(ii) *Transition rule*. A bank that ceases to engage in the business of banking as the result of a transaction to which section 381(a) applies is not treated as ceasing to engage in the business of banking if, on or before March 29, 1994, either the transaction occurs or the bank enters into a binding written agreement to carry out the transaction.

(3) *Certain section 381 transactions*. This paragraph (c)(3) applies if a bank to which this section applies transfers outstanding loans to another corporation on or after the first day of the bank's disqualification year (and before it has included in income the full amount of its net section 481(a) adjustment) in a transaction to which section 381(a) applies, and under paragraph (c)(2) (i) or (ii) of this section the transferor bank is not treated as ceasing to engage in the business of banking as a result of the transaction. If this paragraph (c)(3) applies, the acquiring corporation (the acquiror) steps into the shoes of the transferor with respect to using the recapture method prescribed by this section and assumes all of the transferor's rights and obligations under paragraph (b) of this section. The unrecaptured balance of the transferor's net section 481(a) adjustment carries over in the transaction to the acquiror, and the acquiror must complete the four-year recapture procedure begun by the transferor. In applying this procedure, the transferor's taxable year that ends on or includes the date of the acquisition and the acquiror's first taxable year ending after the date of the acquisition represent two consecutive taxable years within the four-year recapture period.

(4) *Examples*. The following examples illustrate the principles of this paragraph (c):

Example 1. Bank P is a bank to which this §1.585–6 applies. P's disqualification year is its taxable year beginning on January 1, 1989, and P recaptures 10 percent of its net section 481(a) adjustment in that year pursuant to §1.585–6(b)(1). In July 1990 P disposes of a portion of its loan portfolio in a transaction to which section 381(a) does not apply, and P continues to engage in the business of banking. Pursuant to §1.585–6(c)(1), the disposition does not affect P's obligation under §1.585–6(b)(1) to recapture the remainder of its net section 481(a) adjustment in 1990, 1991 and 1992. Nor does the disposition affect the amount of the adjustment.

Example 2. Assume the same facts as in Example 1, except that P ceases to engage in the business of banking in 1990, as determined under the principles of §1.446–1(e)(3)(ii) and its administrative procedures. Pursuant to §1.585–6(c)(2)(i), in 1990 P must include in income the remaining 90 percent of its net section 481(a) adjustment.

Example 3. Assume the same facts as in Example 1, except that P's 1990 disposition of loans is a transaction to which section 381(a) applies, P ceases to engage in the business of banking as a result of the transaction, and P's taxable year ends on the date of the transaction. Thus, in the transaction, P transfers substantially all of its loans to an acquiring corporation (Q). Q is a calendar year taxpayer. Because the transaction occurred before March 29, 1994, the transition rule of §1.585–6(c)(2)(ii) applies, and P is not treated as ceasing to engage in the business of banking. Pursuant to §1.585–6(c)(3), Q steps into P's shoes with respect to using the recapture method prescribed by §1.585–6. The unrecaptured balance of P's net section 481(a) adjustment carries over to Q in the section 381(a) transaction, and Q must complete the four-year recapture procedure begun by P. Pursuant to §§1.585–6(b) and 1.585–6(c)(3), P includes 20 percent of its net section 481(a) adjustment in income in its taxable year ending on the date of the section 381(a) transaction, and Q includes 30 percent of the adjustment in income in 1990 and 40 percent in 1991.

Example 4. Assume the same facts as in Example 3. Assume also that Q becomes a large bank under §1.585–5(b) as a result of the transaction and maintained a bad debt reserve immediately before the transaction. Q

must change to the specific charge-off method for all of its loans in the first taxable year that it is a large bank. Thus, Q not only completes the recapture procedure begun by P but also follows the rules prescribed by §1.585–6 or §1.585–7 with respect to its own reserve.

Example 5. Assume the same facts as in Example 3. Assume also that Q is not a large bank after the transaction and properly establishes a bad debt reserve for the loans it receives in the transaction. This establishment of the reserve results in a new negative section 481(a) adjustment. Thus, Q not only completes the recapture procedure begun by P but also takes into account the new negative adjustment as required under section 381.

(d) *Suspension of recapture by financially troubled banks*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, a bank that is financially troubled (within the meaning of paragraph (d)(3) of this section) for any taxable year must not include any amount in income under paragraphs (a) and (b) of this section for that taxable year and must disregard that taxable year in applying paragraphs (a) and (b) of this section to other taxable years. See paragraph (d)(4) of this section for rules on determining estimated tax payments of financially troubled banks, and see paragraph (d)(5) of this section for examples illustrating this paragraph (d).

(2) *Election to recapture.* A bank that is financially troubled (within the meaning of paragraph (d)(3) of this section) for its disqualification year may elect to include in income, in one taxable year, any percentage of its net section 481(a) adjustment that is greater than 10 percent. This election may be made for the bank's disqualification year, for the first taxable year after the disqualification year in which the bank is not financially troubled (within the meaning of paragraph (d)(3) of this section), or for any intervening taxable year. Any such election must be made at the time and in the manner prescribed by §1.585–8. A bank that makes this election must include an amount in income under paragraphs (a) and (b) of this section in the year for which the election is made (election year) and must not disregard this year in applying paragraphs (a) and (b) of this section to other taxable years. Such a bank must follow the rules of paragraph (b)(2) of this section in applying paragraph (b) of this section to later taxable years, treating the election year as the disqualification year for purposes of applying paragraph (b)(2) of this section. However, if the bank is financially troubled for any year after its election year, the bank must not include any amount in income under paragraphs (a) and (b) of this section for the later year and must disregard the later year in applying paragraphs (a) and (b) of this section to other taxable years.

(3) *Definition of financially troubled*—(i) *In general.* For purposes of this section, a bank is considered financially troubled for any taxable year if the bank's nonperforming loan percentage for that year exceeds 75 percent. For this purpose, a bank's nonperforming loan percentage is the percentage determined by dividing the sum of the outstanding balances of the bank's nonperforming loans (as defined in paragraph (d)(3)(iii) of this section) as of the close of each quarter of the taxable year, by the sum of the amounts of the bank's equity (as defined in paragraph (d)(3)(iv) of this section) as of the close of each such quarter. The quarters for a short taxable year of at least 3 months are the same as those of the bank's annual accounting period, except that quarters ending before or after the short year are disregarded. If a taxable year consists of less than 3 months, the first or last day of the taxable year is treated as the last day of its only quarter. In lieu of determining its nonperforming loan percentageon the basis of loans and equity as of the close of each quarter of the taxable year, a bank may, for all years, determine this percentage on the basis of loans and equity as of the close of each report date (as defined in §1.585–5(c)(2), without regard to §1.585–5(c)(2)(i)(B)). In the case of a bank that is a foreign corporation, all nonperforming loans and equity of the bank are taken into account, including loans and equity that are not effectively connected with the conduct of a banking business within the United States.

(ii) *Parent-subsidiary controlled groups*—(A) *In general.* If a bank is a member of a parent-subsidiary controlled group (as defined in §1.585–

5(d)(2)) for the taxable year, the nonperforming loans and the equity of all members of the bank's financial group (as determined under paragraph (d)(3)(ii)(B) of this section) are treated as the nonperforming loans and the equity of the bank for purposes of paragraph (d)(3)(i) of this section. However, any equity interest that a member of a bank's financial group holds in another member of this group is not to be counted in determining equity. Similarly, any loan that a member of a bank's financial group makes to another member of the group is not to be counted in determining nonperforming loans. All banks that are members of the same parent-subsidiary controlled group must (for all taxable years that they are members of this group) determine their nonperforming loan percentage on the basis of the close of each quarter of the taxable year, or all must (for all such taxable years) determine this percentage on the basis of the close of each report date (as determined under §1.585–5(c)(2)(ii), applied without regard to §1.585–5(c)(2)(i)(B)).

(B) *Financial group*—(*1*) *In general.* All banks that are members of the same parent-subsidiary controlled group must (for all taxable years that they are members of this group) determine their financial group under paragraph (d)(3)(ii)(B)(*2*) of this section, or all must (for all such taxable years) determine their financial group under paragraph (d)(3)(ii)(B)(*3*) of this section.

(*2*) *Financial institution members of parent-subsidiary controlled group.* A bank's financial group, determined under this paragraph (d)(3)(ii)(B)(*2*), consists of all financial institutions within the meaning of section 265(b)(5) (and comparable foreign financial institutions) that are members of the parent-subsidiary controlled group of which the bank is a member.

(*3*) *All members of parent-subsidiary controlled group.* A bank's financial group, determined under this paragraph (d)(3)(ii)(B)(*3*), consists of all members of the parent-subsidiary controlled group of which the bank is a member.

(iii) *Nonperforming loan*—(A) *In general.* For purposes of this section, a nonperforming loan is any loan (as defined in paragraph (d)(3)(iii)(B) of this section) that is considered to be nonperforming by the holder's primary Federal regulatory agency. Nonperforming loans include the following types of loans as defined by the Federal Financial Institutions Examination Council: Loans that are past due 90 days or more and still accruing; loans that are in nonaccrual status; and loans that are restructured troubled debt. A loan is not considered to be nonperforming merely because it is past due, if it is past due less than 90 days. The outstanding balances of nonperforming loans are determined on the basis of amounts that are required to be reported to the holder's primary Federal regulatory agency. For purposes of this paragraph (d)(3)(iii)(A), a holder that does not have a Federal regulatory agency is treated as Federally regulated under the standards prescribed by the Federal Financial Institutions Examination Council.

(B) *Loan.* For purposes of paragraph (d)(3)(iii)(A) of this section, a loan is any extension of credit that is defined and treated as a loan under the standards prescribed by the Federal Financial Institutions Examination Council. (Accordingly, a troubled debt restructuring that is in substance a foreclosure or repossession is not considered a loan.) In addition, a debt evidenced by a security issued by a foreign government is treated as a loan if the security is issued as an integral part of a restructuring of one or more troubled loans to the foreign government (or an agency or instrumentality thereof). Similarly, a deposit with the central bank of a foreign country is treated as a loan if the deposit is made under a deposit facility agreement that is entered into as an integral part of a restructuring of one or more troubled loans to the foreign country's government (or an agency or instrumentality thereof).

(iv) *Equity.* For purposes of this section, the equity of a bank or other financial institution is its equity (i.e., assets minus liabilities) as required to be reported to the institution's primary Federal regulatory agency (or, if the institution does not have a Federal regulatory agency, as required under the standards prescribed by the Federal Financial Institutions Examination

Council). The balance in a reserve for bad debts is not treated as equity.

(4) *Estimated tax payments of financially troubled banks.* For purposes of applying section 6655(e)(2)(A)(i) with respect to any installment of estimated tax, a bank that is financially troubled as of the due date of the installment is treated as if no amount will be included in income under paragraphs (a) and (b) of this section for the taxable year. For this purpose, a bank is considered financially troubled as of the due date of an installment of estimated tax only if its nonperforming loan percentage (computed under paragraph (d)(3) of this section) would exceed 75 percent for a short taxable year ending on that date. For purposes of computing this nonperforming loan percentage, the ending of such a short taxable year would not cause the last day of that year to be treated as the last day of a quarter of the taxable year.

(5) *Examples.* The following examples illustrate the principles of this paragraph (d):

Example 1. Bank R is a bank to which this §1.585–6 applies. R's disqualification year is its taxable year beginning on January 1, 1987. R is not financially troubled (within the meaning of §1.585–6(d)(3)) for taxable year 1987 or for any taxable year after 1989, but it is financially troubled for taxable years 1988 and 1989. Since R is not financially troubled for its disqualification year, R must include an amount in income under §1.585–6 (a) and (b) for that year (taxable year 1987). R may make the election allowed by §1.585–6(b)(2) for that year. Since R is financially troubled for taxable years 1988 and 1989, pursuant to §1.585–6(d)(1) R does not include any amount in income under §1.585–6 (a) and (b) for these years, and it treats taxable years 1990, 1991 and 1992 as the first, second and third taxable years after its disqualification year for purposes of applying §1.585–6 (a) and (b).

Example 2. Assume the same facts as in Example 1, except that R is financially troubled for taxable year 1987 (its disqualification year). R may make the election allowed by §1.585–6(d)(2) for 1987 (the disqualification year), for 1990 (the first year after the disqualification year in which R is not financially troubled), or for 1988 or 1989 (the intervening years). R elects to include 60 percent of its net section 481(a) adjustment in income in 1987. Thus, the remainder of the adjustment, for purposes of applying the rules of §1.585–6(b)(2), is 40 percent. R must include in income 2/9 of the remainder in 1990, 1/3 of the remainder in 1991, and 4/9 of the remainder in 1992.

Example 3. Bank S, which is not a member of a parent-subsidiary controlled group, is a bank to which this §1.585–6 applies. S's disqualification year is its taxable year beginning on January 1, 1987. S determines its nonperforming loan percentage under §1.585–6(d)(3) on a quarterly basis. S is not financially troubled for taxable year 1987 and includes 10 percent of its net section 481(a) adjustment in income in that year. S's outstanding balance of nonperforming loans (as defined in §1.585–6(d)(3)(iii)) is $80 million on March 31, 1988; $68 million on June 30, 1988; and $59 million on September 30, 1988. The amount of S's equity (as defined in §1.585–6(d)(3)(iv)) is $100 million on each of these threedates. Thus, S's nonperforming loan percentage, computed under §1.585–6(d)(3), would be 80 percent (80/100) for a short taxable year ending on April 15 or June 15, 74 percent [(80 + 68) ÷ 200] for a short taxable year ending on September 15, and 69 percent [(80 + 68 + 59) ÷ 300] for a short taxable year ending on December 15. Since S's nonperforming loan percentage for a short taxable year ending on April 15 or June 15 would exceed 75 percent, pursuant to §1.585–6(d)(4) S is considered financially troubled as of these dates. Thus, S is treated as if no amount will be included in income under §1.585–6 (a) and (b) for the year for purposes of applying section 6655(e)(2)(A)(i) with respect to the installments of estimated tax that are due on April 15, 1988, and June 15, 1988. However, since S's nonperforming loan percentage for a short taxable year ending on September 15 or December 15 would not exceed 75 percent, S is not considered financially troubled as of these dates. Thus, S is treated as if 20 percent of its net section 481(a) adjustment will be included in income under §1.585–6 (a) and (b) for the year for purposes of applying section 6655(e)(2)(A)(i) with respect to the installments of estimated tax that are due on September 15, 1988, and December 15, 1988.

[T.D. 8513, 58 FR 68760, Dec. 29, 1993; 59 FR 15502, Apr. 1, 1994]

§1.585–7 Elective cut-off method of changing from the reserve method of section 585.

(a) *General rule.* Any large bank (as defined in §1.585–5(b)) that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year (as defined in §1.585–5(d)(1)) may elect to use the cut-off method set forth in this section. Any such election must be made at the time and in the manner prescribed by §1.585–8. If a bank makes this election, the bank must maintain its bad debt reserve for its pre- disqualification loans, as prescribed in

paragraph (b) of this section, and the bank must include in income any excess balance in this reserve, as required by paragraph (c) of this section. The bank may not deduct, for its disqualification year or any subsequent taxable year, any amount allowed under section 166(a) for pre-disqualification loans (as defined in paragraph (b)(2) of this section) that become worthless in whole or in part, except as allowed by paragraph (b)(1) of this section. However, except as provided in paragraph (d)(3) of this section, the bank may deduct, for its disqualification year or any subsequent taxable year, amounts allowed under section 166(a) for loans that the bank originates or acquires on or after the first day of its disqualification year and that become worthless in whole or in part. If a bank makes the election allowed by this paragraph (a), its change to the specific charge-off method of accounting for bad debts in its disqualification year does not give rise to a section 481(a) adjustment.

(b) *Maintaining reserve for pre-disqualification loans*—(1) *In general*. A bank that makes the election allowed by paragraph (a) of this section must maintain its bad debt reserve for its pre-disqualification loans (as defined in paragraph (b)(2) of this section). Except as provided in paragraph (d)(3) of this section, the bank must charge against the reserve the amount of any losses resulting from these loans (including losses resulting from the sale or other disposition of these loans), and the bank must add to the reserve the amount of recoveries with respect to these loans. In general, the reserve must be maintained in the manner provided by former section 166(c) of the Internal Revenue Code and the regulations thereunder. However, after the balance in the reserve is reduced to zero, the bank is to account for any losses and recoveries with respect to outstanding pre-disqualification loans under the specific charge-off method of accounting for bad debts, as if the bank always had accounted for these loans under this method.

(2) *Definition of pre-disqualification loans*. For purposes of this section, a pre-disqualification loan of a bank is any loan that the bank held on the last day of its taxable year immediately preceding its disqualification year (as defined in §1.585–5(d)(1)). If the amount of a pre-disqualification loan is increased during or after the disqualification year, the amount of the increase is not treated as a pre-disqualification loan.

(c) *Amount to be included in income when reserve balance exceeds loan balance*. If, as of the close of any taxable year, the balance in a bank's reserve that is maintained under paragraph (b) of this section exceeds the balance of the bank's outstanding pre-disqualification loans, the bank must include in income the amount of the excess for the taxable year. The balance in the reserve is then reduced by the amount of this excess. See paragraph (d) of this section for rules on the application of this paragraph (c) when a bank disposes of loans.

(d) *Effect of disposing of loans*—(1) *In general*. Except as provided in paragraphs (d)(2) and (d)(3) of this section, if a bank that makes the election allowed by paragraph (a) of this section sells or otherwise disposes of any of its outstanding pre-disqualification loans, the bank is to reduce the balance of its outstanding pre-disqualification loans by the amount of the loans disposed of, for purposes of applying paragraph (c) of this section.

(2) *Section 381 transactions*. If a bank that makes the election allowed by paragraph (a) of this section transfers outstanding pre-disqualification loans to another corporation in a transaction to which section 381(a) applies, the acquiring corporation (the acquiror) must follow the rules of paragraph (d)(2)(i) or (ii) of this section.

(i) *Acquiror completes cut-off method of change*. Except as provided in paragraph (d)(2)(ii) of this section, the acquiror steps into the shoes of the transferor in the section 381(a) transaction with respect to using the cut-off method of change. Thus, the transferor's bad debt reserve immediately before the section 381(a) transaction carries over to the acquiror, and the acquiror must complete the cut-off method begun by the transferor. For purposes of completing the transferor's cut-off method, the acquiror's balance of outstanding pre-disqualification loans immediately after the section

381(a) transaction is the balance of these loans that it receives in the transaction, and the acquiror assumes all of the transferor's rights and obligations under this section.

(ii) *Acquiror uses reserve method.* If the acquiror is not a large bank (within the meaning of §1.585–5(b)) immediately after the section 381(a) transaction and uses a reserve method of accounting for bad debts attributable to the pre-disqualification loans (and any other loans) received in the transaction, the acquiror does not step into the shoes of the transferor with respect to using the cut-off method of change. The transferor's bad debt reserve immediately before the section 381(a) transaction carries over to the acquiror, but the acquiror does not continue the cut-off method begun by the transferor. If the six-year moving average amount (as defined in §1.585–2(c)(1)(ii)) for all of the loans received in the transaction exceeds the balance of the reserve that carries over to the acquiror, the acquiror increases this balance by the amount of the excess. Any such increase in the reserve results in a negative section 481(a) adjustment that is taken into account as required under section 381.

(3) *Dispositions intended to change the status of pre-disqualification loans.* This paragraph (d)(3) applies if a bank that makes the election allowed by paragraph (a) of this section sells, exchanges, or otherwise disposes of a significant amount of its pre-disqualification loans (as defined in paragraph (b)(2) of this section) and a principal purpose of the transaction is to avoid the provisions of this section by increasing the amount of loans for which deductions are allowable under the specific charge-off method. If this paragraph (d)(3) applies, the District Director may disregard the disposition for purposes of paragraphs (b)(1) and (d)(1) of this section or treat the replacement loans as pre-disqualification loans. If loans are so treated as pre-disqualification loans, no deductions are allowable under the specific charge-off method for the loans, except as provided in paragraph (b)(1) of this section, and the disposition that causes the loans to be so treated may be disregarded for purposes of paragraphs (b)(1) and (d)(1) of this section. If a bank sells pre-disqualification loans and uses the proceeds of the sale to originate new loans, this paragraph (d)(3) does not apply to the transaction.

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

Example 1. Bank M is a bank that properly elects to use the cut-off method set forth in this §1.585–7. M's disqualification year is its taxable year beginning on January 1, 1987. On December 31, 1986, M had outstanding loans of $700 million (pre-disqualification loans), and the balance in its bad debt reserve was $10 million. M must maintain its reserve for its pre-disqualification loans in accordance with §1.585–7(b), and it may not deduct any addition to this reserve for taxable year 1987 or any later year. For these years, M may deduct amounts allowed under section 166(a) for loans that it originates or acquires after December 31, 1986, and that become worthless in whole or in part.

Example 2. Assume the same facts as in Example 1. Also assume that in 1987 M collects $150 million of its pre- disqualification loans, M determines that $2 million of its pre-disqualification loans are worthless, and M recovers $1 million of pre-disqualification loans that it had previously charged against the reserve as worthless. On December 31, 1987, the balance in M's bad debt reserve is $9 million ($10 million − $2 million + $1 million), and the balance of its outstanding pre-disqualification loans is $548 million ($700 million − $150 million − $2 million).

Example 3. Assume the same facts as in Examples 1 and 2. Also assume that on December 31, 1990, the balance in M's bad debt reserve is $5 million and the balance of its outstanding pre-disqualification loans is $25 million. In 1991 M collects $21 million of its outstanding pre-disqualification loans and determines that $1 million of its outstanding pre-disqualification loans are worthless. Thus, on December 31, 1991, the balance in M's bad debt reserve is $4 million ($5 million − $1 million), and the balance of its outstanding pre-disqualification loans is $3 million ($25 million − $21 million − $1 million). Accordingly, M must include $1 million ($4 million − $3 million) in income in taxable year 1991, pursuant to §1.585–7(c). On January 1, 1992, the balance in M's reserve is $3 million ($4 million − $1 million).

Example 4. Assume the same facts as in Examples 1 through 3. Also assume that in 1992 M transfers substantially all of its assets to another corporation (N) in a transaction to which section 381(a) applies, and N is treated as a large bank under §1.585–5(b)(2) for taxable years ending after the date of the transaction. Pursuant to §1.585–7(d)(2)(i), N steps into M's shoes with respect to using the cut-

off method. M's bad debt reserve immediately before the section 381(a) transaction carries over to N, and N must complete the cut-off procedure begun by M. For this purpose, N's balance of outstanding pre-disqualification loans immediately after the section 381(a) transaction is the balance of these loans that it receives from M.

Example 5. Assume the same facts as in Examples 1 through 4, except that N is not treated as a large bank after the section 381(a) transaction. Also assume that N uses the reserve method of section 585 and plans to use this method for all of the loans it acquires from M (including loans that were not pre-disqualification loans). Pursuant to §1.585–7(d)(2)(ii), M's bad debt reserve immediately before the section 381(a) transaction carries over to N in the transaction; however, N does not continue the cut-off procedure begun by M and does not treat any loan as a pre-disqualification loan. If the six-year moving average amount (as defined in §1.585–2(c)(1)(ii)) for all of N's newly acquired loans exceeds the balance of the reserve that carries over to N, N increases this balance by the amount of the excess. Any such increase in the reserve results in a negative section 481(a) adjustment that is taken into account as required under section 381.

[T.D. 8513, 58 FR 68762, Dec. 29, 1993; 59 FR 15502, Apr. 1, 1994]

§1.585–8 Rules for making and revoking elections under §§1.585–6 and 1.585–7.

(a) *Time of making elections*—(1) *In general.* Any election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) must be made on or before the later of—

(i) February 28, 1994; or

(ii) The due date (taking extensions into account) of the electing bank's original tax return for its disqualification year (as defined in §1.585–5(d)(1)) or, for elections under §1.585–6(d)(2), the year for which the election is made.

(2) *No extension of time for payment.* Payments of tax due must be made in accordance with chapter 62 of the Internal Revenue Code. However, if an election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) is made or revoked on or before February 28, 1994 and the making or revoking of the election results in an underpayment of estimated tax (within the meaning of section 6655(a)) with respect to an installment of estimated tax due on or before the date the election was so made or revoked, no addition to tax will be imposed under section 6655(a) with respect to the amount of the underpayment attributable to the making or revoking of the election.

(b) *Manner of making elections*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, an electing bank must make any election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) by attaching a statement to its tax return (or amended return) for its disqualification year or, for elections under §1.585–6(d)(2), the year for which the election is made. This statement must contain the following information:

(i) The name, address and taxpayer identification number of the electing bank;

(ii) The nature of the election being made (i.e., whether the election is to include in income more than 10 percent of the bank's net section 481(a) adjustment under §1.585–6 (b)(2) or (d)(2) or to use the cut-off method under §1.585–7); and

(iii) If the election is under §1.585–6(b)(2) or (d)(2), the percentage being elected.

(2) *Certain tax returns filed before December 29, 1993.* A bank is deemed to have made an election under §1.585–6(b)(2) or (d)(2) if the bank evidences its intent to make an election under section 585(c)(3)(A)(iii)(I) or section 585(c)(3)(B)(ii) for its disqualification year (or, for elections under §1.585–6(d)(2), the election year), by designating a specific recapture amount on its tax return or amended return for that year (or attaching a statement in accordance with §301.9100–7T(a)(3)(i) of this chapter), and the return is filed before December 29, 1993. A bank is deemed to have made an election under §1.585–7(a) if the bank evidences its intent to make an election under section 585(c)(4) for its disqualification year by attaching a statement in accordance with §301.9100–7T(a)(3)(i) of this chapter to its tax return or amended return for that year, and the return is filed before December 29, 1993.

(c) *Revocation of elections*—(1) *On or before final date for making election.* An election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) may be revoked

without the consent of the Commissioner on or before the final date prescribed by paragraph (a)(1) of this section for making the election. To do so, the bank that made the election must file an amended tax return for its disqualification year (or, for elections under §1.585–6(d)(2), the year for which the election was made) and attach a statement that—

(i) Includes the bank's name, address and taxpayer identification number;

(ii) Identifies and withdraws the previous election; and

(iii) If the bank is making a new election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a), contains the information described in paragraphs (b)(1)(ii) and (b)(1)(iii) of this section.

(2) *After final date for making election.* An election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) may be revoked only with the consent of the Commissioner after the final date prescribed by paragraph (a)(1) of this section for making the election. The Commissioner will grant this consent only in extraordinary circumstances.

(d) *Elections by banks that are members of parent-subsidiary controlled groups.* In the case of a bank that is a member of a parent-subsidiary controlled group (as defined in §1.585–5(d)(2)), any election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) with respect to the bank is to be made separately by the bank. An election made by one member of such a group is not binding on any other member of the group.

(e) *Elections made or revoked by amended return on or before February 28, 1994.* This paragraph (e) applies to any election that a bank seeks to make under paragraph (b) of this section, or revoke under paragraph (c) of this section, by means of an amended return that is filed on or before February 28, 1994. To make or revoke an election to which this paragraph (e) applies, a bank must file (before expiration of each applicable period of limitations under section 6501) this amended return and amended returns for all taxable years after the taxable year for which the election is made or revoked by amended return, to any extent necessary to report the bank's tax liability in a manner consistent with the making or revoking of the election by amended return.

[T.D. 8513, 58 FR 68764, Dec. 29, 1993; 59 FR 4583, Feb. 1, 1994; 59 FR 15502, Apr. 1, 1994]

§1.586–1 Reserve for losses on loans of small business investment companies, etc.

(a) *General rule.* As an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, a taxpayer which is a financial institution to which section 586 and this section apply is allowed a deduction under section 166(c) for a reasonable addition to a reserve for bad debts provided such financial institution has adopted or adopts the reserve method of treating bad debts in accordance with paragraph (b) of §1.166–1. In the case of such a taxpayer, the amount of the reasonable addition to such reserve for a taxable year beginning after July 11, 1969, shall be an amount determined by the taxpayer which does not exceed the amount computed under §1.586–2. A financial institution to which section 586 and this section apply which adopts the reserve method is not entitled to charge-off any bad debts pursuant to section 166(a) with respect to a loan (as defined in §1.586–2(c)(2)). Except as provided by §1.586–2, regarding the manner of computation of the addition to the reserve for bad debts, the reserve for bad debts of a financial institution to which this section applies shall be maintained in the same manner as is provided by section 166(c) and the regulations thereunder with respect to reserves for bad debts. Except as provided by this section, no deduction is allowable for an addition to a reserve for bad debts of a financial institution to which section 586 and this section apply. For rules relating to deduction with respect to debts which are not loans (as defined in §1.586–2(c)(2)), see section 166(a) and the regulations thereunder.

(b) *Application of section.* Section 586 and this section shall apply only to the following financial institutions:

(1) Any small business investment company operating under the Small Business Investment Act of 1958 as amended and supplemented (72 Stat. 689), and

(2) Any business development corporation, which for purposes of this section, means a corporation which was created by or pursuant to an act of a State legislature for purposes of promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans which would generally not be made by banks (as defined in section 581 and the regulations thereunder) within such region or State in the ordinary course of their businesses (except on the basis of a partial participation), and which is operated primarily for such purposes.

[T.D. 7444, 41 FR 53482, Dec. 7, 1976]

§ 1.586–2 Addition to reserve.

(a) *General rule.* Except as provided by paragraph (b) of this section, the amount computed under this section is the amount necessary to increase the balance of the reserve for bad debts (as of the close of the taxable year) to the greater of:

(1) The amount which bears the same ratio to loans outstanding at the close of the taxable year as (i) the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (ii) the sum of the loans outstanding at the close of such 6 or fewer taxable years, or

(2) The lower of:

(i) The balance of the reserve as of the close of the base year, or

(ii) If the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the base year, the amount which bears the same ratio to loans outstanding at the close of the taxable year as the balance of the reserve as of the close of the base year bears to the amount of loans outstanding at the close of the base year.

For purposes of subparagraph (2) of this paragraph, the term *base year* means the last taxable year beginning on or before July 11, 1969. For purposes of applying this paragraph, a period shorter than the 6 years generally would be appropriate only where there is a change in the type of a substantial portion of the loans outstanding such that the risk of loss is substantially increased. For example, if the major portion of a business development corporation's portfolio of loans changes from agricultural loans to industrial loans which results in a substantial increase in the risk of loss, a period shorter than the 6 years may be appropriate. If approval is granted to use a shorter period, the experience for those taxable years which are excluded shall not be used for any subsequent year. A request for approval to exclude the experience of a prior taxable year shall not be considered unless it is sent to the Commissioner at least 30 days before the close of the current taxable year. The request shall include a statement of the reasons such experience should be excluded.

(b) *New financial institutions*—(1) *Small business investment companies.* In the case of a new financial institution which is a small business investment company to which section 586 applies, the amount computed under this section is the greater of the amount computed under paragraph (a) of this section or the amount necessary to increase the balance of the reserve for bad debts as of the close of the taxable year to the amount which bears the same ratio to loans outstanding at the close of the taxable year as:

(i) The total bad debts (as determined by the Commissioner) sustained by all such small business investment companies during the 12-month period ending on March 31 that ends with or within the taxpayer's previous taxable year, and during the five 12-month periods ending on March 31 that precede such 12-month period, adjusted for recoveries of bad debts during such periods (as determined by the Commissioner), bears to

(ii) The sum of the loans outstanding (as determined by the Commissioner) by all such small business investment companies at the close of each of such six 12-month periods ending on March 31.

(2) *Business development corporations.* In the case of a new financial institution which is a business development corporation to which section 586 applies, the amount computed under this section is the greater of the amount

computed under paragraph (a) of this section or the amount necessary to increase the balance of the reserve for bad debts as of the close of the taxable year to the amount which bears the same ratio to loans outstanding at the close of the taxable year as:

(i) The total bad debts (as determined by the Commissioner) sustained by all such business development corporations during the calendar year ending with or within the taxpayer's previous taxable year and during the 5 calendar years preceding such calendar year, adjusted for recoveries of bad debts during such period (as determined by the Commissioner), bears to

(ii) The sum of the loans outstanding (as determined by the Commissioner) by all such business development corporations at the close of each of such 6 calendar years.

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

(1) *New financial institution*. A financial institution is a new financial institution for any taxable year beginning less than 10 years after the day on which it (or any predecessor) was authorized to do business as a financial institution described in the applicable subparagraph of §1.586–1(b). For this purpose, the term *predecessor* means (i) any taxpayer which transferred more than 50 percent of the total amount of its assets to the taxpayer and is described in the same subparagraph of §1.586–1(b) which describes the taxpayer, or (ii) any predecessor of such predecessor.

(2) *Loan*. (i) The term *loan* means debt, as the term *debt* is used in section 166 and the regulations there-under.

(ii) The term *loan* does not include the following items:

(A) Discount or interest receivable reflected in the face amount of an outstanding loan, which discount or interest has not been included in gross income;

(B) A debt evidenced by a security (as defined in section 165(g)(2)(C) and the regulations thereunder); and

(C) Any loan which is entered into or acquired for the primary purpose of enlarging the otherwise available bad debt deduction.

[T.D. 7444, 41 FR 53482, Dec. 7, 1976]

MUTUAL SAVINGS BANKS, ETC.

§ 1.591–1 Deduction for dividends paid on deposits.

(a) *In general*. (1) In the case of a taxpayer described in paragraph (c)(1) or (2) of this section, whichever is applicable, there are allowed as deductions from gross income amounts which during the taxable year are paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

(2) The deduction provided in section 591 is applicable to the taxable year in which amounts credited as dividends or interest become withdrawable by the depositor or holder of an account subject only to customary notice of intention to withdraw. Thus, amounts which, as of the last day of the taxable year, are credited as dividends or interest, but which are not withdrawable by depositors or holders of accounts until the following business day, are deductible under section 591 in the year subsequent to the taxable year in which they were so credited. A deduction under this section will not be denied by reason of the fact that the amounts credited as dividends or interest, otherwise deductible under section 591, are subject to the terms of a pledge agreement between the taxpayer and the depositor or holder of an account. In the case of a domestic building and loan association having nonwithdrawable capital stock represented by shares, no deduction is allowable under this section for amounts paid or credited as dividends on such shares. In the case of a taxable year ending after December 31, 1962, for special rules governing the treatment of dividends or interest paid or credited for periods representing more than 12 months, see section 461(e).

(b) *Serial associations, bonus plans, etc.* If a taxpayer described in paragraph (c)(1) or (2) of this section, whichever is applicable, operates in whole or in part as a serial association, maintains a bonus plan, or issues shares, or accepts deposits, subject to fines, penalties,

forfeitures, or other withdrawal fees, it may deduct under section 591 the total amount credited as dividends or interest upon such shares or deposits, credited to a bonus account for such shares or deposits, or allocated to a series of shares for the taxable year, notwithstanding that as a customary condition of withdrawal:

(1) Amounts invested in, and earnings credited to, series shares must be withdrawn in multiples of even shares, or

(2) Such taxpayer has the right, pursuant to bylaw, contract, or otherwise, to retain or recover a portion of the total amount invested in, or credited as earnings upon, such shares or deposits, such bonus account, or series of shares, as a fine, penalty, forfeiture, or other withdrawal fee

In any taxable year in which the right referred to in subparagraph (2) of this paragraph is exercised, there is includible in the gross income of such taxpayer for such taxable year amounts retained or recovered by the taxpayer pursuant to the exercise of such right. If the provisions of paragraph (a) of § 1.163–4 (relating to deductions for original issue discount) apply to deposits made with respect to a certificate of deposit, time deposit, bonus plan or other deposit arrangement, the provisions of this paragraph shall not apply.

(c) *Effective date.* The provisions of paragraphs (a) and (b) of this section shall apply to:

(1) Dividends or interest paid or credited after October 16, 1962, by any taxpayer which (at the time of such payment or credit) qualifies as (i) a mutual savings bank not having capital stock represented by shares, (ii) a domestic building and loan association (as defined in section 7701(a)(19)), (iii) a cooperative bank (as defined in section 7701(a)(32)), or (iv) any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law; and

(2) Dividends paid or credited before October 17, 1962, by any taxpayer which (at the time of such payment or credit) qualifies as (i) a mutual savings bank not having capital stock represented by shares, (ii) a cooperative bank without capital stock organized and operated for mutual purposes and without profit, or (iii) a domestic building and loan association (as defined in section 7701(a)(19) before amendment by section 6(c) of the Revenue Act of 1962 (76 Stat. 982)).

[T.D. 6728, 29 FR 5855, May 5, 1964, as amended by T.D. 7154, 36 FR 24997, Dec. 28, 1971]

§ 1.592–1 Repayment of certain loans by mutual savings banks, building and loan associations, and cooperative banks.

There is deductible, under section 592, from the gross income of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, amounts paid by such institutions during the taxable year in repayment of loans made before September 1, 1951, by the United States or any agency or instrumentality thereof which is wholly owned by the United States, or by any mutual fund established under the authority of the laws of any State. For example, amounts paid by such institution in repayment of loans made by the Reconstruction Finance Corporation before September 1, 1951, are deductible under this section. Section 592 is not applicable, however, in the case of amounts paid in repayment of loans made by an agency or instrumentality not wholly owned by the United States.

§ 1.593–1 Additions to reserve for bad debts.

(a) *In general.* A mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit may, as an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, deduct amounts credited to a reserve for bad debts in the manner and under the circumstances prescribed in this section and § 1.593–2. In the case of such an institution, the selection of either of the alternative methods for treating bad debts may be made by thetaxpayer in the return for its first taxable year beginning after December 31, 1951. The method selected shall be subject to the

approval of the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, unless permission is granted by the Commissioner to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective.

(b) *Addition to reserve.* Except as otherwise provided in §1.593–2, the reasonable addition to a reserve for bad debts shall be any amount determined by the taxpayer which does not exceed the lesser of:

(1) The amount of its taxable income for the taxable year, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income (such as section 170, relating to charitable, etc., contributions and gifts), or

(2) The amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.

(c) *Adjustments to reserve.* Bad debt losses sustained during the taxable year shall be charged against the bad debt reserve. Recoveries of debts charged against the bad debt reserve during a prior taxable year in which the institution was subject to tax under chapter 1 of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939 shall be credited to the bad debt reserve. The establishment of such reserve and all adjustments made thereto must be reflected on the regular books of account of the institution at the close of the taxable year, or as soon as practicable thereafter. Minimum amounts credited in compliance with Federal or State statutes, regulations, or supervisory orders to reserve or similar accounts, or additional amounts credited to such reserve or similar accounts and permissive under such statutes, regulations, or orders, against which charges may be made for the purpose of absorbing losses sustained by an institution, will be deemed to have been credited to the bad debt reserve.

(d) *Definitions.* When used in this section and in §1.593–2:

(1) *Institution.* The term *institution* means either a mutual savings bank not having capital stock represented by shares, a domestic building and loan association as defined in section 7701(a)(19), or a cooperative bank without capital stock organized and operated for mutual purposes and without profit.

(2) *Surplus, undivided profits, and reserves.* (i) The phrase *surplus, undivided profits, and reserves* means the amount by which the total assets of an institution exceed the amount of the total liabilities of such an institution.

(ii) For this purpose the term *total assets* means the sum of money, plus the aggregate of the adjusted basis of the property other than money, held by an institution. Such adjusted basis for any asset is its adjusted basis for determining gain upon sale or exchange for Federal income tax purposes. (See sections 1011 through 1022, and the regulations thereunder. For special rules with respect to adjustments to basis for prior taxable years during which the institution was exempt from tax, see section 1016(a)(3) and the regulations thereunder.) The determination of the total assets of any taxpayer shall conform to the method of accounting employed by such taxpayer in determining taxable income and to the rules applicable in determining its earnings and profits.

(iii) The term *total liabilities* means all liabilities of the taxpayer, which are fixed and determined, absolute and not contingent, and includes those items which constitute liabilities in the sense of debts or obligations. The total deposits or withdrawable accounts, as defined in subparagraph (3) of this paragraph, shall be considered a liability. In the case of a building and loan association having permanent nonwithdrawable capital stock represented by shares, the paid-in amount of such stock shall also be considered a liability. Reserves for contingencies and other reserves, however, which are mere appropriations of surplus, are not liabilities.

(3) *Total deposits or withdrawable accounts.* The phrase *total deposits or*

withdrawable accounts means the aggregate of (i) amounts placed with an institution for deposit or investment and (ii) earnings outstanding on the books of account of the institution at the close of the taxable year which have been credited as dividends upon such accounts prior to the close of the taxable year, except that such term, in the case of a building and loan association, does not include permanent nonwithdrawable capital stock represented by shares, or earnings credited thereon.

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

Example 1. (i) Institution X, which keeps its books on the basis of the calendar year, has surplus, reserves, and undivided profits of $800,000 as of January 1, 1955, and total deposits or withdrawable accounts of $10,000,000 as of December 31, 1955. During 1955 the institution credits $30,000, as required by a Federal agency, to a Federal insurance reserve for the sole purpose of absorbing losses. Likewise, it credits $25,000, as permitted by State statute, to another reserve fund for the purpose of absorbing losses. In 1955 Institution X charges $5,000 against its bad debt reserve for losses sustained during the taxable year.

(ii) The taxable income of Institution X for the taxable year 1955, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is $200,000.

(iii) Upon the basis of the facts as stated in subdivision (i) of this example, the amount by which 12 percent of the total deposits or withdrawable accounts of Institution X at the close of taxable year 1955 exceeds the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year is $400,000 (12 percent of $10,000,000, minus $800,000).

(iv) Institution X, therefore, may deduct, for the taxable year 1955, as an addition to a reserve for bad debts, any amount it may determine that does not exceed the lesser of the amounts determined in subdivision (ii) or (iii) of this example. That amount is $200,000 (as determined in subdivision (ii) of this example). Since under paragraph (c) of this section, the $30,000 credited to the reserve as required by the Federal agency and the $25,000 credited to the reserve as permitted by the State statute are regarded as amounts credited to a reserve for bad debts account Institution X can credit an additional $145,000 ($200,000 minus $55,000) to a general reserve for bad debts account at any time during the taxable year.

(v) The loss of $5,000 charged to the bad debt reserve during the taxable year does not affect the amount of the addition to the bad debt reserve provided for in paragraph (b) of this section. It is of significance only in determining the surplus, undivided profits, and reserves of Institution X as of January 1, 1956.

Example 2. The taxable income of Institution Y for the taxable year 1955, computed without regard to the deduction under section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is determined to be $250,000. The amount by which 12 percent of the total deposits or withdrawable accounts of Institution Y at the close of the taxable year exceeds the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year is $500,000. Institution Y credits $250,000 to its bad debt reserve in 1955. In 1957, it is determined that the correct taxable income of Institution Y for 1955, computed without regard to any deduction under section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is $275,000 and not $250,000. Assuming that Institution Y credits the additional $25,000 to its bad debt reserve, $275,000 is allowable as a deduction from gross income for such institution for the taxable year 1955.

§ 1.593–2 Additions to reserve for bad debts where surplus, reserves, and undivided profits equal or exceed 12 percent of deposits or withdrawable accounts.

Where 12 percent of the total deposits or withdrawable accounts of an institution at the close of the taxable year is equal to or less than the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year, a reasonable addition to the reserve for bad debts as determined under the general provisions of section 166(c) may be allowable as a deduction from gross income. In making such determination, there shall be taken into account (a) surplus or bad debt reserves existing at the close of December 31, 1951 (i.e., the amount of surplus, undivided profits, and reserves accumulated prior to January 1, 1952, and in existence at the close of December 31, 1951), and (b) changes in the surplus, undivided profits, and reserves of the institution from December 31, 1951, until the beginning of the taxable year. A deduction for an addition to the reserve

for bad debts pursuant to this section will be authorized only in those cases where the institution proves to the satisfaction of the Commissioner that the bad debt experience of the institution warrants an addition to the reserve for bad debts in excess of that provided in paragraph (b) of § 1.593–1. For definitions, see paragraph (d) of § 1.593–1.

§ 1.593–3 Taxable years affected.

Sections 1.593–1 and 1.593–2 apply only to taxable years beginning after December 31, 1953, and ending after August 16, 1954, but before January 1, 1963, and all references to sections of the Code are to the Internal Revenue Code of 1954 before amendment by the Revenue Act of 1962. Sections 1.593–4 through 1.593–11 apply only to taxable years ending after December 31, 1962, and all references to sections of the Code are to the Internal Revenue Code of 1954 after amendment by the Revenue Act of 1962.

[T.D. 6728, 29 FR 5857, May 5, 1964]

§ 1.593–4 Organizations to which section 593 applies.

The provisions of section 593 and §§ 1.593–5 through 1.593–11 (except subsection (f) of section 593 and § 1.593–10) apply to any mutual savings bank not having capital stock represented by shares, any domestic building and loan association, and any cooperative bank without capital stock organized and operated for mutual purposes and without profit. The term *thrift institution*, as used in this section and §§ 1.593–5 through 1.593–11, refers to any such financial institution. For definition of the terms *domestic building and loan association* and *cooperative bank*, see paragraphs (19) and (32), respectively, of section 7701(a).

[T.D. 549, 43 FR 21454, May 18, 1978]

§ 1.593–5 Addition to reserves for bad debts.

(a) *Amount of addition.* As an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, a thrift institution is allowed a deduction under section 166(c) for a reasonable addition to a reserve for bad debts. In the case of a thrift institution, the amount of the reasonable addition to such reserve for a taxable year may not exceed:

(1) For taxable years beginning after July 11, 1969, the sum of (i) the amount determined to be the reasonable addition to the reserve for losses on nonqualifying loans, determined in the same manner as is provided with respect to additions to the reserve for losses on qualifying real property loans under paragraph (d) of § 1.593–6A (relating to the experience method), and (ii) the amount determined under § 1.593–6A to be the reasonable addition to the reserve for losses on qualifying real property loans, or

(2) For taxable years beginning before July 12, 1969, the sum of (i) the amount determined under § 1.166–4 to be the reasonable addition to the reserve for losses on nonqualifying loans, and (ii) the amount determined under § 1.593–6 to be the reasonable addition to the reserve for losses on qualifying real property loans.

(b) *Crediting to reserves required*—(1) *In general.* The amounts referred to in paragraph (a) (1) and (2) of this section must be credited, respectively, to the reserve for losses on nonqualifying loans and to the reserve for losses on qualifying real property loans by the close of the taxable year, or as soon as practicable thereafter. For rules with respect to accounting for such reserves see paragraph (a)(2) of § 1.593–7.

(2) *Subsequent adjustments.* If an adjustment with respect to the income tax return for a taxable year is made, and if such adjustment (whether initiated by the taxpayer or the Commissioner) has the effect of permitting an increase, or requiring a reduction, in the amount claimed on such return as an addition to the reserve for losses on nonqualifying loans or to the reserve for losses on qualifying real property loans, then the amount initially credited to such reserve for such year pursuant to subparagraph (1) of this paragraph may have to be increased or decreased, as the case may be, to the extent necessary to reflect such adjustment.

(c) *Transition year*. For rules governing the computation of taxable income in the case of a taxable year beginning in 1962 and ending in 1963, see § 1.593–9.

[T.D. 6728, 29 FR 5857, May 5, 1964, as amended by T.D. 549, 43 FR 21455, May 18, 1978]

§ 1.593–6 Pre-1970 addition to reserve for losses on qualifying real property loans.

(a) *In general*. For purposes of paragraph (a)(2)(ii) of § 1.593–5, the amount of the addition to the reserve for losses on qualifying real property loans for any taxable year beginning before July 12, 1969, is the amount which the taxpayer determines to constitute a reasonable addition to such reserve for such year. However, the amount so determined for such year:

(1) Cannot exceed the largest of the amounts computed under one of the three methods described in paragraph (b), (c), or (d) of this section (relating, respectively, to the percentage of taxable income method, the percentage of real property loans method, and the experience method),

(2) Cannot exceed the maximum permissible addition described in paragraph (e) of this section (if applicable), and

(3) Shall be determined without regard to any amount charged for any taxable year against the reserve for losses on qualifying real property loans pursuant to § 1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association)

For each taxable year the taxpayer must include in its income tax return for such year a computation of the addition under this section. The use of a particular method in the return for a taxable year is not a binding election by the taxpayer to apply such method either for such taxable year or for subsequent taxable years. Thus, in the case of a subsequent adjustment described in paragraph (b)(2) of § 1.593–5 which has the effect of permitting an increase, or requiring a reduction, in the amount claimed in the return for a taxable year as an addition to the reserve for losses on qualifying real property loans, the amount of such addition may be recomputed under whichever method the taxpayer selects for the purposes of such recomputation, irrespective of the method initially applied for such taxable year. However, a taxpayer may not subsequently reduce the amount claimed in the return for a taxable year for the purpose of obtaining a larger deduction in a later year.

(b) *Percentage of taxable income method*—(1) *In general*. The amount determined under the percentage of taxable income method for any taxable year is an amount equal to 60 percent of the taxable income for such year, minus the amount determined under § 1.166–4 as a reasonable addition for such year to the reserve for losses on nonqualifying loans. However, the amount determined under such method shall not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to an amount equal to 6 percent of such loans outstanding at such time.

(2) *Taxable income defined*. For purposes of this paragraph, taxable income shall be computed:

(i) By excluding from gross income any amount included therein by reason of the application of § 1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association);

(ii) Without regard to any deduction allowable under section 166(c) for an addition to a reserve for bad debts;

(iii) Without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income (such as section 170, relating to charitable, etc., contributions and gifts), other than sections 243, 244, and 245 (relating to deductions for dividends received); and

(iv) Without regard to any net operating loss carryback to such year under section 172

In computing the deductions under sections 243, 244, and 245, section 246(b) (relating to limitation on aggregate amount of deduction) shall not apply. For purposes of subdivision (iii) of this subparagraph, a net operating loss deduction under section 172 is not a deduction the amount of which is dependent upon the amount of taxable income.

(c) *Percentage of real property loans method*—(1) *General rule*. The amount determined under the percentage of real property loans method for any taxable year is the amount necessary to increase the balance (as of the close of such year) of the reserve for losses on qualifying real property loans to:

(i) An amount equal to 3 percent of such loans outstanding at such time, plus

(ii) In the case of a taxpayer described in subparagraph (2) of this paragraph, an amount equal to:

(*a*) The lesser of 2 percent of such loans outstanding at such time, or $80,000, reduced (but not below zero) by

(*b*) The balance as of the close of such year, if any, of such taxpayer's supplemental reserve for losses on loans.

(2) *Certain new companies*. (i) Subparagraph (1)(ii) of this paragraph applies only in the case of a taxpayer which is a new company, and which does not have capital stock with respect to which distributions of property (as defined in section 317(a)) are not allowable as a deduction under section 591.

(ii) For purposes of this subparagraph, a taxpayer is a new company for any taxable year only if such year begins not more than 10 calendar years after the first day on which such taxpayer, or any predecessor of such taxpayer, was authorized by Federal or State law to do business as (*a*) a mutual savings bank not having capital stock represented by shares, (*b*) a domestic building and loan association, (*c*) a cooperative bank without capital stock organized and operated for mutual purposes and without profit, or (*d*) any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law.

(iii) As used in subdivision (ii) of this subparagraph, the term *calendar year* has the meaning assigned to such term in section 441 (relating to the period for computation of taxable income); and the term *predecessor* means any organization which transferred more than 50 percent of the total amount of its assets to the taxpayer, and which, prior to the time of such transfer, was (*a*) authorized by Federal or State law to do business as a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, or (*b*) any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law. The term *predecessor* also means any predecessor of such predecessor.

(d) *Experience method*. The amount determined under the experience method for any taxable year is the amount determined under §1.166–4 to be a reasonable addition for such year to the reserve for losses on qualifying real property loans.

(e) *Maximum permissible addition where percentage of taxable income method or percentage of real property loans method is applied*—(1) *12 percent of deposits limitation*. If, for the taxable year, the taxpayer uses either the percentage of taxable income method described in paragraph (b) of this section or the percentage of real property loans method described in paragraph (c) of this section, then (unless subparagraph (2) of this paragraph applies) the maximum permissible addition for such year is equal to the lesser of:

(i) The amount determined under such paragraph (b) or (c), or

(ii) An amount which, when added to the amount determined under §1.166–4 as an addition for such year to the reserve for losses on nonqualifying loans, equals the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of the taxpayer's surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof which is attributable to the period before the first taxable year beginning after December 31, 1951)

For definition of the terms *surplus, undivided profits, and reserves* and *total deposits or withdrawable accounts*, see paragraph (f) of this section.

(2) *Special rule where a domestic building and loan association or cooperative bank exceeds certain assets limitations*. If, for the taxable year, the taxpayer uses either the percentage of taxable income method described in paragraph (b) of this section or the percentage of

real property loans method described in paragraph (c) of this section, and if for such year such taxpayer qualifies as a domestic building and loan association under the first sentence of paragraph (19) of section 7701(a) (or as a cooperative bank under paragraph (32) thereof) solely by reason of the application of the second sentence of such paragraph (19) (that is, solely by reason of the fact that for such year more than 36 percent, but not more than 41 percent, of the amount of the total assets of such association or bank consists of assets other than assets described in section 7701(a)(19)(D)(ii)), then the maximum permissible addition for such year is equal to the amount determined under subparagraph (1) of this paragraph, reduced in accordance with the following table:

If the percentage of the taxpayer's assets which are not assets described in section 7701(a)(1()(D)(ii) exceeds—*Percent*	But does not exceed—*Percent*	The reduction shall be the following proportion of the amount determined under such subparagraph (1)—
36	37	1/12
37	38	1/6
38	39	1/4
39	40	1/3
40	41	5/12

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

(1) *Surplus, undivided profits, and reserves*. The term *surplus, undivided profits, and reserves* means the amount by which the total assets of the taxpayer exceed its total liabilities. The determination of such total assets and total liabilities shall conform to the method of accounting employed by the taxpayer in determining taxable income and to the rules applicable in determining its earnings and profits. Total deposits or withdrawable accounts (as defined in subparagraph (3) of this paragraph but determined as of the beginning of the taxable year) shall be considered a liability. In the case of a domestic building and loan association having permanent nonwithdrawable capital stock represented by shares, the paid-in amount of such stock shall also be considered a liability. However, reserves for contingencies and other reserves which are mere appropriations of surplus are not liabilities for purposes of this section.

(2) *Total assets*. The term *total assets* means the sum of money (including time or demand deposits with, or withdrawable accounts in, any financial institution), plus the aggregate of the adjusted basis (determined under § 1.1011–1) of the property other than money held by the taxpayer. For special rules with respect to adjustments to basis in the case of property acquired by the taxpayer in a transaction described in section 595(a), see section 595.

(3) *Total deposits or withdrawable accounts*. The term *total deposits or withdrawable amounts* means the total of the amounts placed with the taxpayer for deposit or investment. Such term also includes earnings outstanding on the books of account of the taxpayer at the close of the taxable year which have been credited as dividends or interest upon such deposits or withdrawable accounts prior to the close of such taxable year, and which are withdrawable on demand subject only to customary notice of intention to withdraw. In the case of a domestic building and loan association, however, such phrase does not include permanent nonwithdrawable capital stock represented by shares, or earnings credited thereon.

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

Example 1. (i) *Facts*. X is a domestic building and loan association which was organized in 1947 and which makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. X's accounts contain the following entries:

Account	Balance as of—	
	Jan. 1, 1965	Dec. 31, 1965
Total deposits or withdrawable accounts	$1,000,000	$1,200,000
Nonqualifying loans	50,000	60,000
Qualifying real property loans	900,000	940,000
Reserve for losses on nonqualifying loans	200	*160
Reserve for losses on qualifying real property loans	24,000	*21,000
Supplemental reserve for losses on loans	60,800	60,800
Surplus, undivided profits, and other reserves	15,000	18,040

*Computed before any addition for 1965 under section 166(c).

X's taxable income for 1965 (before any deductible addition to a reserve for bad debts and without regard to charitable contributions of $200) is $20,000, computed as follows:

Interest and other income	$19,940
Dividends received from Y Corporation, a domestic corporation subject to taxation under chapter 1 of the Code	400
	20,340
Deduction for 85 percent of dividends received computed without regard to the limitation of section 246(b)	340
Taxable income	20,000

It is assumed that under § 1.166–4 X's addition for 1965 to its reserve for losses on nonqualifying loans is $80.

(ii) *Computation of addition to reserve for losses on qualifying real property loans—(a) In general.* X determines that the reasonable addition for 1965 to its reserve for losses on qualifying real property loans is $11,920. Such amount, compared under the percentage of taxable income method, is the largest of the amounts determined under (*b*), (*c*), and (*d*) of this subdivision, and does not exceed the 12 percent of deposits limitation computed under (*e*) of this subdivision.

(*b*) *Percentage of taxable income method.* The amount determined under the percentage of taxable income method is $11,920, that is, 60 percent of the taxable income for 1965, or $12,000 (60 percent of $20,000), minus $80, the addition for such year to the reserve for losses on nonqualifying loans. This amount is not subject to reduction under the 6 percent of qualifying real property loans limitation described in paragraph (b) (1) of this section since the addition of $11,920 to the $21,000 balance of the reserve for losses on qualifying real property loans at the close of 1965 will not increase such balance to an amount in excess of $56,400, that is, 6 percent of such loans of $940,000 outstanding at such time.

(*c*) *Percentage of real property loans method.* Since X is not a new company within the meaning of paragraph (c) (2) of this section, the amount determined under the percentage of real property loans method is $7,200, that is, the amount necessary to increase the balance of the reserve for losses on qualifying real property loans at the close of 1965 from $21,000 to an amount equal to 3 percent of such loans outstanding at such time, or $28,200 (3 percent of $940,000).

(*d*) *Experience method.* The amount determined under the experience method is zero since it is assumed that the $21,000 balance of the reserve for losses on qualifying real property loans at the close of 1965 before any addition for such year exceeds the maximum amount to which such reserve could be increased under such method.

(*e*) *12 percent of deposits limitation.* The amount determined under the 12 percent of deposits limitation is $43,920, that is, $44,000 (the excess of 12 percent of $1,200,000 of deposits at the close of 1965, or $144,000, over the $100,000 of surplus, undivided profits, and reserves at the beginning of such year), minus $80, the addition for such year to the reserve for losses on nonqualifying loans. Since such $43,920 is greater than $11,920 (the amount determined under (b) of this subdivision), the 12 percent of deposits limitation does not apply for 1965.

(iii) *Computation of taxable income for 1965.* X's taxable income for 1965, after deducting the additions for such year to its reserves for losses on nonqualifying loans and on qualifying real property loans, after deducting the charitable contributions which were not taken into account in computing taxable income for purposes of the addition to the reserve for losses on qualifying real property loans, after including in taxable income dividends received from Y Corporation, and after taking into account the deduction for dividends received under section 243 (subject to the limitation in section 246(b)), is $7,800, computed as follows:

Interest and other income	$19,940	
Dividends received from Y Corporation	400	
		$20,340
Less:		
Deduction for charitable contributions	200	
85 percent of dividends received from Y Corporation	340	
Additions to reserves for bad debts	12,000	
		12,540
Taxable income		7,800

Example 2. Assume the same facts as in example 1, except that X Corporation was organized in 1957, and qualifies for the taxable year 1965 as a new company within the meaning of paragraph (c) (2) of this section. The maximum permissible addition for 1965 to X's reserve for losses on qualifying real property loans is $18,000, the amount computed under the percentage of real property loans method, since such amount is greater than (i) $11,920, the amount computed under the percentage of taxable income method, or (ii) zero, the amount computed under the experience method. The $18,000 amount (as computed under the percentage of real property loans method) is the amount necessary to increase the reserve for losses on qualifying real property loans from the $21,000 closing balance to $39,000, computed as follows:

3 percent of $940,000 of qualifying real property loans at close of 1965		$28,200
Plus:		
Lesser of $80,000 or $18,800 (2 percent of such loans of $940,000)	$18,800	

Reduced by the balance of supplemental reserve for losses on loans	8,000	
	$10,800	
		39,000

Example 3. Assume the same facts as in example 1, except that for 1965, 38.4 percent of X's total assets consist of assets other than the assets described in section 7701(a)(19)(D)(ii). In such case, the maximum permissible addition of $11,920 for such year to the reserve for losses on qualifying real property loans (as determined under subdivision (ii) of example 1) would be reduced by $2,980 (¼ of $11,920) to $8,940.

[T.D. 6728, 29 FR 5857, May 5, 1964, as amended by T.D. 549, 43 FR 21455, May 18, 1978]

§ 1.593–6A Post-1969 addition to reserve for losses on qualifying real property loans.

(a) *In general*—(1) *Amount of addition determined for the taxable year.* For purposes of paragraph (a)(1)(ii) of § 1.593–5, the amount of the addition to the reserve for losses on qualifying real property loans for any taxable year beginning after July 11, 1969, is the amount which the taxpayer determines to constitute a reasonable addition to such reserve for such year. However, the amount so determined for such year:

(i) Cannot exceed the largest of the amount determined under section 593 (b) (2), (3), or (4) (relating, respectively, to the percentage of taxable income method, the percentage method, and the experience method), and

(ii) Shall be determined without regard to any amount charged for any taxable year against the reserve for losses on qualifying real property loans pursuant to § 1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association).

For each taxable year the taxpayer must include in its income tax return for such year a computation of the amount of the addition determined under this section. The use of a particular method in the return for a taxable year is not a binding election by the taxpayer to apply such method either for such taxable year or for subsequent taxable years. Thus, in the case of a subsequent adjustment described in paragraph (b)(2) of § 1.593–5 which has the effect of permitting an increase, or requiring a reduction, in the amount claimed in the return for a taxable year as an addition to the reserve for losses on qualifying real property loans, the amount of such addition may be recomputed under whichever method the taxpayer selects for the purpose of such recomputation, irrespective of the method initially applied for such taxable year.

(2) *Method of determination.* For purposes of this section and § 1.596–1 (relating to limitation on dividends received deduction), a thrift institution is deemed to have determined the addition to its reserve for losses on qualifying real property loans for the taxable year under the percentage of taxable income method provided by section 593(b)(2) and paragraph (b) of this section if the amount finally determined to be a reasonable addition for such year to such reserve exceeds the amount determined for such year under section 593(b)(3) (relating to the percentage method) and exceeds the amount determined for such year under section 593(b)(4) (relating to the experience method).

(b) *Percentage of taxable income method*—(1) *In general.* Subject to the limitations described in subparagraph (4) of this paragraph and in paragraph (e) of this section, the amount determined under section 593(b)(2) and this paragraph for the taxable year, if such section and paragraph are applicable, is an amount equal to the applicable percentage of the taxable income for such year, reduced by the amount determined under subparagraph (3) of this paragraph. For this purpose, taxable income is computed as provided in subparagraph (5) of this paragraph, and the applicable percentage (except as reduced under subparagraph (2) of this paragraph) is determined under the following table:

For a taxable year beginning in—	The applicable percentage under this subparagraph is—
1969	60 percent.
1970	57 percent.
1971	54 percent.
1972	51 percent.
1973	49 percent.
1974	47 percent.
1975	45 percent.
1976	43 percent.

For a taxable year beginning in—	The applicable percentage under this subparagraph is—
1977	42 percent.
1978	41 percent.
1979 or thereafter	40 percent.

(2) *Reduction of applicable percentage in certain cases*—(i) *General rules.* If for the taxable year the percentage of the assets of a thrift institution, which are assets described in section 7701(a)(19)(C) (relating to assets of a domestic building and loan association) is less than:

(*a*) 82 percent of the total assets in the case of a thrift institution other than a mutual savings bank, the applicable percentage for such year provided by subparagraph (1) of this paragraph is reduced by three-fourths of 1 percentage point for each 1 percentage point of such difference; or

(*b*) 72 percent of the total assets in the case of a thrift institution which is a mutual savings bank, the applicable percentage for such year provided by subparagraph (1) of this paragraph is reduced by 1½ percentage points for each 1 percentage point of such difference.

If such percentage is less than 60 percent of the total assets in the case of any thrift institution (less than 50 percent of the total assets for a taxable year beginning before 1973 in the case of a thrift institution which is a mutual savings bank), section 593(b)(2) and this paragraph are not applicable. The percentage of total assets specified in this subparagraph is computed as of the close of the taxable year or, at the option of the taxpayer, may be computed on the basis of the average assets outstanding during the taxable year. Such average is determined by computing such percentage either as of the close of each month, as of the close of each quarter, or as of the close of each semiannual period during the taxable year and by using the yearly average of the monthly, quarterly, or semiannual percentages. A thrift institution which is a mutual savings bankand which determines the amount of the reasonable addition for the taxable year to the reserve for losses on qualifying real property loans under this paragraph shall file for such taxable year a statement which shall show the amount of assets defined in paragraph (e) of § 402.1–2 (Temporary Regulations on Procedure and Administration under Tax Reform Act of 1969) as of the close of the taxable year and a brief description and the amount of all other assets, together with a description of the method used in determining such amounts. If the percentage specified in this subparagraph is computed by such thrift institution on the basis of the average assets outstanding during the taxable year, the statement shall also show such information as of the end of each month, each quarter, or each semiannual period and the manner of calculating the average.

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

Example. M is a cooperative bank to which section 593 applies. For its taxable year beginning in 1970, 80.4 percent of M's assets (computed as of the close of such year) constitute assets described in section 7701(a)(19)(C). M's assets which are assets described in section 7701(a)(19)(C), when computed on semiannual, quarterly, and monthly bases, constitute 79.8, 79.6, and 79.5 percent, respectively, of its total assets computed on the corresponding bases. M's applicable percentage for 1970 is 56.25 percent, determined as follows:

	Percent
Percentage of total assets specified in (*a*) of subdivision (i) of this subparagraph	82.0
Percentage of total assets constituting assets described in section 7701(a)(19)(C)	80.4
Difference	1.6
Applicable percentage determined under table in subparagraph (1) of this paragraph	57.0
Reduction of applicable percentage required by (*a*) of subdivision (i) of this subparagraph (¾ of 1 percentage point for each full percentage point of difference)	.75
Applicable percentage	56.25

(3) *Reduction for addition to reserve for nonqualifying loans*—(i) *General rule.* Subparagraph (1) of this paragraph provides that, subject to certain limitations, the amount determined under the percentage of taxable income method provided by section 593(b)(2) and this paragraph for the taxable year is an amount equal to the applicable percentage of the taxable income for such year, reduced by the amount determined under this subparagraph. In the case of a thrift institution other

than a mutual savings bank, the amount determined under this subparagraph is an amount equal to the amount determined under paragraph (a)(1)(i) of § 1.593–5 to be a reasonable addition for the taxable year to the reserve for losses on nonqualifying loans multiplied by a fraction:

(*a*) The numerator of which is 18 percent, and

(*b*) The denominator of which is the percentage (in no case less than 18 percent) of the assets of the taxpayer for such year which are not assets defined in paragraph (e) of § 402.1–2 of this chapter.

In the case of a thrift institution which is a mutual savings bank, the amount determined under this subparagraph is an amount determined in the manner described in the preceding sentence, except that the numerator of the fraction described therein is 28 percent, and the denominator of such fraction shall not be less than 28 percent. For purposes of this subparagraph, the percentage of assets for a taxable year which are not assets defined in paragraph (e) of § 402.1–2 of this chapter is determined upon the same annual or average basis as is used in determining the percentage specified in subparagraph (2) of this paragraph.

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. K is a domestic building and loan association to which section 593 applies. The amount determined under subparagraph (1) of this paragraph (before reduction by the amount determined under this subparagraph) to be the reasonable addition for the taxable year to K's reserve for losses on qualifying real property loans is $100,000. The amount determined under paragraph (a)(1)(i) of § 1.593–5 as the reasonable addition for the taxable year to the association's reserve for losses on nonqualifying loans is $10,000. The percentage of K's assets which are not assets defined in paragraph (e) of § 402.1–2 is 24 percent. The amount determined under subparagraph (1) of this paragraph ($100,000) must be reduced by $7,500.

$10,000 × 18 percent/24 percent.

Therefore, subject to the limitations described in subparagraph (4) of this paragraph and in paragraph (e) of this section, the amount determined under this paragraph to be the reasonable addition for the taxable year to K's reserve for losses on qualifying real property loans is $92,500 ($100,000 less $7,500).

Example 2. The facts are the same as in example 1, except that the percentage of K's assets which are not assets defined in paragraph (e) of § 402.1–2 is 12 percent. The amount determined under subparagraph (1) of this paragraph (before reduction by the amount determined under this subparagraph) to be the reasonable addition for the taxable year to K's reserve for losses on qualifying real property loans must be reduced by $10,000.

$10,000 × 18 percent/18 percent.

Because the denominator of the fraction may not be less than 18 percent, the fraction used in determining the amount of such reduction is equal to 1.

(4) *Overall limitation.* The amount determined under this paragraph shall not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to 6 percent of such loans outstanding at such time.

(5) *Computation of taxable income.* For purposes of this paragraph, taxable income is computed:

(i) By excluding from gross income any amount included therein by reason of the application of section 593(e) and § 1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association).

(ii) Without regard to any deduction allowable under section 166(c) (whether or not determined under section 593) and the regulations thereunder for an addition to a reserve for bad debts.

(iii) (*a*) By excluding from gross income an amount equal to the excess (if any) or (*1*) the total gains of the taxable year arising from sales and exchanges at a gain of (*i*) obligations the interest on which is excludable from gross income under section 103, and (*ii*) corporate stock, over (*2*) the total losses of such year arising from sales and exchanges at a loss of such obligations and stock.

(*b*) The provisions of this subdivision (iii) may be illustrated by the following example:

Example. For its taxable year beginning in 1971, the gains and losses of a domestic building and loan association from sales of stock and securities (all of which were made on December 31, 1971) were as follows:

	Gain	Loss
Municipal bonds acquired July 1, 1969, the interest on which is excludable from income under sec. 103	$25,000	.....
Stock of Corporation A, acquired July 14, 1971	.....	$6,000
Stock of Corporation B, acquired Dec. 22, 1970	$3,000	.....

For purposes of this paragraph, the association's taxable income for 1971 is computed by excluding $22,000 ($25,000 + $3,000 − $6,000) from its gross income.

(iv) By excluding from gross income an amount equal to the lesser of (*a*) three-eighths of the net long-term capital gain for the taxable year or (b) three-eighths of the net long-term capital gain for the taxable year from the sale or exchange of property other than property described in subdivision (iii) of this subparagraph.

(v)(*a*) By excluding from gross income so much of the amount of dividends with respect to which a deduction is allowable under part VIII, subchapter B, chapter 1, subtitle A of theCode (section 241 and following) as is in excess of the applicable percentage (determined under subparagraphs (1) and (2) of this paragraph) of the dividends received deduction (determined under part VIII, subchapter B, chapter 1, subtitle A of the Code, without regard to section 596) for the taxable year.

(*b*) The provisions of this subdivision (v) may be illustrated by the following example:

Example. For its taxable year beginning in 1977, a domestic building and loan association receives dividends of $100 with respect to which a dividends received deduction of $85 is allowable under section 243(a)(1). The association receives no other dividends for the taxable year. The association's applicable percentage for the taxable year, as determined under subparagraphs (1) and (2) of this paragraph, is 42 percent. For purposes of this paragraph, the association's taxable income is computed by excluding from gross income the excess of the amount of dividends received ($100) over the applicable percentage of the allowable dividends received deduction (42 percent of $85, or $35.70), computed without regard to section 596. Thus, for purposes of this paragraph, $64.30 ($100 less $35.70) is excluded from gross income. See section 596 and §1.596–1 with respect to the computation of the dividends received deduction for purposes of determining taxable income under section 63(a).

(vi) For taxable years beginning before January 1, 1978, without regard to any deduction the amount of which is computed upon, or may be subject to a limitation computed upon, the amount of taxable income, and without regard to any net operating loss carryback to such year from a taxable year beginning before January 1, 1979. (For purposes of this subparagraph, a net operating loss deduction under section 172 is not a deduction the amount of which may be subject to a limitation computed upon the amount of taxable income.)

(vii) For taxable years beginning after December 31, 1977, by taking into account any deduction the amount of which is computed upon or may be subject to a limitation computed upon the amount of taxable income, and any other deduction or loss allowed under subtitle A of the Code, such as any deduction allowable under section 172 or any loss allowable under section 1212 (a), unless otherwise provided in this subparagraph.

(c) *Percentage method*. [Reserved]

(d) *Experience method*. [Reserved]

(e) *Percentage of deposits limitation where percentage of taxable income method or percentage method is applied*. If the amount determined by the taxpayer to constitute a reasonable addition for the taxable year to the reserve for losses on qualifying real property loans is greater than the amount determined under paragraph (d) of this section (relating to the experience method), the amount so determined cannot exceed an amount which, when added to the amount determined under paragraph (a)(1)(i) of §1.593–5 to be a reasonable addition for such year to the reserve for losses on nonqualifying loans, equals the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of the taxpayer's surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof which is attributable to the period before the first taxable year beginning after December 31, 1951. The terms *surplus, undivided profit, and reserves* and *total deposits or*

withdrawable accounts have the same meanings as are assigned to them in paragraph (f) of § 1.593.6.

[T.D. 549, 43 FR 21455, May 18, 1978, as amended by T.D. 7626, 44 FR 31177, May 31, 1979]

§ 1.593–7 Establishment and treatment of reserves for bad debts.

(a) *Establishment of reserves*—(1) *In general*. A taxpayer described in § 1.593–4 shall establish and maintain a reserve for losses on nonqualifying loans, a reserve for losses on qualifying real property loans, and, if required under paragraph (b)(4) or (c)(3)(i)(*c*) of this section, a supplemental reserve for losses on loans. For rules governing the crediting of additions to the reserve for losses on nonqualifying loans and the reserve for losses on qualifying real property loans, see paragraph (b) of § 1.593–5.

(2) *Accounting for reserves*. (i) The taxpayer shall establish and maintain as a permanent part of its regular books of account an account for each of the reserves established pursuant to subparagraph (1) of this paragraph. For purposes of the preceding sentence, a taxpayer may establish and maintain a permanent subsidiary ledger containing an account for each of such reserves. If a taxpayer maintains such a permanent subsidiary ledger, the total of the reserve accounts in such ledger and the total of the reserve accounts in any other ledger must be reconciled.

(ii) Any credit or charge to a reserve established pursuant to subparagraph (1) of this paragraph must be made to such reserve irrespective of whether the amount thereof is also credited or charged to any surplus, reserve, or other account which the taxpayer may be required or permitted to maintain pursuant to any Federal or State statute, regulation, or supervisory order. Minimum amounts credited in compliance with such Federal or State statutes, regulations, or supervisory orders to reserve or similar accounts, or additional amounts credited to such reserve or similar accounts and permissible under such statutes, regulations, or orders, against which charges may be made for the purpose of absorbing losses sustained by the taxpayer, may also be credited to the reserve for losses on nonqualifying loans or the reserve for losses on qualifying real property loans, provided that the total of the amounts so credited to the reserve for losses on nonqualifying loans, or to the reserve for losses on qualifying real property loans, for any taxable years does not exceed the amount described in subparagraph (1) or (2) of § 1.593–5(a) (whichever applies) as the addition to such reserve for such year year.

(b) *Allocation of pre-1963 reserves*—(1) *In general*. In the case of a taxpayer described in § 1.593–4, the pre-1963 reserves, if any, of such taxpayer shall be allocated to (and constitute the opening balance of) the reserve for losses on nonqualifying loans, the reserve for losses on qualifying real property loans, and, if required under subparagraph (4) of this paragraph, the supplemental reserve for losses on loans. The term *pre-1963 reserves* means the net amount (determined as of the close of December 31, 1962) accumulated for taxable years beginning after December 31, 1951, in the taxpayer's reserve for bad debts pursuant to section 166(c) of the Internal Revenue Code of 1954 and section 23(k) (1) of the Internal Revenue Code of 1939 (including the amount of any bad debt reserves acquired from another taxpayer). For purposes of the preceding sentence in the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, the part of such year occurring before January 1, 1963, shall be treated as a taxable year. Thus, the pre-1963 reserves of the taxpayer shall be an amount equal to:

(i) The sum of the amounts allowed as deductions for additions to a reserve for bad debts for taxable years beginning after December 31, 1951, and ending before January 1, 1963, plus

(ii) In the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, the amount (determined under § 1.593–1 or 1.593–2) which would be allowable under section 166(c) as a deduction for an addition to a reserve for bad debts for the part of such year occurring before January 1, 1963, if such part year constituted a taxable year, minus

(iii) The total amount of bad debts charged against a reserve for bad debts during the period which begins with the opening of the first taxable year

beginning after December 31, 1951, and which ends at the close of December 31, 1962 plus

(iv) The total amount of recoveries during the period described in subdivision (iii) of this subparagraph, on bad debts charged against a reserve for bad debts in a taxable year beginning after December 31, 1951.

(2) *Allocation to opening balance of reserve for losses on nonqualifying loans.* (i) As of the close of December 31, 1962 the pre-1963 reserves shall first be allocated to (and constitute the opening balance of) the reserve for losses on nonqualifying loans in an amount equal to the lesser of (*a*) the amount of such pre-1963 reserves, or (*b*) the amount determined under subdivision (ii) of this subparagraph.

(ii) The amount referred to in subdivision (i)(*b*) of this subparagraph shall be the amount which would constitute a reasonable addition to the reserve for losses on nonqualifying loans under §1.166–4 for a period in which the taxpayer's nonqualifying loans increased from zero to the amount thereof outstanding at the close of December 31, 1962.

(3) *Allocation to opening balance of reserve for losses on qualifying real property loans.* (i) Any portion of the pre-1963 reserves remaining after the allocation provided in subparagraph (2) of this paragraph shall, as of the close of December 31, 1962, be allocated to (and constitute the opening balance of) the reserve for losses on qualifying real property loans in an amount equal to the lesser of (*a*) the amount of such remaining portion, or (*b*) the amount determined under subdivision (ii) of this subparagraph. If the amount described in (*a*) of the preceding sentence is less than the amount described in (*b*) thereof, see §1.593–8 for allocation of pre-1952 surplus, if any, to the opening balance of such reserve.

(ii) The amount referred to in subdivision (i)(*b*) of this subparagraph shall be an amount equal to the greater of:

(*a*) 3 percent of the taxpayer's qualifying real property loans outstanding at the close of December 31, 1962, or

(*b*) The amount which would constitute a reasonable addition to the reserve for losses on such loans under §1.166–4 for a period in which the amount of such loans increased from zero to the amount thereof outstanding at the close of December 31, 1962.

(4) *Allocation to supplemental reserve for losses on loans.* Any portion of the pre-1963 reserves remaining after the allocations provided in subparagraphs (2) and (3) of this paragraph shall be allocated in its entirety to the supplemental reserve for losses on loans. (5) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. (i) *Facts.* X Corporation, a domestic building and loan association organized on April 1, 1954, makes its returns on the basis of a taxable year ending March 31 and the reserve method of accounting for bad debts. For its taxable years ending March 31, 1955, through March 31, 1962, X was allowed a total of $750,000 as deductible additions to its reserve for bad debts under section 166(c). For its taxable year ending March 31, 1963, X was allowed a deduction under section 166(c) for an addition to a reserve for bad debts. Of such deduction $46,000 was determined under §1.593–1 (relating to additions to reserve for bad debts) by reference to §1.593–9 (relating to taxable income for taxable years beginning in 1962 and ending in 1963) as the amount which would be allowable for the period April 1 through December 31, 1962, if such period constituted a taxable year. During the taxable years ending March 31, 1955, through March 31, 1963, X charged bad debts of $55,000 against its reserve for bad debts and made recoveries on such debts of $10,000. Of suchbad debt charges and recoveries, $50,000 was charged off and $9,000 was recovered prior to January 1, 1963. At the close of December 31, 1962, X had outstanding nonqualifying loans of $500,000 and outstanding qualifying real property loans of $10 million. It is assumed that, under §1.166–4, $2,000 would constitute a reasonable addition to the reserve for losses on nonqualifying loans for a period in which such loans increased from zero to $500,000 and $20,000 would constitute a reasonable addition to the reserve for losses on qualifying real property loans for a period in which such loans increased from zero to $10 million.

(ii) *Pre-1963 reserves determined.* X's pre-1963 reserves are $755,000, computed as follows:

Deductible additions to reserve for bad debts:.		
Years ending March 31, 1955 through March 31, 1962	$750,000	
Period April 1 through December 31, 1962	46,000	
		$796,000

Less:		
Net bad debt losses for period April 1, 1954 through December 31, 1962:		
Bad debts	50,000	
Recoveries	(9,000)	41,000
		755,000

(iii) *Allocation to opening balance of reserve for losses on nonqualifying loans.* The portion of the $755,000 of pre-1963 reserves to be allocated to the reserve for losses on nonqualifying loans as the opening balance thereof is $2,000 since such amount would constitute a reasonable addition to the reserve for losses on nonqualifying loans under §1.166–4 for a period in which the amount of such loans increased from zero to $500,000.

(iv) *Allocation to opening balance of reserve for losses on qualifying real property loans.* Of the $753,000 ($755,000 minus $2,000) of pre-1963 reserves remaining after the allocation described in subdivision (iii) of this example, $300,000 (3 percent of $10 million, the total amount of qualifying real property loans outstanding at the close of December 31, 1962) is allocated to the opening balance of the reserve for losses on qualifying real property loans, since such amount is greater than $20,000, the amount which would constitute a reasonable addition to the reserve for losses on such loans under §1.166–4 for a period in which the amount of such loans increased from zero to $10 million.

(v) *Allocation to supplemental reserve for losses on loans.* The balance of the pre-1963 reserves, or $453,000 ($755,000 minus the sum of $2,000 and $300,000), is allocated in its entirety to the supplemental reserve for losses on loans.

Example 2. Assume the same facts as in example 1, except that X was organized in 1936, and on December 31, 1962, had pre-1963 reserves of only $15,000 (rather than $755,000). In such case, $2,000 of such pre-1963 reserves would be allocated to, and constitute the opening balance of, the reserve for losses on nonqualifying loans, and $13,000 ($15,000 minus $2,000) would be allocated to and constitute part of the opening balance of the reserve for losses on qualifying real property loans. However, since such $13,000 is less than $300,000 (3 percent of $10 million), the opening balance of the reserve for losses on qualifying real property loans must be increased by so much of the taxpayer's pre-1952 surplus as is necessary to increase such opening balance to $300,000. For rules on the allocation of pre-1952 surplus to the opening balance of the reserve for losses on qualifying real property loans, see §1.593–8.

(c) *Treatment of reserves*—(1) *In general.* Except as provided in paragraph (d) of §1.593–8 (relating to the allocation of pre-1952 surplus), each of the reserves established pursuant to paragraph (a) of this section shall be treated, for purposes of subtitle A of the Code, as a reserve for bad debts, except that no deduction shall be allowed under section 166 for any addition to the supplemental reserve for losses on loans. Accordingly, if in any taxable year the taxpayer charges any of the reserves established pursuant to paragraph (a) of this section for an item other than a bad debt, gross income for such year shall be increased by the amount of such charge. For special rules in case of certain nondeductible distributions to shareholders by a domestic building and loan association, see §1.593–10.

(2) *Bad debt losses.* Any bad debt in respect of a nonqualifying loan shall be charged against the reserve for losses on nonqualifying loans, and any bad debt in respect of a qualifying real property loan shall be charged against the reserve for losses on qualifying real property loans. At the option of the taxpayer, however, any bad debt in respect of either class of loans may be charged in whole or in part against the supplemental reserve for losses on loans.

(3) *Recoveries of bad debts.* Any amount recovered after December 31, 1962, in respect of a bad debt shall be credited to the reserves established pursuant to paragraph (a) of this section in the following manner:

(i) If the recovery is in respect of a bad debt which was charged prior to January 1, 1963, against a reserve for bad debts established pursuant to section 166(c) of the Internal Revenue Code of 1954, or section 23(k)(1) of the Internal Revenue Code of 1939, then the amount recovered shall be credited:

(*a*) First, to the reserve for losses on nonqualifying loans in an amount equal to the amount, if any, by which the amount determined under subdivision (ii) of paragraph (b)(2) of this section exceeds the opening balance of such reserve (determined under such paragraph (b)(2)),

(*b*) Second, to the reserve for losses on qualifying real property loans in an amount equal to the amount, if any, by which the amount determined under subdivision (ii) of paragraph (b)(3) of

this section exceeds the opening balance of such reserve (determined under such paragraph (b)(3)), and

(*c*) Finally, to the supplemental reserve for losses on loans

For purposes of determining the amounts of the credits under (*a*) and (*b*) of this subdivision, the opening balances of the reserve for losses on nonqualifying loans and the reserve for losses on qualifying real property loans shall be deemed to include the sum of the amounts of any prior credits made to such reserves pursuant to this subdivision.

(ii) If the recovery is in respect of a bad debt which is charged after December 31, 1962, against only one of the reserves established pursuant to paragraph (a) of this section, the entire amount recovered shall be credited to the reserve so charged.

(iii) If the recovery is in respect of a bad debt which is charged after December 31, 1962, against more than one of the reserves established pursuant to paragraph (a) of this section, then the amount recovered shall be credited to each of the reserves so charged in the ratio which the amount of the bad debt charged against such reserve bears to the total amount of such bad debt charged against both such reserves.

(iv) Subdivision (i) of this subparagraph may be illustrated by the following example:

Example. In 1962, the taxpayer sustained a bad debt of $10,000, which was charged against a reserve for bad debts established pursuant to section 166(c). As of the close of December 31, 1962, the balance of the taxpayer's reserve for losses on nonqualifying loans was $2,000, the amount determined under paragraph (b)(2)(ii) of this section. As of the same time, the balance of the taxpayer's reserve for losses on qualifying real property loans was $100,000, but the amount determined under paragraph (b)(3)(ii) of this section was $106,000. In 1963, the taxpayer recovers $8,000 of the $10,000 charged off in 1962. Of the $8,000 recovered in 1963, $6,000 ($106,000 minus $100,000) is credited to the reserve for losses on qualifying real property loans, and the balance of $2,000 is credited to the supplemental reserve for losses on loans.

[T.D. 6728, 29 FR 5859, May 5, 1964, as amended by T.D. 549, 43 FR 21457, May 18, 1978]

§ 1.593–8 Allocation of pre-1952 surplus to opening balance of reserve for losses on qualifying real property loans.

(a) *General rule*. In the case of a taxpayer described in § 1.593–4, if the amount of pre-1963 reserves allocated (under paragraph (b)(3)(i) of § 1.593–7) to the opening balance of the reserve for losses on qualifying real property loans is less than an amount equal to the greater of:

(1) The total amount of qualifying real property loans outstanding at the close of December 31, 1962, multiplied by 3 percent, or

(2) The amount which would constitute a reasonable addition to the reserve for losses on such loans under § 1.166–4 for a period in which the amount of such loans increased from zero to the amount thereof outstanding at the close of December 31, 1962

then such opening balance shall be increased by an amount equal to so much of the *pre-1952 surplus* of the taxpayer as is necessary to increase such opening balance to the greater of the amounts described in subparagraph (1) or (2) of this paragraph. The amount of such increase shall be deemed to be included in such opening balance solely for the limited purpose described in paragraph (d) of this section.

(b) *Pre-1952 surplus defined*—(1) *In general*. For purposes of this section and § 1.593–7, the term *pre-1952 surplus* means an amount equal to:

(i) The sum of the taxpayer's surplus, undivided profits, and reserves determined (under the principles of paragraph (d)(2) of § 1.593–1) as of the close of the taxpayer's last taxable year beginning before January 1, 1952 (including any amount acquired from another taxpayer), minus

(ii) The amount of any impairments of such sum (as determined under paragraph (c) of this section).

(2) *Reduction for certain excludable interest*. (i) The amount otherwise determined under subparagraph (1) of this paragraph may, at the option of the taxpayer, be reduced by the portion, if any, of such amount which is attributable to interest which would have been excludable from gross income of such taxpayer under section 22(b)(4) of

the Internal Revenue Code of 1939 (relating to interest on governmental obligations) or the corresponding provisions of prior revenue laws, had such taxpayer been subject, when such interest was received or accrued, to the income tax imposed by such Code or prior revenue laws.

(ii) For purposes of subdivision (i) of this subparagraph, the portion of the amount otherwise determined under subparagraph (1) of this paragraph which is attributable to interest which would have been excludable from gross income shall be determined by multiplying such amount by the ratio which:

(*a*) The total amount of such excludable interest for the period before the taxpayer's first taxable year beginning after December 31, 1951, bears to

(*b*) The total amount of the taxpayer's gross income, plus the total amount of such excludable interest, for such period

If the amount determined under subparagraph (1)(i) of this paragraph includes any amount acquired from another taxpayer, then the gross income and excludable interest of the taxpayer for the period before its first taxable year beginning after December 31, 1951, shall include the gross income and excludable interest (for the same period) of such other taxpayer.

(c) *Impairment of surplus, undivided profits, and reserves*—(1) *General rule*. In the case of a taxable year beginning after December 31, 1951, and ending before January 1, 1963, if for such year:

(i) The amount described in paragraph (b)(1)(i) of this section (as decreased under subparagraph (3)(i) of this paragraph), exceeds

(ii) The sum of the taxpayer's surplus, undivided profits, and reserves (excluding the amount of any pre-1963 reserves) determined as of the close of such year under the principles of paragraph (d)(2) of § 1.593–1

then the amount described in paragraph (b)(1)(i) of this section may, at the option of the taxpayer, be reduced by the amount of such excess.

(2) *Transition year*. In the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, the part of such year which occurs before January 1, 1963, shall be considered to be a taxable year for purposes of subparagraph (1) of this paragraph.

(3) *Rules for applying subparagraph (1)*. (i) For purposes of subparagraph (1)(i) of this paragraph, the amount described in paragraph (b)(1)(i) of this section shall be decreased by the total of any reductions under subparagraph (1) of this paragraph for prior taxable years; and

(ii) For purposes of subparagraph (1)(ii) of this paragraph, the term *pre-1963 reserves* means the amount determined under the principles of paragraph (b)(1) of § 1.593–7 for the period which begins with the first day of the first taxable year beginning after December 31, 1951, and which ends at the close of the taxable year with respect to which the computation under subparagraph (1) is being made.

(d) *Treatment of pre-1952 surplus*. Any portion of the taxpayer's pre-1952 surplus which, pursuant to paragraph (a) of this section, is deemed to be included in the opening balance of the reserve for losses on qualifying real property loans shall not be treated as a reserve for bad debts for any purpose other than computing for any taxable year the amount determined under the method described in paragraph (b), (c), or (d) of § 1.593–6 (relating, respectively, to the percentage of taxable income method, the percentage of real property loans method, and the experience method) or paragraph (b), (c), or (d) of § 1.593–6A (relating, respectively, to the percentage of taxable income method, the percentage method, and the experience method). For such limited purpose, such portion shall be deemed to remain in, and constitute a part of, the reserve for losses on qualifying real property loans. For all other purposes, such portion will retain its character as part of the taxpayer's pre-1952 surplus.

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

Example. (1) *Facts*. X Corporation, a mutual savings bank organized in 1934, makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. For the taxable years 1934 through 1951, X's gross income was $2.7 million, in addition to which X received $300,000 of interest which would have been excludable from gross income under section 22(b)(4) of the Internal

Revenue Code of 1939, or the corresponding provisions of prior revenue laws, if X had been subject to the income tax imposed by such Code or prior revenue laws when such interest was received. At the close of 1951, the sum of X's surplus, undivided profits, and reserves was $650,000. At the close of 1954, X had pre-1963 reserves of $10,000, and surplus, undivided profits, and reserves of $630,000. At the close of 1955, X had pre-1963 reserves of $15,000, and surplus, undivided profits, and reserves of $625,000. At the close of 1962, X had pre-1963 reserves of $55,000, nonqualifying loans of $4 million, and qualifying real property loans of $10 million. It is assumed that, under § 1.166–4, $16,000 would constitute a reasonable addition to the reserve for losses on nonqualifying loans for a period in which such loans increased from zero to $4 million and $20,000 would constitute a reasonableaddition to the reserve for losses on qualifying real property loans for a period in which such loans increased from zero to $10 million.

(2) *Impairment of surplus, undivided profits, and reserves for 1954.* The sum of X's surplus, undivided profits, and reserves at the close of 1951 was impaired during 1954 by $30,000, computed as follows:

Sum of surplus, undivided profits, and reserves at close of 1951	$650,000
Less:	
Sum of surplus, undivided profits, and reserves at close of 1954, excluding pre-1963 reserves at close of such year ($630,000 minus $10,000)	620,000
	30,000

(3) *Impairment of surplus, undivided profits, and reserves for 1955.* The sum of X's surplus, undivided profits, and reserves at the close of 1951 was further impaired during 1955 by $10,000, computed as follows:

Sum of surplus, undivided profits, and reserves at close of 1951, decreased by amount of 1954 impairment ($650,000 minus $30,000)	$620,000
Less:	
Sum of surplus, undivided profits, and reserves at close of 1955, excluding pre-1963 reserves at close of such year ($625,000 minus $15,000)	610,000
	10,000

(4) *Pre-1952 surplus.* X's pre-1952 surplus is $549,000, computed as follows:

Sum of surplus, undivided profits and reserves at close of 1951	$650,000	
Less:		
Sum of impairments for 1954 and 1955 ($30,000 plus $10,000)	40,000	
		$610,000
Less:		
Portion of such $610,000 which is attributable to excludable interest ($610,000 multiplied by $300,000/$3 million)		61,000
		549,000

(5) *Allocation of pre-1963 reserves to reserve for losses on nonqualifying loans and to reserve for losses on qualifying real property loans.* Of the $55,000 of pre-1963 reserves at the close of 1962, $16,000 (the amount which would constitute a reasonable addition to the reserve for losses on nonqualifying loans for a period in which such loans increased from zero to $4 million) shall be allocated to, and constitute the opening balance of, the reserve for losses on nonqualifying loans, and the balance of $39,000 ($55,000 minus $16,000) shall be allocated to, and constitute a part of the opening balance of, the reserve for losses on qualifying real property loans.

(6) *Allocation of pre-1952 surplus to reserve for losses on qualifying real property loans.* X's pre-1963 reserves are not sufficient to bring the opening balance of the reserve for losses on qualifying real property loans to $300,000, which is an amount equal to the greater of:

(i) $300,000 (*i.e.*, $10 million of qualifying real property loans outstanding at the close of 1962, multiplied by 3 percent), or

(ii) $20,000 (the amount which would constitute a reasonable addition to the reserve for losses on such loans under § 1.166–4 for a period in which the amount of such loans increased from zero to the $10 million).

Therefore, $261,000 ($300,000 minus $39,000) of X's pre-1952 surplus of $549,000 shall be deemed to be included in the opening balance of such reserve in order to increase such opening balance to $300,000.

[T.D. 6728, 29 FR 5861, May 5, 1964, as amended by T.D. 549, 43 FR 21457, May 18, 1978]

§ 1.593–10 Certain distributions to shareholders by a domestic building and loan association.

(a) *In general.* Section 593(f) provides that if a domestic building and loan association (as defined in section 7701(a)(19) and the regulations thereunder) distributes property after December 31, 1962, to a shareholder with respect to its stock and if the amount of such distribution is not allowable to the association as a deduction under section 591 (relating to deduction for dividends paid on deposits), then, notwithstanding any other provision of the Code, the distribution shall be treated as provided in paragraphs (b) and (c) of this section. For purposes of

the preceding sentence, the term *distribution* includes any distribution in redemption of stock to which section 302(a) or 303 applies, or in partial or complete liquidation of the association, as well as any other distribution which the association may make to a shareholder with respect to its stock. For definition of the term *property*, see section 317(a). For determination of the amount of a distribution, see section 301(b). For taxable years beginning after July 11, 1969, this paragraph is not applicable to any transaction to which section 381 (relating to carryovers in certain corporate acquisitions) and the regulations thereunder apply.

(b) *Distributions out of certain reserves*—(1) *Distributions not in exchange for stock*. If the distribution is not a redemption to which section 302(a) or 303 applies or in partial or complete liquidation of the association, then to the extent that the distribution is not out of earnings and profits of the taxable year (within the meaning of section 316(a)(2)) or out of earnings and profits accumulated in taxable years beginning after December 31, 1951, the distribution shall be treated as made out of:

(i) First, the reserve for losses on qualifying real property loans (determined under subparagraph (3) of this paragraph), to the extent thereof,

(ii) Second, the supplemental reserve for losses on loans, to the extent thereof, and

(iii) Finally, such other accounts as may be proper.

(2) *Distributions in redemption of stock or in liquidation*. If the distribution is a redemption to which section 302(a) or 303 applies, or in partial or complete liquidation of the association, the distribution shall be treated as made out of:

(i) First, the reserve for losses on qualifying real property loans (as determined under subparagraph (3) of this paragraph), to the extent thereof,

(ii) Second, the supplemental reserve for losses on loans, to the extent thereof,

(iii) Third, earnings and profits of the taxable year (within the meaning of section 316(a)(2)),

(iv) Fourth, earnings and profits accumulated in taxable years beginning after December 31, 1951, and

(v) Finally, such other accounts as may be proper.

(3) *Special rule*. For purposes of subparagraphs (1)(i) and (2)(i) of this paragraph, the reserve for losses on qualifying real property loans shall be an amount equal to:

(i) The balance of such reserve determined as of the close of the taxable year after all adjustments for such year have been made (including the addition for such year determined under §1.593–6 or §1.593–6A (whichever is applicable)), minus.

(ii) The sum of:

(*a*) The amount which would have constituted the opening balance of such reserve (at the close of December 31, 1962) if such opening balance had been determined under the experience method described in paragraph (b)(3)(ii)(*b*) of §1.593–7 (relating to allocation of pre-1963 reserves to the opening balance of the reserve for losses on qualifying real property loans), and

(*b*) The total amount of the annual additions which would have been made to such reserve under section 166(c) for taxable years ending after December 31, 1962, if each such addition had been determined under the experience method described in paragraph (d) of §1.593–6 or paragraph (d) of §1.593–6A, whichever is applicable for the taxable year of such addition.

For purposes of subdivision (i) of this subparagraph, the balance of the reserve for losses on qualifying real property loans shall include the total amount of any pre-1963 reserves allocated thereto under paragraph (b)(3) of §1.593–7, but shall not include any pre-1952 surplus which is deemed to be included therein under paragraph (a) of §1.593–8 (relating to allocation of pre-1952 surplus to the opening balance of the reserve for losses on qualifying real property loans).

(c) *Amount charged against reserve and included in gross income*—(1) *In general*. If a distribution is treated under paragraph (b) (1) or (2) of this section as having been made out of the reserve for losses on qualifying real property loans or out of the supplemental reserve for losses on loans, such reserves shall be

charged with, and gross income for the taxable year shall be increased by, an amount equal to the lesser of:

(i) The amount of such reserves, or

(ii) The amount which, when reduced by the amount of income tax imposed by chapter 1 of the Code and attributable to the inclusion of such amount in gross income, is equal to the amount of such distribution.

(2) *Special rule.* For purposes of subparagraph (1)(ii) of this paragraph, in determining the income tax attributable to the inclusion of an amount in gross income, taxable income shall be determined without regard to any net operating loss carryback to the taxable year under section 172.

(d) *Examples.* This section may be illustrated by the following examples:

Example 1. (i) *Facts.* X Corporation, a domestic building and loan association having nonwithdrawable capital stock represented by shares, was organized in 1946, and makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. As of the close of December 31, 1962, X had $6,900 of earnings and profitsaccumulated in taxable years beginning after December 31, 1951. X's taxable income for 1963 is $30,000 (computed prior to the inclusion of any amount in gross income for such year under section 593(f)) and during such year X received tax-exempt interest of $500. X's earnings and profits for 1963 (computed at the close of the taxable year without diminution by reason of any distributions made during the taxable year) is $20,400. The opening balance of X's reserve for losses on qualifying real property loans as of the close of December 31, 1962 (determined under paragraph (b)(3)(ii)(*a*) of §1.593–7) was $24,500. Pre-1963 reserves of $22,500 were included in such opening balance, but it is assumed that pre-1963 reserves of only $2,500 would have been included in the opening balance if the opening balance had been determined under the experience method described in paragraph (b)(3)(ii)(*b*) of §1.593–7. Pre-1952 surplus of $2,000 was deemed included in such opening balance under paragraph (a) of §1.593–8. The deductible addition to such reserve for 1963 is $47,000. It is assumed that the addition to such reserve for 1963 would have been $2,200 if such addition had been computed under the experience method described in paragraph (d) of §1.593–6. On each of four dates during 1963 (January 1, April 1, July 1, and October 1), X made a $12,000 distribution (which was not a redemption to which section 302(a) or 303 applied or in partial or complete liquidation of X) to its shareholders with respect to its stock.

(ii) *Reserve for losses on qualifying real property loans.* For purposes of paragraph (b)(1)(i) of this section, X's reserve for losses on qualifying real property loans is $64,800, computed as follows:

Closing balance of reserve for losses on qualifying real property loans after addition for 1963 ($24,500 opening balance plus $47,000 addition)		$71,500
Minus:		
Amount of pre-1963 reserves which would have been included in opening balance under experience method	2,500	
Total additions which would have been made under experience method	2,200	
Pre-1952 surplus included in opening balance	2,000	
		6,700
		64,800

(iii) *Treatment of distributions.* Of each $12,000 quarterly distribution, $5,100 ($20,400) earnings and profits of the taxable year divided by 4) is out of X's earnings and profits of the taxable year (within the meaning of section 316(a)(2)); the remainder of the January 1 distribution, $6,900 ($12,000 minus $5,100), is out of X's earnings andprofits accumulated in taxable years beginning after December 31, 1951. Since $20,700 ($6,900 multiplied by 3) is not out of X's earnings and profits, such amount shall be treated as made out of X's reserve for losses on qualifying real property loans (as determined under subdivision (ii) of this example).

(iv) *Amount charged against reserve for losses on qualifying real property loans and included in gross income.* The reserve for losses on qualifying real property loans is charged with, and X's gross income for 1963 is increased by, $43,124, which is the lesser of:

(*a*) $64,800 (the reserve as of December 31, 1963, as determined under subdivision (ii) of this example), or

(*b*) $43,124, *i.e.*, the amount which, when reduced by the amount of income tax attributable to the inclusion of such amount in gross income, $22,424 ($43,124 multiplied by a tax rate of 52 percent), is equal to the amount of such distribution, $20,700.

Example 2. (i) *Facts.* Assume the same facts as in example 1 and the following additional facts: X's taxable income for 1964 is $6,000. The deductible addition to the reserve for losses on qualifying real property loans for 1964 is $11,000, but it is assumed that only $2,676 would have been the addition to such reserve for 1964 if such addition had been computed under the experience method described in paragraph (d) of §1.593–6. On December 31, 1964, X makes a $10,000 distribution in a redemption to which section 302(a) applies.

(ii) *Reserve for losses on qualifying real property loans.* For purposes of paragraph (b)(2)(i)

of this section, X's reserve for losses on qualifying real property loans is $30,000, computed as follows:

Closing balance of reserve for losses on qualifying real property loans after addition for 1964 ($71,500 opening balance plus $11,000 addition)		$82,500
Minus:		
Amount of pre-1963 reserves which would have been included in opening balance under the experience method	$2,500	
Total additions which would have been made under the experience method ($2,200 for 1963 plus $2,676 for 1964)	4,876	
Pre-1952 surplus included in opening balance	2,000	
		9,376
		73,124
Less charge against reserve under subdivision (iv) of example 1 for 1963 distribution		43,124
		30,000

(iii) *Treatment of distribution.* The $10,000 distribution in a redemption to which section 302(a) applies shall be treated as made out of X's reserve for losses on qualifying real property loans (as determined under subdivision (ii) of this example).

(iv) *Amount charged against reserve for losses on qualifying real property loans and included in gross income.* The reserve for losses on qualifying real property loans is charged with, and X's gross income for 1964 is increased by, $12,820, which is the lesser of:

(*a*) $30,000 (the reserve as of December 31, 1964, as determined under subdivision (ii) of this example), or

(*b*) $12,820, *i.e.,* the amount which, when reduced by the amount of income tax attributable to the inclusion of such amount in gross income, $2,820 ($12,820 multiplied by a tax rate of 22 percent), is equal to the amount of such distribution, $10,000.

Example 3. (i) *Facts.* X Corporation, a domestic building and loan association having nonwithdrawable capital stock represented by shares, was organized in 1946, and makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. As of the close of December 31, 1962, X had $6,900 of earnings and profits accumulated in taxable years beginning after December 31, 1951. X's taxable income for 1963 is $30,000 (computed prior to the inclusion of any amount in gross income for such year under section 593(f)) and during such year X received tax-exempt interest of $500. X's earnings and profits for 1963 (computed at the close of the taxable year without diminution by reason of any distributions made during the taxable year) is $20,400. The opening balance of X's reserve for losses on qualifying real property loans as of theclose of December 31, 1962 (determined under paragraph (b)(3)(ii)(*a*) of §1.593–7) was $24,500. Pre-1963 reserves of $24,500 were included in such opening balance, but it is assumed that pre-1963 reserves of only $4,500 would have been included in the opening balance if the opening balance had been determined under the experience method described in paragraph (b)(3)(ii)(*b*) of §1.593–7. The deductible addition to such reserve for 1963 is $500. It is assumed that the addition to such reserve for 1963 would have been $100 if such addition had been computed under the experience method described in paragraph (d) of §1.593–6. As of December 31, 1963, the balance of X's supplemental reserve for losses on loans is $30,000. On each of four dates during 1963 (January 1, April 1, July 1, and October 1), X made a $12,000 distribution (which was not a redemption to which section 302(a) or 303 applied or in partial or complete liquidation of X) to its shareholders with respect to its stock.

(ii) *Reserve for losses on qualifying real property loans.* For purposes of paragraph (b)(1)(i) of this section, X's reserve for losses on qualifying real property loans is $20,400, computed as follows:

Closing balance of reserve for losses on qualifying real property loans after addition for 1963 ($24,500 opening balance plus $500 addition)		$25,000
Minus:		
Amount of pre-1963 reserves which would have been included in opening balance under experience method	$4,500	
Total additions which would have been made under experience method	100	
		4,600
		20,400

(iii) *Treatment of distributions.* Of each $12,000 quarterly distribution, $5,100 ($20,400 earnings and profits of the taxable year divided by 4) is out of X's earnings and profits of the taxable year (within the meaning of section 316(a)(2)); the remainder of the January 1 distribution, $6,900 ($12,000 minus $5,100), is out of X's earnings and profits accumulated in taxable years beginning after December 31, 1951. Since $20,700 ($6,900 multiplied by 3) is not out of X's earnings and profits, $20,400 of such amount shall be treated as made outof X's reserve for losses on qualifying real property loans (as determined under subdivision (ii) of this example) and $300 ($20,700 minus $20,400) shall be treated as made out of X's supplemental reserve for losses on loans.

(iv) *Amount included in gross income.* X's gross income for 1963 is increased by $43,124, which is the lesser of:

(*a*) $50,400 ($20,400, the reserve for losses on qualifying real property loans, as determined under subdivision (ii) of this example, plus $30,000, the supplemental reserve for losses on loans), or

(*b*) $43,124, *i.e.*, the amount which, when reduced by the amount of income tax attributable to the inclusion of such amount in gross income, $22,424 ($43,124 multiplied by a tax rate of 52 percent), is equal to the amount of such distribution, $20,700.

(v) *Amount charged against reserve for losses on qualifying real property loans and supplemental reserve for losses on loans.* The reserve for losses on qualifying real property loans is charged with $20,400 (the balance of the reserve as of December 31, 1963, as determined under subdivision (ii) of this example), and the supplemental reserve for losses on loans is charged with $22,724 ($43,124, the amount included in gross income under subdivision (iv) of this example, minus $20,400).

[T.D. 6728, 29 FR 5862, May 5, 1964, as amended by T.D. 549, 43 FR 21457, May 18, 1978]

§ 1.593–11 Qualifying real property loan and nonqualifying loan defined.

(a) *Loan defined.* For purposes of this section, the term *loan* means debt, as the term *debt* is used in section 166 and the regulations thereunder. The term *loan* also includes a redeemable ground rent (as defined in section 1055 (c)) which is owned by the taxpayer, and any property acquired by the taxpayer in a transaction described in section 595(a). For determination of the amount of a loan, see paragraph (d) of this section.

(b) *Qualifying real property loan defined*—(1) *General rule.* For purposes of §§ 1.593–4 through 1.593–10, the term *qualifying real property loan* means any loan (other than a loan described in subparagraph (5) of this paragraph) which is secured by an interest in qualifying real property. For purposes of this section, the term *real property* means any property which, under the law of the jurisdiction in which such property is situated, constitutes real property. The term *real property* also includes a mobile unit which is permanently fixed to real property. The determination of whether a mobile unit is permanently fixed to real property shall be made on the basis of facts and circumstances in each particular case. For example, a mobile unit is permanently fixed to real property during a taxable year if, except for a brief period during which the unit is transported to a site, such unit was placed upon a foundation at a site with wheels and axles removed, affixed to the ground by means of straps, and connected to water, sewer, gas, and electric facilities. See paragraph (e) of this section for the treatment of a REMIC interest as a qualifying real property loan.

(2) *Meaning of Secured.* A loan will be considered as *secured* only if the loan is on the security of any instrument (such as a mortgage, deed of trust, or land contract) which makes the interest of the debtor in the property described therein specific security for the payment of the loan, provided that such instrument is of such a nature that, in the event of default, the property could be subjected to the satisfaction of the loan with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated.

(3) *Meaning of interest.* The word *interest* means an interest in real property which, under the law of the jurisdiction in which such property is situated, constitutes either (i) an interest in fee in such property, (or in the case of a mobile unit, an ownership interest), (ii) a leasehold interest in such property extending or renewable automatically for a period of at least 30 years, or at least 10 years beyond the date scheduled for the final payment on the loan secured by such interest, (iii) a leasehold interest in improved residential real property consisting of a structure or structures containing, in the aggregate, no more than four family units extending for a period of at least 2 years beyond the date scheduled for the final payment on the loan secured by such interest, or (iv) a leasehold interest in such property held subject to a redeemable ground rent defined in section 1055(c).

(4) *Meaning of qualifying real property.* The term *qualifying real property* means any real property which is improved real property, or which from the proceeds of the loan will become improved real property. As used in the preceding sentence, the term *improved real property* means:

(i) Land on which is located any building of a permanent nature (such as a house, mobile unit, apartment house, office building, hospital, shopping center, warehouse, garage, or other similar permanent structure),

provided that the value of such building is substantial in relation to the value of such land,

(ii) Any building lot or site which, by reason of installations and improvements that have been completed in keeping with applicable governmental requirements and with general practice in the community, is a building lot or site ready for the construction of any building of a permanent nature within the meaning of paragraph (b)(4)(i) of this section.

(iii) Real property which, because of its state of improvement, produces sufficient income to maintain such real property and retire the loan in accordance with the terms thereof, or

(iv) A mobile unit which is permanently fixed to real property.

(5) *Loans not included*. The term *qualifying real property loan* does not include:

(i) Any loan evidenced by a security as defined in section 165(g)(2)(C),

(ii) Any loan (whether or not evidenced by a security as so defined) the primary obligor on which is (*a*) a government or a political subdivision or instrumentality thereof, (*b*) a bank (as defined in section 581), or (*c*) another member of the same affiliated group,

(iii) Any loan to the extent such loan is secured by a deposit in or share of the taxpayer (including a share of nonwithdrawable capital stock), determined as of the close of the taxable year, and

(iv) Any loan which (within a 60-day period beginning in one taxable year of the taxpayer and ending in the next taxable year of such taxpayer) is made or acquired, and then repaid or disposed of, unless both the transaction by which the loan is made or acquired and the transaction by which the loan is repaid or disposed of are established to the satisfaction of the district director to be for bona fide business purposes

As used in subdivision (ii)(*c*) of this subparagraph, the term *affiliated group* shall have the meaning assigned to such term by section 1504(a) (relating to the definition of an affiliated group), except that the phrase *more than 50 percent* shall be substituted for the phrase *at least 80 percent* each place the latter phrase appears in section 1504(a), and all corporations shall be treated as includible corporations (without regard to any of the exclusions provided in section 1504(b)).

(c) *Nonqualifying loan defined*. For purposes of §§ 1.593–4 through 1.593–9, the term *nonqualifying loan* means any loan which is not a qualifying real property loan.

(d) *Amount of loan determined*—(1) *General rule*. Except as provided in subparagraph (2) of this paragraph, the amount of any qualifying real property loan or nonqualifying loan, for purposes of section 593, is the adjusted basis of such loan as determined under § 1.1011–1. However, the adjusted basis, determined under § 1.1011–1, of any *loan in process* does not include the unadvanced portion of such loan. For the basis of a redeemable ground rent reserved or created by the taxpayer before April 11, 1963, see section 1055(b)(3); and for the basis of a loan represented by property acquired by the taxpayer in a transaction described in section 595(a), see section 595(c).

(2) *Limitation*. If the total amount advanced on any loan exceeds the loan value of any interest in qualifying real property which secures such loan, then the portion of such loan which, as of the close of any taxable year, will be considered as a qualifying real property loan shall be determined under the principles of section 7701(a)(19) and the regulations thereunder.

(e) *Treatment of REMIC interests as qualifying real property loans*—(1) *In general*. For purposes of section 593 and §§ 1.593–4 through 1.593–10, if, for any calendar quarter, at least 95 percent of a REMIC's assets (as determined in accordance with § 1.860F–4(e)(1)(ii) or § 1.6049–7(f)(3)) are qualifying real property loans (as defined in paragraph (b) of this section), then, for that calendar quarter, all the regular and residual interests in that REMIC are treated as qualifying real property loans. If less than 95 percent of a REMIC's assets are qualifying real property loans, then a percentage of each regular or residual interest is treated as a qualifying real property loan. The percentage equals the percentage of the REMIC's assets that are qualifying real property loans. See § 1.860F–4(e)(1)(ii)(B) and § 1.6049–7(f)(3) for information required to be

provided to regular and residual interest holders if the 95-percent test is not met.

(2) *Treatment of REMIC assets for section 593 purposes*—(i) *Manufactured housing treated as qualifying real property*. For purposes of paragraph (e)(1) of this section, the term ''qualifying real property'' includes manufactured housing treated as a single family residence under section 25(e)(10).

(ii) *Status of cash flow investments*. For purposes of paragraph (e)(1) of this section, cash flow investments (as defined in section 860G(a)(6) and § 1.860G–2(g)(1)) are treated as qualifying real property loans.

[T.D. 6728, 29 FR 5864, May 5, 1964, as amended by T.D. 549, 43 FR 21458, May 18, 1978; T.D. 8458, 57 FR 61298, Dec. 24, 1992]

§ 1.594–1 Mutual savings banks conducting life insurance business.

(a) *Scope of application*. Section 594 applies to the case of a mutual savings bank not having capital stock represented by shares which conducts a life insurance business, if:

(1) The conduct of the life insurance business is authorized under State law,

(2) The life insurance business is carried on in a separate department of the bank,

(3) The books of account of the life insurance business are maintained separately from other departments of the bank, and

(4) The life insurance department of the bank would, if it were treated as a separate corporation, qualify as a life insurance company under section 801.

(b) *Computation of tax*. In the case of a mutual savings bank conducting a life insurance business to which section 594 is applicable, the tax upon such bank consists of the sum of the following:

(1) A partial tax computed under section 11 upon the taxable income of the bank determined without regard to any items of income or deduction properly allocable to the life insurance department, and

(2) A partial tax computed on the income (or, in the case of taxable years beginning before January 1, 1955, the taxable income (as defined in section 803)) of the life insurance department determined without regard to any items of income or deduction not properly allocable to such department, at the rates and in the manner provided in subchapter L (section 801 and following), chapter 1 of the Code, with respect to life insurance companies.

§ 1.595–1 Treatment of foreclosed property by certain creditors.

(a) *Nonrecognition of gain or loss on the acquisition of security property by certain creditors*—(1) *In general*. Section 595(a) provides that in the case of a creditor which is an organization described in section 593(a) (that is, a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless for purposes of section 166 (relating to bad debts), as the result of a transaction by which such creditor bids in at foreclosure, or reduces to ownership or possession by agreement or process of law, any property (whether real or personal, tangible or intangible) which was security for the payment of any indebtedness (whether or not a qualifying real property loan as defined in section 593(e)(1)). The treatment provided by section 595(a) is mandatory (regardless of whether such creditor utilizes the specific deduction or reserve method of accounting for bad debts) if, for the taxable year in which the property is bid in at foreclosure, or reduced to ownership or possession by agreement or process of law, the creditor is an organization described in section 593(a), even though the creditor subsequently becomes an organization not described in section 593(a). For definition of the terms *domestic building and loan association* and *cooperative bank* for taxable years beginning after October 16, 1962, see paragraphs (19) and (32), respectively, of section 7701(a).

(2) *Effective date*. Section 595 applies to any transaction (described in subparagraph (1) of this paragraph) occurring after December 31, 1962, except that such section does not apply to any such transaction in which the taxable event determined without regard to

section 595 (that is, the sale or exchange to the creditor of the security property by reason of the default or anticipated default of the debtor) occurred before January 1, 1963.

(b) *Rules for determining when security property is reduced to ownership or possession by agreement or process of law*—(1) *Ownership or possession*. For purposes of this section, security property shall be considered as reduced to ownership or possession by agreement or process of law on the earliest date on which the creditor, by reason of the default or anticipated default of the debtor:

(i) Acquires, by agreement or process of law, a title to, or a right or interest in, the security property which under local law is indefeasible and which the creditor can validly dispose of apart from the indebtedness which the property secures, or

(ii) Acquires, by agreement or process of law, an enforceable right to direct the use to which the security property shall be put, including, in the case of real property, whether or not the property shall continue to be occupied by the debtor who has defaulted (regardless of whether such creditor has obtained indefeasible title to the property), or

(iii) Sells or otherwise disposes of the security property or any interest therein.

(2) *Agreement or process of law*. The reduction of security property to ownership or possession by agreement includes, where valid under local law, such methods as voluntary conveyance from the debtor (including a conveyance directly to the Federal Housing Commissioner) and abandonment to the creditor. The reduction of security property to ownership or possession by process of law includes foreclosure proceedings in which a competitive bid is entered, such as foreclosure by judicial sale or by power of sale contained in the loan agreement without recourse to the courts, as well as those types of foreclosure proceedings in which a competitive bid is not entered, such as strict foreclosure and foreclosure by entry and possession, by writ of entry, or by publication or notice.

(c) *Examples*. The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. On January 31, 1963, X, a creditor which is an organization described in section 593(a), purchases at a foreclosure sale residential real property which was security for a debt owing to X, and with respect to which the debtor has defaulted. Under local law, there is a 1-year statutory redemption period (during which period the debtor is entitled to remain in possession) so that X must wait until February 1, 1964, to obtain indefeasible title to the property. No gain or loss is recognized by reason of the purchase at the foreclosure sale on January 31, 1963. However, the date on which the security property is considered as reduced to ownership or possession by agreement or process of law is February 1, 1964. If, under local law, there were no statutory redemption period so that X obtained indefeasible title to the security property at the foreclosure sale, the date on which the security property would be considered as so reduced is January 31, 1963. Furthermore, with respect to either of the preceding situations, if the foreclosure sale had occurred on November 1, 1962 (instead of on January 31, 1963), section 595 would not apply to the transaction since the taxable event in respect of such transaction occurred prior to January 1, 1963.

Example 2. The facts are the same as in example 1, except that instead of purchasing the property at a foreclosure sale, X, pursuant to the provisions of local law, enters upon the security property on January 31, 1963, and acquires an enforceable right to direct whether the property shall continue to be occupied by the debtor. X does not obtain indefeasible title to the property until February 1, 1964. The date on which the security property is considered as reduced to ownership or possession by agreement or process of law is January 31, 1963.

(d) *Basis of acquired property*. Section 595(c) provides that the basis of any property to which section 595(a) applies (hereinafter referred to as *acquired property*) shall be the adjusted basis of the indebtedness for which such property was security, determined as of the date of acquisition of such property, properly increased for costs of acquisition. The date of acquisition is the date, determined under paragraph (b) of this section, on which the security property is reduced to ownership or possession by agreement or process of law. Costs of acquisition are expenditures incurred by the creditor (for example, fees for an attorney, master, trustee, auctioneer, for publication, acquiring title, clearing liens, filing and

recording, and court costs) which are directly related to the foreclosure sale or proceeding, or to the other process used to reduce the security property to ownership or possession, or both, by agreement or process of law. For purposes of determining the adjusted basis of the indebtedness for which the acquired property was security, there shall be included the amount of any unpaid interest with respect to such indebtedness, but only to the extent that it has been included in gross income. The basis of the acquired property, as determined under this paragraph, shall be adjusted in accordance with the rules provided in paragraph (e) of this section.

(e) *Characteristics of acquired property*—(1) *Depreciation; decline in fair market value*. Section 595(b) provides, in part, that for purposes of section 166 (relating to bad debts) acquired property shall be considered as property having the same characteristics as the indebtedness for which such property was security. Thus, no deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion shall be allowed to a creditor with respect to acquired property. However, if, at any time, the adjusted basis of the acquired property exceeds the fair market value of such property (determined by proper appraisal and without regard to any outstanding right of redemption), and the creditor can establish (in the same manner as worthlessness in whole or in part is established for purposes of section 166) that an amount equal to any portion of such excess will not be collected with respect to the indebtedness for which such property was security, the creditor may treat such portion, under the provisions of section 166, as a worthless debt. In such case, the basis of the acquired property shall be reduced by the amount treated as a worthless debt.

(2) *Example*. The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. X Corporation, a creditor which is an organization described in section 593(a), makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. In 1963, A defaults in his payments on a debt owed to X which is secured by residential real property. X reduces the property to ownership or possession by agreement or process of law by bidding it in at a foreclosure sale for $23,000. The adjusted basis of the indebtedness at the date of acquisition of the property (increased for costs of acquisition) is $25,000, and this amount becomes the basis of the acquired property. X obtains a deficiency judgment against A for $2,000. Later in 1963, a proper appraisal enables X to establish that the fair market value of the property is $18,000. X is also able to establish (under the rules of section 166 and the regulations thereunder) that due to A's poor financial condition only $1,000 can be collected on the outstanding deficiency judgment. For the year 1963, X may charge its bad debt reserve for $6,000, computed as follows:

Basis of acquired property	$25,000
Less: Fair market value of acquired property	18,000
Excess	7,000
Less: Collectible portion of deficiency judgment	1,000
Portion of excess treated as worthless debt	6,000

(3) *Capital improvements made after date of acquisition not treated as acquired property*. Except as provided in subparagraph (4) of this paragraph, the term *acquired property* does not include capital improvements made after the date of (acquisition within the meaning of paragraph (d) of this section) of the property. Thus, the applicable deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion shall be allowed, if otherwise allowable, for improvements which are made by the creditor with respect to acquired property and which are properly chargeable to the capital account. If the creditor sells or otherwise disposes of the acquired property with such capital improvements, any amount realized by reason of such sale or other disposition shall be allocated in proportion to the respective fair market values of the acquired property and such capital improvements. The portion of the amount realized which is allocable to the acquired property shall be treated in accordance with the rules prescribed in subparagraph (6) of this paragraph. The portion of the amount realized which is allocable to such capital improvements shall be treated under the applicable rules governing the sale or other disposition of such property and without regard to section 595.

(4) *Treatment of minor capital improvements as acquired property*. A creditor

may treat any minor capital improvements which it makes to a particular acquired property after the date of acquisition (within the meaning of paragraph (d) of this section) in the same manner as the acquired property, provided such creditor treats all minor capital improvements with respect to that particular acquired property in such manner. For purposes of section 595, a capital improvement shall be considered as *minor* only if the cost of such improvement does not exceed $3,000.

(5) *Records for capital improvements.* For purposes of subparagraphs (3) and (4) of this paragraph, the creditor must maintain such records as are necessary to clearly reflect, with respect to each particular acquired property, the cost of each capital improvement and whether the taxpayer treated minor capital improvements with respect to such property in the same manner as the acquired property.

(6) *Amounts realized with respect to acquired property.* Section 595(b) provides, in part, that any amount realized with respect to acquired property shall be treated as a payment on account of the indebtedness for which such property was security, and any loss with respect thereto shall be treated as a bad debt to which the provisions of section 166 (relating to bad debts) apply. An amount realized with respect to acquired property means an amount representing a recovery of capital, such as proceeds from the sale or other disposition of the property, payments on the original indebtedness made by or on behalf of the debtor (including amounts received under an insurance contract with the Federal Housing Administration or a guarantee by the Veterans' Administration), and collections on a deficiency judgment obtained against the debtor (other than amounts treated as interest under applicable local law). Amounts realized with respect to acquired property include amounts which otherwise would be treated in the manner prescribed in section 351 (relating to transfer to a corporation controlled by transferor), section 354 (relating to exchanges of stock and securities in certain reorganizations), section 453 (relating to installment method), section 1031 (relating to exchange of property held for productive use or for investment), or section 1033 (relating to involuntary conversions). For purposes of section 595(b), if a corporation distributes acquired property in a distribution to which section 311 (relating to taxability of corporation on distribution) or section 336 (relating to nonrecognition of gain or loss to a corporation on distribution of its property in partial or complete liquidation) applies, the fair market value of the acquired property at the time of the distribution shall be treated as an amount realized with respect to such property. However, no amount shall be considered realized by reason of the distribution or transfer of acquired property in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies, and in the case of such a distribution or transfer the acquired property shall be treated by the distributee or transferee as having the same characteristics as it had in the hands of the distributor or transferor at the time of such distribution or transfer. The following rules shall apply to amounts realized with respect to acquired property:

(i) Any amount realized shall be applied against and reduce the adjusted basis of the acquired property, and to the extent that such amount exceeds the adjusted basis, it shall, in the case of a creditor using the specific deduction method of accounting for bad debts, be included in gross income as ordinary income, or, in the case of a creditor using the reserve method of accounting for bad debts, be credited to the appropriate bad debt reserve (that is, the reserve for losses on qualifying real property loans or the reserve for losses on nonqualifying loans). Any amounts credited during the taxable year to a reserve for bad debts pursuant to this subdivision shall not be considered as a part of the addition under section 593 for such year, but shall be included in the balance of the reserve for purposes of computing such addition to the reserve for such taxable year. Thus, for example, an amount credited to the reserve for losses on qualifying real property loans during a taxable year shall not be considered as a part of the addition to such reserve

computed under the percentage of taxable income method. However, the amount of such credit shall be included in the balance of such reserve for the purpose of determining the amount necessary to increase the balance of such reserve (as of the close of such taxable year) to an amount equal to 3 percent of qualifying real property loans and for the purpose of determining whether such balance exceeds 6 percent of such loans.

(ii) If an amount realized on the sale or other disposition of the acquired property is insufficient to restore to the creditor the adjusted basis of the property, the difference between such adjusted basis and such amount realized shall be treated as a bad debt to which the provisions of section 166 apply. If the creditor subsequently realizes an additional amount with respect to the original indebtedness or the acquired property, such additional amount shall be treated as the recovery of a bad debt.

(7) *Treatment of rents, similar amounts, and expenses.* Section 595 does not change the treatment of rents, royalties, dividends, interest, or similar amounts received or accrued by the creditor with respect to acquired property, nor does it change the treatment of expenses incurred with respect to such property. (See, however, subparagraph (1) of this paragraph for treatment of depreciation, etc.) Thus, for example, if the acquired property is a governmental obligation within the meaning of section 103 (relating to interest on certain governmental obligations), interest payments received by the creditor with respect to such obligation would not be included in gross income.

(8) *Examples.* The provisions of subparagraphs (6) and (7) of this paragraph may be illustrated by the following examples:

Example 1. (i) *Facts.* X Corporation, a creditor which is an organization described in section 593(a), uses the reserve method of accounting for bad debts. On May 1, 1964, X reduces to ownership or possession by agreement or process of law improved real property which is security for an indebtedness of A which is in default. On the date of acquisition there remains unpaid on the indebtedness $20,000 principal and $700 interest. X has previously included the $700 interest in gross income. Subsequent to acquisition, X incurs expenses totaling $500 for maintenance, and during the period June 1 through September 30, 1964, rents the property for a total rental of $400. Under local law, X is accountable to A for the rents received and A is accountable to X for the expenses incurred. There are no other receipts or expenses until October 1, 1964, at which time X sells the acquired property for $22,000. Under local law, A is not entitled to any portion of the sales proceeds.

(ii) *Treatment of rents, expenses, and sales proceeds.* X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700
Plus: Expenses charged to debtor	500
	21,200
Less: Rents credited to debtor	400
Adjusted basis of acquired property at sale	20,800
Less: Portion of $22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,800
	0
Portion of sales proceeds credited to reserve for losses on qualifying real property loans ($22,000 minus $20,800)	1,200

(iii) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the $1,200 portion of the sales proceeds would be treated as ordinary income.

Example 2. (i) *Facts.* The facts are the same as in example 1 except that under local law X is not accountable to A for any portion of the rents received and A is not accountable to X for the expenses incurred by X.

(ii) *Treatment of rents and expenses.* X includes in gross income the total rent receipts of $400 and deducts (if otherwise allowable) the expenses of $500.

(iii) *Treatment of sales proceeds.* As the result of the sale of the acquired property, X credits $1,300 to the reserve for losses on qualifying real property loans, computed as follows:

Basis of acquired property at acquisition and at date of sale (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700
Less: Portion of $22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,700
	0
Portion of sales proceeds credited to reserve for losses on qualifying real property loans ($22,000 minus $20,700)	1,300

(iv) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the $1,300 portion of the

sales proceeds would be treated as ordinary income.

Example 3. (i) *Facts.* The facts are the same in example 1 except that X sells the acquired property for $15,000.

(ii) *Treatment of rents, expenses, and sales proceeds.* X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700
Plus: Expenses charged to debtor	500
	21,200
Less: Rents credited to debtor	400
Adjusted basis of acquired property at sale	20,800
Less: Portion of $15,000 sales proceeds applied in reduction of adjusted basis of acquired property	15,000
Amount charged to reserve for losses on qualifying real property loans	5,800

(iii) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the excess of $5,800 would be allowed as a specific bad debt deduction.

[T.D. 6814, 30 FR 4473, Apr. 7, 1965]

§ 1.596–1 Limitation on dividends received deduction.

(a) *In general.* For taxable years beginning after July 11, 1969, in the case of mutual savings banks, domestic building and loan associations, and cooperative banks, if the addition to the reserve for losses on qualifying real property loans for the taxable year is determined under section 593(b)(2) (relating to the percentage of taxable income method), the total amount allowed as a deduction with respect to dividends received under part VIII, subchapter B, chapter 1, subtitle A of the Code (section 241 *et seq.*) (determined without regard to section 596 and this section) for such taxable year is reduced as provided by this section. In such case, the dividends received deduction otherwise determined under part VIII, subchapter B, chapter 1, subtitle A of the Code, is reduced by an amount equal to the applicable percentage for such year (determined solely under subparagraphs (A) and (B) of section 593(b)(2) and the regulations thereunder) of such total amount. For the rule under which a mutual savings bank, domestic building and loan association, or cooperative bank is deemed to have determined the addition to its reserve for losses on qualifying real property loans for the taxable year under section 593(b)(2), see § 1.593–6A(a)(2).

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

Example. X Corporation, a domestic building and loan association, determines the addition to its reserve for losses on qualifying real property loans under section 593(b)(2) for its taxable year beginning in 1971. During that taxable year, X Corporation received a total of $100,000 as dividends from domestic corporations subject to tax under chapter 1 of the Code. X Corporation received no other dividends during the taxable year. Under part VIII, subchapter B, chapter 1, subtitle A of the Code, a deduction, determined without regard to section 596 and this section, of $85,000 would be allowed with respect to the dividends. For the taxable year, the applicable percentage, determined under subparagraphs (A) and (B) of section 593(b)(2), is 54 percent. Under section 596 and this section, the amount allowed as a deduction under section 243 and the regulations thereunder is reduced by $45,900 (54 percent of $85,000) to $39,100 ($85,000 less $45,900).

(c) *Dividends received by members of a controlled group.* If a thrift institution that computes a deduction under section 593(b)(2) is a member of a controlled group of corporations (within the meaning of section 1563(a), determined by substituting *50 percent* for *80 percent* each place it appears therein) and if the thrift institution, without a bona fide business purpose, transfers stock, directly or indirectly, to another member of the group, the Commissioner may allocate any dividends with respect to the stock to the thrift institution. If the Commissioner allocates a dividend to a thrifty institution under this paragraph (c), the Commissioner will also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation, at a time and in a manner consistent with the procedures of § 1.482–1(d)(2). This paragraph (c) applies to taxable years ending on or after August 30, 1975.

[T.D. 7149, 36 FR 20944, Nov. 2, 1971, as amended by T.D. 7631, 44 FR 40496, July 11, 1979]

§ 1.597–1 Definitions.

For purposes of the regulations under section 597—

(a) Unless the context otherwise requires, the terms *consolidated group*,

member and *subsidiary* have the meanings provided in § 1.1502–1; and

(b) The following terms have the meanings provided below—

Acquiring. The term *Acquiring* means a corporation that is a transferee in a Taxable Transfer, other than a deemed transferee in a Taxable Transfer described in § 1.597–5(b).

Agency. The term *Agency* means the Resolution Trust Corporation, the Federal Deposit Insurance Corporation, any similar instrumentality of the United States government, and any predecessor or successor of the foregoing (including the Federal Savings and Loan Insurance Corporation).

Agency Control. An Institution or entity is under *Agency Control* if Agency is conservator or receiver of the Institution or entity, or if Agency has the right to appoint any of the Institution's or entity's directors.

Agency Obligation. The term *Agency Obligation* means a debt instrument that Agency issues to an Institution or to a direct or indirect owner of an Institution.

Bridge Bank. The term *Bridge Bank* means an Institution that is organized by Agency to hold assets and liabilities of another Institution and that continues the operation of the other Institution's business pending its acquisition or liquidation, and that is any of the following—

(1) A national bank chartered by the Comptroller of the Currency under section 11(n) of the Federal Deposit Insurance Act (12 U.S.C. 1821(n)) or section 21A(b)(10)(A) of the Federal Home Loan Bank Act (12 U.S.C. 1441a(b)(10)(A)) or any successor sections;

(2) A Federal savings association chartered by the Director of the Office of Thrift Supervision under section 21A(b)(10)(A) of the Federal Home Loan Bank Act (12 U.S.C. 1441a(b)(10)(A)) or any successor section; or

(3) A similar Institution chartered under any other statutory provisions.

Consolidated Subsidiary. The term *Consolidated Subsidiary* means a member of the consolidated group of which an Institution is a member that bears the same relationship to the Institution that the members of a consolidated group bear to their common parent under section 1504(a)(1).

Continuing Equity. An Institution has *Continuing Equity* for any taxable year if, on the last day of the taxable year, the Institution is not (1) a Bridge Bank, (2) in Agency receivership, or (3) treated as a New Entity.

Controlled Entity. The term *Controlled Entity* means an entity under Agency Control.

Federal Financial Assistance (FFA). The term *Federal Financial Assistance* (FFA), as defined by section 597(c), means any money or property provided by Agency to an Institution or to a direct or indirect owner of stock in an Institution under section 406(f) of the National Housing Act (12 U.S.C. 1729(f)), section 21A(b)(4) of the Federal Home Loan Bank Act (12 U.S.C. 1441a(b)(4)), section 11(f) or 13(c) of the Federal Deposit Insurance Act (12 U.S.C. 1821(f), 1823(c)), or under any similar provision of law. Any such money or property is FFA, regardless of whether the Institution or any of its affiliates issues Agency a note or other obligation, stock, warrants, or other rights to acquire stock in connection with Agency's provision of the money or property. FFA includes Net Worth Assistance, Loss Guarantee payments, yield maintenance payments, cost to carry or cost of funds reimbursement payments, expense reimbursement or indemnity payments, and interest (including original issue discount) on an Agency Obligation.

Institution. The term *Institution* means an entity that is, or immediately before being placed under Agency Control was, a bank or domestic building and loan association within the meaning of section 597 (including a Bridge Bank). Except as otherwise provided in the regulations under section 597, the term *Institution* includes a New Entity or Acquiring that is a bank or domestic building and loan association within the meaning of section 597.

Loss Guarantee. The term *Loss Guarantee* means an agreement pursuant to which Agency or a Controlled Entity guarantees or agrees to pay an Institution a specified amount upon the disposition or charge-off (in whole or in part) of specific assets, an agreement pursuant to which an Institution has a

right to put assets to Agency or a Controlled Entity at a specified price, or a similar arrangement.

Net Worth Assistance. The term *Net Worth Assistance* means money or property (including an Agency Obligation to the extent it has a fixed principal amount) that Agency provides as an integral part of a Taxable Transfer, other than FFA that accrues after the date of the Taxable Transfer. For example, Net Worth Assistance does not include Loss Guarantee payments, yield maintenance payments, cost to carry or cost of funds reimbursement payments, or expense reimbursement or indemnity payments. An Agency Obligation is considered to have a fixed principal amount notwithstanding an agreement providing for its adjustment after issuance to reflect a more accurate determination of the condition of the Institution at the time of the acquisition.

New Entity. The term *New Entity* means the new corporation that is treated as purchasing all of the assets of an Old Entity in a Taxable Transfer described in § 1.597–5(b).

Old Entity. The term *Old Entity* means the Institution or Consolidated Subsidiary that is treated as selling all of its assets in a Taxable Transfer described in § 1.597–5(b).

Residual Entity. The term *Residual Entity* means the entity that remains after an Institution transfers deposit liabilities to a Bridge Bank.

Taxable Transfer. The term *Taxable Transfer* has the meaning provided in § 1.597–5(a)(1).

[T.D. 8641, 60 FR 66094, Dec. 21, 1995]

§ 1.597–2 Taxation of Federal financial assistance.

(a) *Inclusion in income*—(1) *In general*. Except as otherwise provided in the regulations under section 597, all FFA is includible as ordinary income to the recipient at the time the FFA is received or accrued in accordance with the recipient's method of accounting. The amount of FFA received or accrued is the amount of any money, the fair market value of any property (other than an Agency Obligation), and the issue price of any Agency Obligation (determined under § 1.597–3(c)(2)). An Institution (and not the nominal recipient) is treated as receiving directly any FFA that Agency provides in a taxable year to a direct or indirect shareholder of the Institution, to the extent money or property is transferred to the Institution pursuant to an agreement with Agency.

(2) *Cross references*. See paragraph (c) of this section for rules regarding the timing of inclusion of certain FFA. See paragraph (d) of this section for additional rules regarding the treatment of FFA received in connection with transfers of money or property to Agency or a Controlled Entity, or paid pursuant to a Loss Guarantee. See § 1.597–5(c)(1) for additional rules regarding the inclusion of Net Worth Assistance in the income of an Institution.

(b) *Basis of property that is FFA*. If FFA consists of property, the Institution's basis in the property equals the fair market value of the property (other than an Agency Obligation) or the issue price of the Agency Obligation, as determined under § 1.597–3(c)(2).

(c) *Timing of inclusion of certain FFA*—(1) *Scope*. This paragraph (c) limits the amount of FFA an Institution must include in income currently under certain circumstances and provides rules for the deferred inclusion in income of amounts in excess of those limits. This paragraph (c) does not apply to a New Entity or Acquiring.

(2) *Amount currently included in income by an Institution without Continuing Equity*. The amount of FFA an Institution without Continuing Equity must include in income in a taxable year under paragraph (a)(1) of this section is limited to the sum of—

(i) The excess at the beginning of the taxable year of the Institution's liabilities over the adjusted bases of the Institution's assets; and

(ii) The amount by which the excess for the taxable year of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income (determined without regard to FFA) is greater than the excess at the beginning of the taxable year of the adjusted bases of the Institution's assets over the Institution's liabilities.

(3) *Amount currently included in income by an Institution with Continuing*

Equity. The amount of FFA an Institution with Continuing Equity must include in income in a taxable year under paragraph (a)(1) of this section is limited to the sum of—

(i) The excess at the beginning of the taxable year of the Institution's liabilities over the adjusted bases of the Institution's assets;

(ii) The greater of—

(A) The excess for the taxable year of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income (determined without regard to FFA); or

(B) The excess for the taxable year of the deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) of the consolidated group of which the Institution is a member on the last day of the Institution's taxable year over the group's gross income (determined without regard to FFA); and

(iii) The excess of the amount of any net operating loss carryover of the Institution (or in the case of a carryover from a consolidated return year of the Institution's current consolidated group, the net operating loss carryover of the group) to the taxable year over the amount described in paragraph (c)(3)(i) of this section.

(4) *Deferred FFA*—(i) *Maintenance of account*. An Institution must establish a deferred FFA account commencing in the first taxable year in which it receives FFA that is not currently included in income under paragraph (c)(2) or (c)(3) of this section, and must maintain that account in accordance with the requirements of this paragraph (c)(4). The Institution must add the amount of any FFA that is not currently included in income under paragraph (c)(2) or (c)(3) of this section to its deferred FFA account. The Institution must decrease the balance of its deferred FFA account by the amount of deferred FFA included in income under paragraphs (c)(4)(ii), (iv) and (v) of this section. (See also paragraph (d)(5)(i)(B) of this section for other adjustments that decrease the deferred FFA account.) If, under paragraph (c)(3) of this section, FFA is not currently included in income in a taxable year, the Institution thereafter must maintain its deferred FFA account on a FIFO (first in, first out) basis (e.g., for purposes of the first sentence of paragraph (c)(4)(iv) of this section).

(ii) *Deferred FFA recapture*. In any taxable year in which an Institution has a balance in its deferred FFA account, it must include in income an amount equal to the lesser of the amount described in paragraph (c)(4)(iii) of this section or the balance in its deferred FFA account.

(iii) *Annual recapture amount*—(A) *Institutions without Continuing Equity*—(1) *In general*. In the case of an Institution without Continuing Equity, the amount described in this paragraph (c)(4)(iii) is the amount by which—

(*i*) The excess for the taxable year of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income (taking into account FFA included in income under paragraph (c)(2) of this section); is greater than

(*ii*) The Institution's remaining equity as of the beginning of the taxable year.

(*2*) *Remaining equity*. The Institution's remaining equity is—

(*i*) The amount at the beginning of the taxable year in which the deferred FFA account was established equal to the adjusted bases of the Institution's assets minus the Institution's liabilities (which amount may be positive or negative); plus

(*ii*) The Institution's taxable income (computed without regard to any carryover from any other year) in any subsequent taxable year or years; minus

(*iii*) The excess in any subsequent taxable year or years of the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) over its gross income.

(B) *Institutions with Continuing Equity*. In the case of an Institution with Continuing Equity, the amount described in this paragraph (c)(4)(iii) is the amount by which the Institution's deductions allowed by chapter 1 of the Internal Revenue Code (other than net operating and capital loss carryovers) exceed its gross income (taking into

account FFA included in income under paragraph (c)(3) of this section).

(iv) *Additional deferred FFA recapture by an Institution with Continuing Equity.* To the extent that, as of the end of a taxable year, the cumulative amount of FFA deferred under paragraph (c)(3) of this section that an Institution with Continuing Equity has recaptured under this paragraph (c)(4) is less than the cumulative amount of FFA deferred under paragraph (c)(3) of this section that the Institution would have recaptured if that FFA had been included in income ratably over the six taxable years immediately following the taxable year of deferral, the Institution must include that difference in income for the taxable year. An Institution with Continuing Equity must include in income the balance of its deferred FFA account in the taxable year in which it liquidates, ceases to do business, transfers (other than to a Bridge Bank) substantially all of its assets and liabilities, or is deemed to transfer all of its assets under § 1.597–5(b).

(v) *Optional accelerated recapture of deferred FFA.* An Institution that has a deferred FFA account may include in income the balance of its deferred FFA account on its timely filed (including extensions) original income tax return for any taxable year that it is not under Agency Control. The balance of its deferred FFA account is income on the last day of that year.

(5) *Exceptions to limitations on use of losses.* In computing an Institution's taxable income or alternative minimum taxable income for a taxable year, sections 56(d)(1), 382 and 383 and §§ 1.1502–15, 1.1502–21, and 1.1502–22 (or §§ 1.1502–15A, 1.1502–21A, and 1.1502–22A, as appropriate) do not limit the use of the attributes of the Institution to the extent, if any, that the inclusion of FFA (including recaptured FFA) in income results in taxable income or alternative minimum taxable income (determined without regard to this paragraph (c)(5)) for the taxable year. This paragraph (c)(5) does not apply to any limitation under section 382 or 383 or § 1.1502–15, § 1.1502–21 or § 1.1502–22 (or § 1.1502–15A, § 1.1502–21A or § 1.1502–22A, as appropriate) that arose in connection with or prior to a corporation becoming a Consolidated Subsidiary of the Institution.

(6) *Operating rules*—(i) *Bad debt reserves.* For purposes of paragraphs (c)(2), (c)(3) and (c)(4) of this section, the adjusted bases of an Institution's assets are reduced by the amount of the Institution's reserves for bad debts under section 585 or 593, other than supplemental reserves under section 593.

(ii) *Aggregation of Consolidated Subsidiaries.* For purposes of this paragraph (c), an Institution is treated as a single entity that includes the income, expenses, assets, liabilities, and attributes of its Consolidated Subsidiaries, with appropriate adjustments to prevent duplication.

(iii) *Alternative minimum tax.* To compute the alternative minimum taxable income attributable to FFA of an Institution for any taxable year under section 55, the rules of this section, and related rules, are applied by using alternative minimum tax basis, deductions, and all other items required to be taken into account. All other alternative minimum tax provisions continue to apply.

(7) *Earnings and profits.* FFA that is not currently included in income under this paragraph (c) is included in earnings and profits for all purposes of the Internal Revenue Code to the extent and at the time it is included in income under this paragraph (c).

(d) *Transfers of money or property to Agency, and property subject to a Loss Guarantee*—(1) *Transfers of property to Agency.* The transfer of property to Agency or a Controlled Entity is a taxable sale or exchange in which the Institution is treated as realizing an amount equal to—

(i) The property's fair market value; or

(ii) For property subject to a Loss Guarantee, the greater of the property's fair market value or the guaranteed value or price at which the property can be put at the time of transfer.

(2) *FFA with respect to property covered by a Loss Guarantee other than on transfer to Agency.* (i) FFA provided pursuant to a Loss Guarantee with respect to covered property is included in the amount realized with respect to the property to the extent the total

amount realized does not exceed the greater of—

(A) The property's fair market value; or

(B) The guaranteed value or price at which the property can be put at the time of transfer.

(ii) For the purposes of this paragraph (d)(2), references to an amount realized include amounts obtained in whole or partial satisfaction of loans, amounts obtained by virtue of charging off or marking to market covered property, and other amounts similarly related to property, whether or not disposed of.

(3) *Treatment of FFA received in exchange for property.* FFA included in the amount realized for property under this paragraph (d) is not includible in income under paragraph (a)(1) of this section. The amount realized is treated in the same manner as if realized from a person other than Agency or a Controlled Entity. For example, gain attributable to FFA received with respect to a capital asset retains its character as capital gain. Similarly, FFA received with respect to property that has been charged off for income tax purposes is treated as a recovery to the extent of the amount previously charged off. Any FFA provided in excess of the amount realized under this paragraph (d) is includible in income under paragraph (a)(1) of this section.

(4) *Adjustment to FFA*—(i) *In general.* If an Institution pays or transfers money or property to Agency or a Controlled Entity, the amount of money and fair market value of the property is an adjustment to its FFA to the extent the amount paid and transferred exceeds the amount of money and fair market value of property Agency or a Controlled Entity provides in exchange.

(ii) *Deposit insurance.* This paragraph (d)(4) does not apply to amounts paid to Agency with respect to deposit insurance.

(iii) *Treatment of an interest held by Agency or a Controlled Entity*—(A) *In general.* For purposes of this paragraph (d), an interest described in §1.597–3(b) is not treated as property when transferred by the issuer to Agency or a Controlled Entity nor when acquired from Agency or a Controlled Entity by the issuer.

(B) *Dispositions to persons other than issuer.* On the date Agency or a Controlled Entity transfers an interest described in §1.597–3(b) to a holder other than the issuer, Agency or a Controlled Entity, the issuer is treated for purposes of this paragraph (d)(4) as having transferred to Agency an amount of money equal to the sum of the amount of money and the fair market value of property that was paid by the new holder as consideration for the interest.

(iv) *Consolidated groups.* For purposes of this paragraph (d), an Institution will be treated as having made any transfer to Agency or a Controlled Entity that was made by any other member of its consolidated group. The consolidated group must make appropriate investment basis adjustments to the extent the member transferring money or other property is not the member that received FFA.

(5) *Manner of making adjustments to FFA*—(i) *Reduction of FFA and deferred FFA.* An Institution adjusts its FFA under paragraph (d)(4) of this section by reducing in the following order and in an aggregate amount not greater than the adjustment—

(A) The amount of any FFA that is otherwise includible in income for the taxable year (before application of paragraph (c) of this section); and

(B) The balance (but not below zero) in the deferred FFA account, if any, maintained under paragraph (c)(4) of this section.

(ii) *Deduction of excess amounts.* If the amount of the adjustment exceeds the sum of the amounts described in paragraph (d)(5)(i) of this section, the Institution may deduct the excess to the extent the deduction does not exceed the amount of FFA included in income for prior taxable years reduced by the amount of deductions allowable under this paragraph (d)(5)(ii) in prior taxable years.

(iii) *Additional adjustments.* Any adjustment to FFA in excess of the sum of the amounts described in paragraphs (d)(5)(i) and (ii) of this section is treated—

(A) By an Institution other than a New Entity or Acquiring, as a deduction of the amount in excess of FFA received that is required to be transferred to Agency under section 11(g) of the Federal Deposit Insurance Act (12 U.S.C. 1821(g)); or

(B) By a New Entity or Acquiring, as an adjustment to the purchase price paid in the Taxable Transfer (see § 1.338–7).

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

Example 1. Timing of inclusion of FFA in income. (i) Institution M, a calendar year taxpayer without Continuing Equity because it is in Agency receivership, is not a member of a consolidated group and has not been acquired in a Taxable Transfer. On January 1, 1997, M has assets with a total adjusted basis of $100 million and total liabilities of $120 million. M's deductions do not exceed its gross income (determined without regard to FFA) for 1997. Agency provides $30 million of FFA to M in 1997. The amount of this FFA that M must include in income in 1997 is limited by § 1.597–2(c)(2) to $20 million, the amount by which M's liabilities ($120 million) exceed the total adjusted basis of its assets ($100 million) at the beginning of the taxable year. Pursuant to § 1.597–2(c)(4)(i), M must establish a deferred FFA account for the remaining $10 million.

(ii) If Agency instead lends M the $30 million, M's indebtedness to Agency is disregarded and the results are the same as in paragraph (i) of this *Example 1*. Section 597(c); §§ 1.597–1(b) (defining FFA) and 1.597–3(b).

Example 2. Transfer of property to Agency. (i) Institution M, a calendar year taxpayer without Continuing Equity because it is in Agency receivership, is not a member of a consolidated group and has not been acquired in a Taxable Transfer. At the beginning of 1998, M's remaining equity is $0 and M has a deferred FFA account of $10 million. Agency does not provide any FFA to M in 1998. During the year, M transfers property not covered by a Loss Guarantee to Agency and does not receive any consideration. The property has an adjusted basis of $5 million and a fair market value of $1 million at the time of the transfer. M has no other taxable income or loss in 1998.

(ii) Under § 1.597–2(d)(1), M is treated as selling the property for $1 million, its fair market value, thus recognizing a $4 million loss ($5 million–$1 million). In addition, because M did not receive any consideration from Agency, under § 1.597–2(d)(4) M has an adjustment to FFA of $1 million, the amount by which the fair market value of the transferred property ($1 million) exceeds the consideration M received from Agency ($0). Because no FFA is provided to M in 1998, this adjustment reduces the balance of M's deferred FFA account to $9 million ($10 million–$1 million). Section 1.597–2(d)(5)(i)(B). Because M's $4 million loss causes M's deductions to exceed its gross income by $4 million in 1998 and M has no remaining equity, under § 1.597–2(c)(4)(iii)(A) M must include $4 million of deferred FFA in income, and must decrease the remaining $9 million balance of its deferred FFA account by the same amount, leaving a balance of $5 million.

Example 3. Loss Guarantee. Institution Q, a calendar year taxpayer, sells an asset covered by a Loss Guarantee to an unrelated third party for $4,000. Q's adjusted basis in the asset at the time of sale and the asset's guaranteed value are both $10,000. Pursuant to the Loss Guarantee, Agency pays Q $6,000 ($10,000–$4,000). Q's amount realized from the sale of the asset is $10,000 ($4,000 from the third party and $6,000 from Agency). Section 1.597–2(d)(2). Q realizes no gain or loss on the sale ($10,000–$10,000 = $0), and therefore includes none of the $6,000 of FFA it receives pursuant to the Loss Guarantee in income. Section 1.597–2(d)(3).

[T.D. 8641, 60 FR 66095, Dec. 21, 1995; 61 FR 12135, Mar. 25, 1996, as amended by T.D. 8677, 61 FR 33322, June 27, 1996; T.D. 8823, 64 FR 36099, July 2, 1999; T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001]

§ 1.597–3 Other rules.

(a) *Ownership of assets*. For all income tax purposes, an Institution is treated as the owner of all assets covered by a Loss Guarantee, yield maintenance agreement, or cost to carry or cost of funds reimbursement agreement, regardless of whether Agency (or a Controlled Entity) otherwise would be treated as the owner under general principles of income taxation.

(b) *Debt and equity interests received by Agency*. Debt instruments, stock, warrants, or other rights to acquire stock of an Institution (or any of its affiliates) that Agency or a Controlled Entity receives in connection with a transaction in which FFA is provided are not treated as debt, stock or other equity interests of or in the issuer for any purpose of the Internal Revenue Code while held by Agency or a Controlled Entity. On the date Agency or a Controlled Entity transfers an interest described in this paragraph (b) to a holder other than Agency or a Controlled Entity, the interest is treated

as having been newly issued by the issuer to the holder with an issue price equal to the sum of the amount of money and the fair market value of property paid by the new holder in exchange for the interest.

(c) *Agency Obligations*—(1) *In general*. Except as otherwise provided in this paragraph (c), the original issue discount rules of sections 1271 *et seq*. apply to Agency Obligations.

(2) *Issue price of Agency Obligations provided as Net Worth Assistance*. The issue price of an Agency Obligation that is provided as Net Worth Assistance and that bears interest at either a single fixed rate or a qualified floating rate (and provides for no contingent payments) is the lesser of the sum of the present values of all payments due under the obligation, discounted at a rate equal to the applicable Federal rate (within the meaning of section 1274(d) (1) and (3)) in effect for the date of issuance, or the stated principal amount of the obligation. The issue price of an Agency Obligation that bears a qualified floating rate of interest (within the meaning of § 1.1275–5(b)) is determined by treating the obligation as bearing a fixed rate of interest equal to the rate in effect on the date of issuance under the obligation.

(3) *Adjustments to principal amount*. Except as provided in § 1.597–5(d)(2)(iv), this paragraph (c)(3) applies if Agency modifies or exchanges an Agency Obligation provided as Net Worth Assistance (or a successor obligation). The issue price of the modified or new Agency Obligation is determined under paragraphs (c) (1) and (2) of this section. If the issue price is greater than the adjusted issue price of the existing Agency Obligation, the difference is treated as FFA. If the issue price is less than the adjusted issue price of the existing Agency Obligation, the difference is treated as an adjustment to FFA under § 1.597–2(d)(4).

(d) *Successors*. To the extent necessary to effectuate the purposes of the regulations under section 597, an entity's treatment under the regulations applies to its successor. A successor includes a transferee in a transaction to which section 381(a) applies or a Bridge Bank to which another Bridge Bank transfers deposit liabilities.

(e) [Reserved]

(f) *Losses and deductions with respect to covered assets*. Prior to the disposition of an asset covered by a Loss Guarantee, the asset cannot be charged off, marked to a market value, depreciated, amortized, or otherwise treated in a manner that supposes an actual or possible diminution of value below the greater of the asset's highest guaranteed value or the highest price at which the asset can be put.

(g) *Anti-abuse rule*. The regulations under section 597 must be applied in a manner consistent with the purposes of section 597. Accordingly, if, in structuring or engaging in any transaction, a principal purpose is to achieve a tax result that is inconsistent with the purposes of section 597 and the regulations thereunder, the Commissioner can make appropriate adjustments to income, deductions and other items that would be consistent with those purposes.

[T.D. 8641, 60 FR 66097, Dec. 21, 1995, as amended by T.D. 9048, 68 FR 12290, Mar. 14, 2003]

§ 1.597–4 Bridge Banks and Agency Control.

(a) *Scope*. This section provides rules that apply to a Bridge Bank or other *Institution* under Agency Control and to transactions in which an Institution transfers deposit liabilities (whether or not the Institution also transfers assets) to a Bridge Bank.

(b) *Status as taxpayer*. A Bridge Bank or other Institution under Agency Control is a corporation within the meaning of section 7701(a)(3) for all purposes of the Internal Revenue Code and is subject to all Internal Revenue Code provisions that generally apply to corporations, including those relating to methods of accounting and to requirements for filing returns, even if Agency owns stock of the Institution.

(c) *No section 382 ownership change*. The imposition of Agency Control, the cancellation of Institution stock by Agency, a transaction in which an Institution transfers deposit liabilities to a Bridge Bank, and an election under paragraph (g) of this section are disregarded in determining whether an ownership change has occurred within the meaning of section 382(g).

(d) *Transfers to Bridge Banks*—(1) *In general*. Except as otherwise provided in paragraph (g) of this section, the rules of this paragraph (d) apply to transfers to Bridge Banks. In general, a Bridge Bank and its associated Residual Entity are together treated as the successor entity to the transferring Institution. If an Institution transfers deposit liabilities to a Bridge Bank (whether or not it also transfers assets), the Institution recognizes no gain or loss on the transfer and the Bridge Bank succeeds to the transferring Institution's basis in any transferred assets. The associated Residual Entity retains its basis in any assets it continues to hold. Immediately after the transfer, the Bridge Bank succeeds to and takes into account the transferring Institution's items described in section 381(c) (subject to the conditions and limitations specified in section 381(c)), taxpayer identification number (''TIN''), deferred FFA account, and account receivable for future FFA as described in paragraph (g)(4)(ii) of this section. The Bridge Bank also succeeds to and continues the transferring Institution's taxable year.

(2) *Transfers to a Bridge Bank from multiple Institutions*. If two or more Institutions transfer deposit liabilities to the same Bridge Bank, the rules in paragraph (d)(1) of this section are modified to the extent provided in this paragraph (d)(2). The Bridge Bank succeeds to the TIN and continues the taxable year of the Institution that transfers the largest amount of deposits. The taxable years of the other transferring Institutions close at the time of the transfer. If all the transferor Institutions are members of the same consolidated group, the Bridge Bank's carryback of losses to the Institution that transfers the largest amount of deposits is not limited by section 381(b)(3). The limitations of section 381(b)(3) do apply to the Bridge Bank's carrybacks of losses to all other transferor Institutions. If the transferor Institutions are not all members of the same consolidated group, the limitations of section 381(b)(3) apply with respect to all transferor Institutions. See paragraph (g)(6)(ii) of this section for additional rules that apply if two or more Institutions that are not members of the same consolidated group transfer deposit liabilities to the same Bridge Bank.

(e) *Treatment of Bridge Bank and Residual Entity as a single entity*. A Bridge Bank and its associated Residual Entity or Entities are treated as a single entity for income tax purposes and must file a single combined income tax return. The Bridge Bank is responsible for filing all income tax returns and statements for this single entity and is the agent of each associated Residual Entity to the same extent as if the Bridge Bank were the common parent of a consolidated group including the Residual Entity. The term *Institution* includes a Residual Entity that files a combined return with its associated Bridge Bank.

(f) *Rules applicable to members of consolidated groups*—(1) *Status as members*. Unless an election is made under paragraph (g) of this section, Agency Control of an Institution does not terminate the Institution's membership in a consolidated group. Stock of a subsidiary that is canceled by Agency is treated as held by the members of the consolidated group that held the stock prior to its cancellation. If an Institution is a member of a consolidated group immediately before it transfers deposit liabilities to a Bridge Bank, the Bridge Bank succeeds to the Institution's status as the common parent or, unless an election is made under paragraph (g) of this section, as a subsidiary of the group. If a Bridge Bank succeeds to an Institution's status as a subsidiary, its stock is treated as held by the shareholders of the transferring Institution, and the stock basis or excess loss account of the Institution carries over to the Bridge Bank. A Bridge Bank is treated as owning stock owned by its associated Residual Entities, including for purposes of determining membership in an affiliated group.

(2) *No 30-day election to be excluded from consolidated group*. Neither an Institution nor any of its Consolidated Subsidiaries may be excluded from a consolidated group for a taxable year under § 1.1502–76(b)(5)(ii), as contained in 26 CFR part 1 edition revised April 1, 1994, if the Institution is under Agency Control at any time during the year.

(3) *Coordination with consolidated return regulations*. The provisions of the regulations under section 597 take precedence over conflicting provisions in the regulations under section 1502.

(g) *Elective disaffiliation*—(1) *In general*. A consolidated group of which an Institution is a subsidiary may elect irrevocably not to include the Institution in its affiliated group if the Institution is placed in Agency receivership (whether or not assets or deposit liabilities of the Institution are transferred to a Bridge Bank). See paragraph (g)(6) of this section for circumstances under which a consolidated group is deemed to make this election.

(2) *Consequences of election*. If the election under this paragraph (g) is made with respect to an Institution, the following consequences occur immediately before the subsidiary Institution to which the election applies is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, immediately before the consolidated group is deemed to make the election) and in the following order—

(i) All adjustments of the Institution and its Consolidated Subsidiaries under section 481 are accelerated;

(ii) Deferred intercompany gains and losses with respect to the Institution and its Consolidated Subsidiaries are taken into account and the Institution and its Consolidated Subsidiaries take into account any other items required under the regulations under section 1502 for members that become nonmembers within the meaning of § 1.1502–32(d)(4);

(iii) The taxable year of the Institution and its Consolidated Subsidiaries closes and the Institution includes the amount described in paragraph (g)(3) of this section in income as ordinary income as its last item for that taxable year;

(iv) The members of the consolidated group owning the common stock of the Institution include in income any excess loss account with respect to the Institution's stock under § 1.1502–19 and any other items required under the regulations under section 1502 for members that own stock of corporations that become nonmembers within the meaning of § 1.1502–32(d)(4); and

(v) If the Institution's liabilities exceed the aggregate fair market value of its assets on the date the Institution is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, on the date the consolidated group is deemed to make the election), the members of the consolidated group treat their stock in the Institution as worthless. (*See* §§ 1.337(d)–2, 1.1502–35(f), and1.1502–36 for rules applicable when a member of a consolidated group is entitled to a worthless stock deduction with respect to stock of another member of the group.) In all other cases, the consolidated group will be treated as owning stock of a nonmember corporation until such stock is disposed of or becomes worthless under rules otherwise applicable.

(3) *Toll charge*. The amount described in this paragraph (g)(3) is the excess of the Institution's liabilities over the adjusted bases of its assets immediately before the Institution is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, immediately before the consolidated group is deemed to make the election). In computing this amount, the adjusted bases of an Institution's assets are reduced by the amount of the Institution's reserves for bad debts under section 585 or 593, other than supplemental reserves under section 593. For purposes of this paragraph (g)(3), an Institution is treated as a single entity that includes the assets and liabilities of its Consolidated Subsidiaries, with appropriate adjustments to prevent duplication. The amount described in this paragraph (g)(3) for alternative minimum tax purposes is determined using alternative minimum tax basis, deductions, and all other items required to be taken into account. In computing the increase in the group's taxable income or alternative minimum taxable income, sections 56(d)(1), 382 and 383 and §§ 1.1502–15, 1.1502–21 and 1.1502–22 (or §§ 1.1502–15A, 1.1502–21A and 1.1502–22A, as appropriate) do not limit the use of the attributes of the Institution and its Consolidated Subsidiaries to the extent, if any, that the inclusion of the amount described in this paragraph (g)(3) in income would result in the

group having taxable income or alternative minimum taxable income (determined without regard to this sentence) for the taxable year. The preceding sentence does not apply to any limitation under section 382 or 383 or § 1.1502–15, 1.1502–21, or 1.1502–22 (or § 1.1502–15A, 1.1502–21A, or 1.1502–22A, as appropriate) that arose in connection with or prior to a corporation becoming a Consolidated Subsidiary of the Institution.

(4) *Treatment of Institutions after disaffiliation*—(i) *In general*. If the election under this paragraph (g) is made with respect to an Institution, immediately after the Institution is placed in Agency receivership (or, in the case of a deemed election under paragraph (g)(6) of this section, immediately after the consolidated group is deemed to make the election), the Institution and each of its Consolidated Subsidiaries are treated for income tax purposes as new corporations that are not members of the electing group's affiliated group. Each new corporation retains the TIN of the corresponding disaffiliated corporation and is treated as having received the assets and liabilities of the corresponding disaffiliated corporation in a transaction to which section 351 applies (and in which no gain was recognized under section 357(c) or otherwise). Thus, the new corporation has no net operating or capital loss carryforwards. An election under this paragraph (g) does not terminate the single entity treatment of a Bridge Bank and its Residual Entities provided in paragraph (e) of this section.

(ii) *FFA*. A new Institution is treated as having a non-interest bearing, nontransferable account receivable for future FFA with a basis equal to the amount described in paragraph (g)(3) of this section. If a disaffiliated Institution has a deferred FFA account at the time of its disaffiliation, the corresponding new Institution succeeds to and takes into account that deferred FFA account.

(iii) *Filing of consolidated returns*. If a disaffiliated Institution has Consolidated Subsidiaries at the time of its disaffiliation, the corresponding new Institution is required to file a consolidated income tax return with the subsidiaries in accordance with the regulations under section 1502.

(iv) *Status as Institution*. If an Institution is disaffiliated under this paragraph (g), the resulting new corporation is treated as an Institution for purposes of the regulations under section 597 regardless of whether it is a bank or domestic building and loan association within the meaning of section 597.

(v) *Loss carrybacks*. To the extent a carryback of losses would result in a refund being paid to a fiduciary under section 6402(i), an Institution or Consolidated Subsidiary with respect to which an election under this paragraph (g) (other than under paragraph (g)(6)(ii) of this section) applies is allowed to carry back losses as if the Institution or Consolidated Subsidiary had continued to be a member of the consolidated group that made the election.

(5) *Affirmative election*—(i) *Original Institution*—(A) *Manner of making election*. Except as otherwise provided in paragraph (g)(6) of this section, a consolidated group makes the election provided by this paragraph (g) by sending a written statement by certified mail to the affected Institution on or before the later of 120 days after its placement in Agency receivership or May 31, 1996. The statement must contain the following legend at the top of the page: ''THIS IS AN ELECTION UNDER § 1.597–4(g) TO EXCLUDE THE BELOW-REFERENCED INSTITUTION AND CONSOLIDATED SUBSIDIARIES FROM THE AFFILIATED GROUP,'' and must include the names and taxpayer identification numbers of the common parent and of the Institution and Consolidated Subsidiaries to which the election applies, and the date on which the Institution was placed in Agency receivership. The consolidated group must send a similar statement to all subsidiary Institutions placed in Agency receivership during the consistency period described in paragraph (g)(5)(ii) of this section. (Failure to satisfy the requirement in the preceding sentence, however, does not invalidate the election with respect to any subsidiary Institution placed in Agency receivership during the consistency period described in paragraph (g)(5)(ii) of

this section.) The consolidated group must include a copy of any election statement and accompanying certified mail receipt as part of its first income tax return filed after the due date under this paragraph (g)(5) for such statement. A statement must be attached to this return indicating that the individual who signed the election was authorized to do so on behalf of the consolidated group. Agency cannot make this election under the authority of section 6402(i) or otherwise.

(B) *Consistency limitation on affirmative elections*. A consolidated group may make an affirmative election under this paragraph (g)(5) with respect to a subsidiary Institution placed in Agency receivership only if the group made, or is deemed to have made, the election under this paragraph (g) with respect to every subsidiary Institution of the group placed in Agency receivership on or after May 10, 1989 and within five years preceding the date the subject Institution was placed in Agency receivership.

(ii) *Effect on Institutions placed in receivership simultaneously or subsequently*. An election under this paragraph (g), other than under paragraph (g)(6)(ii) of this section, applies to the Institution with respect to which the election is made or deemed made (the original Institution) and each subsidiary Institution of the group placed in Agency receivership or deconsolidated in contemplation of Agency Control or the receipt of FFA simultaneously with the original Institution or within five years thereafter.

(6) *Deemed Election*—(i) *Deconsolidations in contemplation*. If one or more members of a consolidated group deconsolidate (within the meaning of §1.1502–19(c)(1)(ii)(B)) a subsidiary Institution in contemplation of Agency Control or the receipt of FFA, the consolidated group is deemed to make the election described in this paragraph (g) with respect to the Institution on the date the deconsolidation occurs. A subsidiary Institution is conclusively presumed to have been deconsolidated in contemplation of Agency Control or the receipt of FFA if either event occurs within six months after the deconsolidation.

(ii) *Transfers to a Bridge Bank from multiple groups*. On the day an Institution's transfer of deposit liabilities to a Bridge Bank results in the Bridge Bank holding deposit liabilities from both a subsidiary Institution and an Institution not included in the subsidiary Institution's consolidated group, each consolidated group of which a transferring Institution or the Bridge Bank is a subsidiary is deemed to make the election described in this paragraph (g) with respect to its subsidiary Institution. If deposit liabilities of another Institution that is a subsidiary member of any consolidated group subsequently are transferred to the Bridge Bank, the consolidated group of which the Institution is a subsidiary is deemed to make the election described in this paragraph (g) with respect to that Institution at the time of the subsequent transfer.

(h) *Examples*. The following examples illustrate the provisions of this section:

Facts. Corporation X, the common parent of a consolidated group, owns all the stock (with a basis of $4 million) of Institution M, an insolvent Institution with no Consolidated Subsidiaries. At the close of business on April 30, 1996, M has $4 million of deposit liabilities, $1 million of other liabilities, and assets with an adjusted basis of $4 million and a fair market value of $3 million.

Example 1. Effect of receivership on consolidation. On May 1, 1996, Agency places M in receivership and begins liquidating M. X does not make an election under §1.597–4(g). M remains a member of the X consolidated group after May 1, 1996. Section 1.597–4(f)(1).

Example 2. Effect of Bridge Bank on consolidation. (i) *Additional facts*. On May 1, 1996, Agency places M in receivership and causes M to transfer all of its assets and deposit liabilities to Bridge Bank MB.

(ii) *Consequences without an election to disaffiliate*. M recognizes no gain or loss from the transfer and MB succeeds to M's basis in the transferred assets, M's items described in section 381(c) (subject to the conditions and limitations specified in section 381(c)) and TIN. Section 1.597–4(d)(1). (If M had a deferred FFA account, MB would also succeed to that account. Section 1.597–4(d)(1).) MB continues M's taxable year and succeeds to M's status as a member of the X consolidated group after May 1, 1996. Section 1.597–4 (d)(1) and (f). MB and M are treated as a single entity for income tax purposes. Section 1.597–4(e).

(iii) *Consequences with an election to disaffiliate.* If, on July 1, 1996, X makes an election under § 1.597–4(g) with respect to M, the following consequences are treated as occurring immediately before M was placed in Agency receivership. M must include $1 million ($5 million of liabilities—$4 million of adjusted basis) in income as of May 1, 1996. Section 1.597–4(g) (2) and (3). M is then treated as a new corporation that is not a member of the X consolidated group and that has assets (including a $1 million account receivable for future FFA) with a basis of $5 million and $5 million of liabilities received from disaffiliated corporation M in a section 351 transaction. New corporation M retains the TIN of disaffiliated corporation M. Section 1.597–4(g)(4). Immediately after the disaffiliation, new corporation M is treated as transferring its assets and deposit liabilities to Bridge Bank MB. New corporation M recognizes no gain or loss from the transfer and MB succeeds to M's TIN and taxable year. Section 1.597–4(d)(1). Bridge Bank MB is treated as a single entity that includes M and has $5 million of liabilities, an account receivable for future FFA with a basis of $1 million, and other assets with a basis of $4 million. Section 1.597–4(d)(1).

[T.D. 8641, 60 FR 66098, Dec. 21, 1995, as amended by T.D. 8677, 61 FR 33322, 33323, June 27, 1996; T.D. 8823, 64 FR 36099, July 2, 1999; T.D. 9048, 68 FR 12290, Mar. 14, 2003; T.D. 9187, 70 FR 10326, Mar. 3, 2005; T.D. 9254, 71 FR 13018, Mar. 14, 2006; T.D. 9424, 73 FR 53986, Sept. 17, 2008]

§ 1.597–5 Taxable Transfers.

(a) *Taxable Transfers*—(1) *Defined.* The term *Taxable Transfer* means—

(i) A transaction in which an entity transfers to a transferee other than a Bridge Bank—

(A) Any deposit liability (whether or not the Institution also transfers assets), if FFA is provided in connection with the transaction; or

(B) Any asset for which Agency or a Controlled Entity has any financial obligation (e.g., pursuant to a Loss Guarantee or Agency Obligation); or

(ii) A deemed transfer of assets described in paragraph (b) of this section.

(2) *Scope.* This section provides rules governing Taxable Transfers. Rules applicable to both actual and deemed asset acquisitions are provided in paragraphs (c) and (d) of this section. Special rules applicable only to deemed asset acquisitions are provided in paragraph (e) of this section.

(b) *Deemed asset acquisitions upon stock purchase*—(1) *In general.* In a deemed transfer of assets under this paragraph (b), an Institution (including a Bridge Bank or a Residual Entity) or a Consolidated Subsidiary of the Institution (the Old Entity) is treated as selling all of its assets in a single transaction and is treated as a new corporation (the New Entity) that purchases all of the Old Entity's assets at the close of the day immediately preceding the occurrence of an event described in paragraph (b)(2) of this section. However, such an event results in a deemed transfer of assets under this paragraph (b) only if it occurs—

(i) In connection with a transaction in which FFA is provided;

(ii) While the Old Entity is a Bridge Bank;

(iii) While the Old Entity has a positive balance in a deferred FFA account (see § 1.597–2(c)(4)(v) regarding the optional accelerated recapture of deferred FFA); or

(iv) With respect to a Consolidated Subsidiary, while the Institution of which it is a Consolidated Subsidiary is under Agency Control.

(2) *Events.* A deemed transfer of assets under this paragraph (b) results if the Old Entity—

(i) Becomes a non-member within the meaning of § 1.1502–32(d)(4) of its consolidated group (other than pursuant to an election under § 1.597–4(g));

(ii) Becomes a member of an affiliated group of which it was not previously a member (other than pursuant to an election under § 1.597–4(g)); or

(iii) Issues stock such that the stock that was outstanding before the imposition of Agency Control or the occurrence of any transaction in connection with the provision of FFA represents 50 percent or less of the vote or value of its outstanding stock (disregarding stock described in section 1504(a)(4) and stock owned by Agency or a Controlled Entity).

(3) *Bridge Banks and Residual Entities.* If a Bridge Bank is treated as selling all of its assets to a New Entity under this paragraph (b), each associated Residual Entity is treated as simultaneously selling its assets to a New Entity in a Taxable Transfer described in this paragraph (b).

(c) *Treatment of transferor*—(1) *FFA in connection with a Taxable Transfer.* A

transferor in a Taxable Transfer is treated as having directly received immediately before a Taxable Transfer any Net Worth Assistance that Agency provides to the New Entity or Acquiring in connection with the transfer. (See §1.597–2 (a) and (c) for rules regarding the inclusion of FFA in income and §1.597–2(a)(1) for related rules regarding FFA provided to shareholders.) The Net Worth Assistance is treated as an asset of the transferor that is sold to the New Entity or Acquiring in the Taxable Transfer.

(2) *Amount realized in a Taxable Transfer*. In a Taxable Transfer described in paragraph (a)(1)(i) of this section, the amount realized is determined under section 1001(b) by reference to the consideration paid for the assets. In a Taxable Transfer described in paragraph (a)(1)(ii) of this section, the amount realized is the sum of the grossed-up basis of the stock acquired in connection with the Taxable Transfer (excluding stock acquired from the Old or New Entity), plus the amount of liabilities assumed or taken subject to in the deemed transfer, plus other relevant items. The grossed-up basis of the acquired stock equals the acquirors' basis in the acquired stock divided by the percentage of the Old Entity's stock (by value) attributable to the acquired stock.

(3) *Allocation of amount realized*—(i) *In general*. The amount realized under paragraph (c)(2) of this section is allocated among the assets transferred in the Taxable Transfer in the same manner as amounts are allocated among assets under §1.338–6(b), (c)(1) and (2).

(ii) *Modifications to general rule*. This paragraph (c)(3)(ii) modifies certain of the allocation rules of paragraph (c)(3)(i) of this section. Agency Obligations and assets covered by Loss Guarantees in the hands of the New Entity or Acquiring are treated as Class II assets. Stock of a Consolidated Subsidiary is treated as a Class II asset to the extent the fair market value of the Consolidated Subsidiary's Class I and Class II assets exceeds the amount of its liabilities. The fair market value of an Agency Obligation is deemed to equal its adjusted issue price immediately before the Taxable Transfer. The fair market value of an asset covered by a Loss Guarantee immediately after the Taxable Transfer is deemed to be not less than the greater of the asset's highest guaranteed value or the highest price at which the asset can be put.

(d) *Treatment of a New Entity and Acquiring*—(1) *Purchase price*. The purchase price for assets acquired in a Taxable Transfer described in paragraph (a)(1)(i) of this section is the cost of the assets acquired. See §1.1060–1T(c)(1). The purchase price for assets acquired in a Taxable Transfer described in paragraph (a)(1)(ii) of this section is the sum of the grossed-up basis of the stock acquired in connection with the Taxable Transfer (excluding stock acquired from the Old or New Entity), plus the amount of liabilities assumed or taken subject to in the deemed transfer, plus other relevant items. The grossed-up basis of the acquired stock equals the acquirors' basis in the acquired stock divided by the percentage of the Old Entity's stock (by value) attributable to the acquired stock. FFA provided in connection with a Taxable Transfer is not included in the New Entity's or Acquiring's purchase price for the acquired assets. Any Net Worth Assistance so provided is treated as an asset of the transferor sold to the New Entity or Acquiring in the Taxable Transfer.

(2) *Allocation of basis*—(i) *In general*. Except as otherwise provided in this paragraph (d)(2), the purchase price determined under paragraph (d)(1) of this section is allocated among the assets transferred in the Taxable Transfer in the same manner as amounts are allocated among assets under §1.338–6(b), (c)(1) and (2).

(ii) *Modifications to general rule*. The allocation rules contained in paragraph (c)(3)(ii) of this section apply to the allocation of basis among assets acquired in a Taxable Transfer. No basis is allocable to Agency's agreement to provide Loss Guarantees, yield maintenance payments, cost to carry or cost of funds reimbursement payments, or expense reimbursement or indemnity payments. A New Entity's basis in assets it receives from its shareholders is determined under general principles of income taxation and is not governed by this paragraph (d).

(iii) *Allowance and recapture of additional basis in certain cases.* If the fair market value of the Class I and Class II assets acquired in a Taxable Transfer is greater than the New Entity's or Acquiring's purchase price for the acquired assets, the basis of the Class I and Class II assets equals their fair market value. The amount by which the fair market value of the Class I and Class II assets exceeds the purchase price is included ratably as ordinary income by the New Entity or Acquiring over a period of six taxable years beginning in the year of the Taxable Transfer. The New Entity or Acquiring must include as ordinary income the entire amount remaining to be recaptured under the preceding sentence in the taxable year in which an event occurs that would accelerate inclusion of an adjustment under section 481.

(iv) *Certain post-transfer adjustments*—(A) *Agency Obligations.* If an adjustment to the principal amount of an Agency Obligation or cash payment to reflect a more accurate determination of the condition of the Institution at the time of the Taxable Transfer is made before the earlier of the date the New Entity or Acquiring files its first post-transfer income tax return or the due date of that return (including extensions), the New Entity or Acquiring must adjust its basis in its acquired assets to reflect the adjustment. In making adjustments to the New Entity's or Acquiring's basis in its acquired assets, paragraph (c)(3)(ii) of this section is applied by treating an adjustment to the principal amount of an Agency Obligation pursuant to the first sentence of this paragraph (d)(2)(iv)(A) as occurring immediately before the Taxable Transfer. (See § 1.597–3(c)(3) for rules regarding other adjustments to the principal amount of an Agency Obligation.)

(B) *Assets covered by a Loss Guarantee.* If, immediately after a Taxable Transfer, an asset is not covered by a Loss Guarantee but the New Entity or Acquiring has the right to designate specific assets that will be covered by a Loss Guarantee, the New Entity or Acquiring must treat any asset so designated as having been subject to the Loss Guarantee at the time of the Taxable Transfer. The New Entity or Acquiring must adjust its basis in the covered assets and in its other acquired assets to reflect the designation in the manner provided by paragraph (d)(2) of this section. The New Entity or Acquiring must make appropriate adjustments in subsequent taxable years if the designation is made after the New Entity or Acquiring files its first post-transfer income tax return or the due date of that return (including extensions) has passed.

(e) *Special rules applicable to Taxable Transfers that are deemed asset acquisitions*—(1) *Taxpayer identification numbers.* Except as provided in paragraph (e)(3) of this section, a New Entity succeeds to the TIN of the transferor in a deemed sale under paragraph (b) of this section.

(2) *Consolidated Subsidiaries*—(i) *In general.* A Consolidated Subsidiary that is treated as selling its assets in a Taxable Transfer under paragraph (b) of this section is treated as engaging immediately thereafter in a complete liquidation to which section 332 applies. The consolidated group of which the Consolidated Subsidiary is a member does not take into account gain or loss on the sale, exchange, or cancellation of stock of the Consolidated Subsidiary in connection with the Taxable Transfer.

(ii) *Certain minority shareholders.* Shareholders of the Consolidated Subsidiary that are not members of the consolidated group that includes the Institution do not recognize gain or loss with respect to shares of Consolidated Subsidiary stock retained by the shareholder. The shareholder's basis for that stock is not affected by the Taxable Transfer.

(3) *Bridge Banks and Residual Entities*—(i) *In general.* A Bridge Bank or Residual Entity's sale of assets to a New Entity under paragraph (b) of this section is treated as made by a single entity under § 1.597–4(e). The New Entity deemed to acquire the assets of a Residual Entity under paragraph (b) of this section is not treated as a single entity with the Bridge Bank (or with the New Entity acquiring the Bridge Bank's assets) and must obtain a new TIN.

(ii) *Treatment of consolidated groups.* At the time of a Taxable Transfer described in paragraph (a)(1)(ii) of this

section, treatment of a Bridge Bank as a subsidiary member of a consolidated group under §1.597–4(f)(1) ceases. However, the New Entity deemed to acquire the assets of a Residual Entity is a member of the selling consolidated group after the deemed sale. The group's basis or excess loss account in the stock of the New Entity that is deemed to acquire the assets of the Residual Entity is the group's basis or excess loss account in the stock of the Bridge Bank immediately before the deemed sale, as adjusted for the results of the sale.

(4) *Certain returns*. If an Old Entity without Continuing Equity is not a subsidiary of a consolidated group at the time of the Taxable Transfer, the controlling Agency must file all income tax returns for the Old Entity for periods ending on or prior to the date of the deemed sale described in paragraph (b) of this section that are not filed as of that date.

(5) *Basis limited to fair market value*. If all of the stock of the corporation is not acquired on the date of the Taxable Transfer, the Commissioner may make appropriate adjustments under paragraphs (c) and (d) of this section to the extent using a grossed-up basis of the stock of a corporation results in an aggregate amount realized for, or basis in, the assets other than the aggregate fair market value of the assets.

(f) *Examples*. The following examples illustrate the provisions of this section:

Example 1. Branch sale resulting in Taxable Transfer. (i) Institution M is a calendar year taxpayer in Agency receivership. M is not a member of a consolidated group. On January 1, 1997, M has $200 million of liabilities (including deposit liabilities) and assets with an adjusted basis of $100 million. M has no income or loss for 1997 and, except as described below, receives no FFA. On September 30, 1997, Agency causes M to transfer six branches (with assets having an adjusted basis of $1 million) together with $120 million of deposit liabilities to N. In connection with the transfer, Agency provides $121 million in cash to N.

(ii) The transaction is a Taxable Transfer in which M receives $121 million of Net Worth Assistance. Section 1.597–5(a)(1). (M is treated as directly receiving the $121 million of Net Worth Assistance immediately before the Taxable Transfer. Section 1.597–5(c)(1).) M transfers branches having a basis of $1 million and is treated as transferring $121 million in cash (the Net Worth Assistance) to N in exchange for N's assumption of $120 million of liabilities. Thus, M realizes a loss of $2 million on the transfer. The amount of the FFA M must include in its income in 1997 is limited by §1.597–2(c) to $102 million, which is the sum of the $100 million excess of M's liabilities ($200 million) over the total adjusted basis of its assets ($100 million) at the beginning of 1997, plus the $2 million excess for the taxable year, which results from the Taxable Transfer, of M's deductions (other than carryovers) over its gross income other than FFA. M must establish a deferred FFA account for the remaining $19 million of FFA. Section 1.597–2(c)(4).

(iii) N, as Acquiring, must allocate its $120 million purchase price for the assets acquired from M among those assets. Cash is a Class I asset. The branch assets are in Classes III and IV. N's adjusted basis in the cash is its amount, i.e., $121 million. Section 1.597–5(d)(2). Because this amount exceeds N's purchase price for all of the acquired assets by $1 million, N allocates no basis to the other acquired assets and, under §1.597–5(d)(2), must recapture the $1 million excess at an annual rate of $166,667 in the six consecutive taxable years beginning with 1997 (subject to acceleration for certain events).

Example 2. Stock issuance by Bridge Bank causing Taxable Transfer. (i) On April 1, 1996, Institution P is placed in receivership and caused to transfer assets and liabilities to Bridge Bank PB. On August 31, 1996, the assets of PB consist of $20 million in cash, loans outstanding with an adjusted basis of $50 million and a fair market value of $40 million, and other non-financial assets (primarily branch assets and equipment) with an adjusted basis of $5 million. PB has deposit liabilities of $95 million and other liabilities of $5 million. P, the Residual Entity, holds real estate with an adjusted basis of $10 million and claims in litigation having a zero basis. P retains no deposit liabilities and has no other liabilities (except its liability to Agency for having caused its deposit liabilities to be satisfied).

(ii) On September 1, 1996, Agency causes PB to issue 100 percent of its common stock for $2 million cash to X. On the same day, Agency issues a $25 million note to PB. The note bears a fixed rate of interest in excess of the applicable federal rate in effect for September 1, 1996. Agency provides Loss Guarantees guaranteeing PB a value of $50 million for PB's loans outstanding.

(iii) The stock issuance is a Taxable Transfer in which PB is treated as selling all of its assets to a new corporation, New PB. Section 1.597–5(b)(1). PB is treated as directly receiving $25 million of Net Worth Assistance (the issue price of the Agency Obligation) immediately before the Taxable Transfer. Section 1.597–3(c)(2); §1.597- 5(c)(1). The amount of

FFA PB must include in income is determined under §1.597–2(a) and (c). PB in turn is deemed to transfer the note to New PB in the Taxable Transfer, together with $20 million of cash, all its loans outstanding (with a basis of $50 million) and its other non-financial assets (with a basis of $5 million). The amount realized by PB from the sale is $100 million, the amount of PB's liabilities deemed to be assumed by New PB. This amount realized equals PB's basis in its assets and thus, PB realizes no gain or loss on the transfer to New PB.

(iv) Residual Entity P also is treated as selling all its assets (consisting of real estate and claims in litigation) for $0 (the amount of consideration received by P) to a new corporation (New P) in a Taxable Transfer. Section 1.597–5(b)(3). (P's only liability is to Agency and a liability to Agency is not treated as a debt under §1.597–3(b).) Thus, P realizes a $10 million loss on the transfer to New P. The combined return filed by PB and P for 1996 will reflect a total loss on the Taxable Transfer of $10 million ($0 for PB and $10 million for P). Section 1.597–5(e)(3). That return also will reflect FFA income from the Net Worth Assistance, determined under §1.597–2 (a) and (c).

(v) New PB is treated as having acquired the assets it acquired from PB for $100 million, the amount of liabilities assumed. In allocating basis among these assets, New PB treats the Agency note and the loans outstanding (which are covered by Loss Guarantees) as Class II assets. For the purpose of allocating basis, the fair market value of the Agency note is deemed to equal its adjusted issue price immediately before the transfer, $25 million. The fair market value of the loans is deemed not to be less than the guaranteed value of $50 million.

(vi) New P is treated as having acquired its assets for no consideration. Thus its basis in its assets immediately after the transfer is zero. New PB and New P are not treated as a single entity. Section 1.597–5(e)(3).

Example 3. Taxable Transfer of previously disaffiliated Institution. (i) Corporation X, the common parent of a consolidated group, owns all the stock of Institution M, an insolvent Institution with no Consolidated Subsidiaries. On April 30, 1996, M has $4 million of deposit liabilities, $1 million of other liabilities, and assets with an adjusted basis of $4 million and a fair market value of $3 million. On May 1, 1996, Agency places M in receivership. X elects under §1.597–4(g) to disaffiliate M. Accordingly, as of May 1, 1996, new corporation M is not a member of the X consolidated group. On May 1, 1996, Agency causes M to transfer all of its assets and liabilities to Bridge Bank MB. Under §1.597–4(e), MB and M are thereafter treated as a single entity which has $5 million of liabilities, an account receivable for future FFA with a basis of $1 million, and other assets with a basis of $4 million. Section 1.597–4(g)(4).

(ii) During May 1996, MB earns $25,000 of interest income and accrues $20,000 of interest expense on depositor accounts and there is no net change in deposits other than the additional $20,000 of interest expense accrued on depositor accounts. MB pays $5,000 of wage expenses and has no other items of income or expense.

(iii) On June 1, 1996, Agency causes MB to issue 100 percent of its stock to corporation Y. In connection with the stock issuance, Agency provides an Agency Obligation for $2 million and no other FFA.

(iv) The stock issuance results in a Taxable Transfer. Section 1.597–5(b). MB is treated as receiving the Agency Obligation immediately prior to the Taxable Transfer. Section 1.597–5(c)(1). MB has $1 million of basis in its account receivable for FFA. This receivable is treated as satisfied, offsetting $1 million of the $2 million of FFA provided by Agency in connection with the Taxable Transfer. The status of the remaining $1 million of FFA as includible income is determined as of the end of the taxable year under §1.597–2(c). However, under §1.597–2(b), MB obtains a $2 million basis in the Agency Obligation received as FFA.

(v) Under §1.597–5(c)(2), in the Taxable Transfer, Old Entity MB is treated as selling, to New Entity MB, all of Old Entity MB's assets, having a basis of $6,020,000 (the original $4 million of asset basis as of April 30, 1996, plus $20,000 net cash from May 1996 activities, plus $2 million in the Agency Obligation received as FFA), for $5,020,000, the amount of Old Entity MB's liabilities assumed by New Entity MB pursuant to the Taxable Transfer. Therefore, Old Entity MB recognizes, in the aggregate, a loss of $1 million from the Taxable Transfer.

(vi) Because this $1 million loss causes Old Entity MB's deductions to exceed its gross income (determined without regard to FFA) by $1 million, Old Entity MB must include in its income the $1 million of FFA not offset by the FFA receivable. Section 1.597–2(c). (As of May 1, 1996, Old Entity MB's liabilities ($5,000,000) did not exceed MB's $5 million adjusted basis of its assets. For the taxable year, MB's deductions of $1,025,000 ($1,000,000 loss from the Taxable Transfer, $20,000 interest expense and $5,000 of wage expense) exceeded its gross income (disregarding FFA) of $25,000 (interest income) by $1,000,000. Thus, under §1.597–2(c), MB includes in income the entire $1,000,000 of FFA not offset by the FFA receivable.)

(vii) Therefore, Old Entity MB's taxable income for the taxable year ending on the date of the Taxable Transfer is $0.

(viii) Residual Entity M is also deemed to engage in a deemed sale of its assets to New Entity M under §1.597–5(b)(3), but there are

no tax consequences as M has no assets or liabilities at the time of the deemed sale.

(ix) Under §1.597–5(d)(1), New Entity MB is treated as purchasing Old Entity MB's assets for $5,020,000, the amount of New Entity MB's liabilities. Of this, $2,000,000 is allocated to the $2 million Agency Obligation, and $3,020,000 is allocated to the other assets New Entity MB is treated as purchasing in the Taxable Transfer.

Example 4. Loss Sharing. Institution N acquires assets and assumes liabilities of another Institution in a Taxable Transfer. Among the assets transferred are three parcels of real estate. In the hands of the transferring Institution, these assets had book values of $100,000 each. In connection with the Taxable Transfer, Agency agrees to reimburse Institution N for 80 percent of any loss (based on the original book value) realized on the disposition or charge-off of the three properties. This arrangement constitutes a Loss Guarantee. Thus, in allocating basis, Institution N treats the three parcels as Class II assets. By virtue of the arrangement with the Agency, Institution N is assured that the parcels will not be worth less to it than $80,000 each, because even if the properties are worthless, Agency will reimburse 80 percent of the loss. Although Institution could obtain payments under the Loss Guarantee if the properties are worth more, it is not guaranteed that it will realize more than $80,000. Accordingly, $80,000 is the highest guaranteed value of the three parcels. Institution N will allocate basis to the Class II assets up to their fair market value. For this purpose, the fair market value of the three parcels is not less than $80,000 each. Section 1.597–5(d)(2)(ii); §1.597–5(c)(3)(ii).

[T.D. 8641, 60 FR 66101, Dec. 21, 1995, as amended by T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001]

§ 1.597–6 Limitation on collection of income tax.

(a) *Limitation on collection where tax is borne by Agency.* If an Institution without Continuing Equity (or any of its Consolidated Subsidiaries) is liable for income tax that is attributable to the inclusion in income of FFA or gain from a Taxable Transfer, the tax will not be collected if it would be borne by Agency. The final determination of whether the tax would be borne by Agency is within the sole discretion of the Commissioner. In determining whether tax would be borne by Agency, the Commissioner will disregard indemnity, tax-sharing, or similar obligations of Agency, an Institution, or its Consolidated Subsidiaries. Collection of the several income tax liability under §1.1502–6 from members of an Institution's consolidated group other than the Institution or its Consolidated Subsidiaries is not affected by this section. Income tax will continue to be subject to collection except as specifically limited in this section. This section does not apply to taxes other than income taxes.

(b) *Amount of tax attributable to FFA or gain on a Taxable Transfer.* For purposes of paragraph (a) of this section, the amount of income tax in a taxable year attributable to the inclusion of FFA or gain from a Taxable Transfer in the income of an Institution (or a Consolidated Subsidiary) is the excess of the actual income tax liability of the Institution (or the consolidated group in which the Institution is a member) over the income tax liability of the Institution (or the consolidated group in which the Institution is a member) determined without regard to FFA or gain or loss on the Taxable Transfer.

(c) *Reporting of uncollected tax.* A taxpayer must specify on the front page of Form 1120 (U.S. Corporate Income Tax Return), to the left of the space provided for ''Total Tax,'' the amount of income tax for the taxable year that is potentially not subject to collection under this section. If an Institution is a subsidiary member of a consolidated group, the amount specified as not subject to collection is zero.

(d) *Assessments of tax to offset refunds.* Income tax that is not collected under this section will be assessed and, thus, used to offset any claim for refund made by or on behalf of the Institution, the Consolidated Subsidiary or any other corporation with several liability for the tax.

(e) *Collection of taxes from Acquiring or a New Entity*—(1) *Acquiring.* No income tax liability (including the several liability for taxes under §1.1502–6) of a transferor in a Taxable Transfer will be collected from Acquiring.

(2) *New Entity.* Income tax liability (including the several liability for taxes under §1.1502–6) of a transferor in a Taxable Transfer will be collected from a New Entity only if stock that was outstanding in the Old Entity remains outstanding as stock in the New

Entity or is reacquired or exchanged for consideration.

(f) *Effect on section 7507*. This section supersedes the application of section 7507, and the regulations thereunder, for the assessment and collection of income tax attributable to FFA.

[T.D. 8641, 60 FR 66103, Dec. 21, 1995]

§ 1.597–7 Effective date.

(a) *FIRREA effective date*. Section 597, as amended by section 1401 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Public Law 101–73, is generally effective for any FFA received or accrued by an Institution on or after May 10, 1989, and for any transaction in connection with which such FFA is provided, unless the FFA is provided in connection with an acquisition occurring prior to May 10, 1989. See § 1.597–8 for rules regarding FFA received or accrued on or after May 10, 1989, that relates to an acquisition that occurred before May 10, 1989.

(b) *Effective date of regulations*. Except as otherwise provided in this section, §§ 1.597–1 through 1.597–6 apply to taxable years ending on or after April 22, 1992. However, the provisions of §§ 1.597–1 through 1.597–6 do not apply to FFA received or accrued for taxable years ending on or after April 22, 1992, in connection with an Agency assisted acquisition within the meaning of Notice 89–102 (1989–2 C.B. 436; see § 601.601(d)(2)) (which does not include a transfer to a Bridge Bank), that occurs before April 22, 1992. Taxpayers not subject to §§ 1.597–1 through 1.597–6 must comply with an interpretation of the statute that is reasonable in light of the legislative history and applicable administrative pronouncements. For this purpose, the rules contained in Notice 89–102 apply to the extent provided in the Notice.

(c) *Elective application to prior years and transactions*—(1) *In general*. Except as limited in this paragraph (c), an election is available to apply §§ 1.597–1 through 1.597–6 to taxable years prior to the general effective date of these regulations. A consolidated group may elect to apply §§ 1.597–1 through 1.597–6 for all members of the group in all taxable years to which section 597, as amended by FIRREA, applies. The common parent makes the election for the group. An entity that is not a member of a consolidated group may elect to apply §§ 1.597–1 through 1.597–6 to all taxable years to which section 597, as amended by FIRREA, applies for which it is not a member of a consolidated group. The election is irrevocable.

(2) *Election unavailable in certain cases*—(i) *Statute of limitations closed*. The election cannot be made if the period for assessment and collection of tax has expired under the rules of section 6501 for any taxable year in which §§ 1.597–1 through 1.597–6 would affect the determination of the electing entity's or group's income, deductions, gain, loss, basis, or other items.

(ii) *No section 338 election under Notice 89–102*. The election cannot be made with respect to an Institution if, under Notice 89–102, it was a Target with respect to which a qualified stock purchase was made, a timely election under section 338 was not made, and on April 22, 1992, a timely election under section 338 could not be made.

(iii) *Inconsistent treatment of Institution that would be New Entity*. If, under § 1.597–5(b), an Institution would become a New Entity before April 22, 1992, the election cannot be made with respect to that Institution unless elections are made by all relevant persons such that §§ 1.597–1 through 1.597–6 apply both before and after the deemed sale under § 1.597–5. However, this requirement does not apply if, under §§ 1.597–1 through 1.597–6, the Institution would not have Continuing Equity prior to the deemed sale.

(3) *Expense reimbursements*. Notice 89–102, 1989–2 C.B. 436, provides that reimbursements paid or accrued pursuant to an expense reimbursement or indemnity arrangement are not included in income but the taxpayer may not deduct, or otherwise take into account, the item of cost or expense to which the reimbursement or indemnity payment relates. With respect to an Agency assisted acquisition within the meaning of Notice 89–102 that occurs before April 22, 1992, a taxpayer that elects to apply these regulations retroactively under this paragraph (c) may continue to account for these items under the rules of Notice 89–102.

(4) *Procedural rules*—(i) *Manner of making election*. An Institution or consolidated group makes the election provided by this paragraph (c) by attaching a written statement to, and including it as a part of, the taxpayer's or consolidated group's first annual income tax return filed on or after March 15, 1996. The statement must contain the following legend at the top of the page: ''THIS IS AN ELECTION UNDER §1.597–7(c),'' and must contain the name, address and employer identification number of the taxpayer or common parent making the election. The statement must include a declaration that ''TAXPAYER AGREES TO EXTEND THE STATUTE OF LIMITATIONS ON ASSESSMENT FOR THREE YEARS FROM THE DATE OF THE FILING OF THIS ELECTION UNDER §1.597–7(c), IF THE LIMITATIONS PERIOD WOULD EXPIRE EARLIER WITHOUT SUCH EXTENSION, FOR ANY ITEMS AFFECTED IN ANY TAXABLE YEAR BY THE FILING OF THIS ELECTION,'' and a declaration that either ''AMENDED RETURNS WILL BE FILED FOR ALL TAXABLE YEARS AFFECTED BY THE FILING OF THIS ELECTION WITHIN 180 DAYS OF MAKING THIS STATEMENT, UNLESS SUCH REQUIREMENT IS WAIVED IN WRITING BY THE DISTRICT DIRECTOR OR HIS DELEGATE'' or ''ALL RETURNS PREVIOUSLY FILED ARE CONSISTENT WITH THE PROVISIONS OF §§1.597–1 THROUGH 1.597–6,'' and be signed by an individual who is authorized to make the election under this paragraph (c) on behalf of the taxpayer. An election with respect to a consolidated group must be made by the common parent of the group, not Agency, and applies to all members of the group.

(ii) *Effect of elective disaffiliation*. To make the affirmative election described in §1.597–4(g)(5) for an Institution placed in Agency receivership in a taxable year ending before April 22, 1992, the consolidated group must send the affected Institution the statement described in §1.597–4(g)(5) on or before May 31, 1996. Notwithstanding the requirements of paragraph (c)(4)(i) of this section, a consolidated group sending such a statement is deemed to make the election described in, and to agree to the conditions contained in, this paragraph (c). The consolidated group must nevertheless attach the statement described in paragraph (c)(4)(i) of this section to its first annual income tax return filed on or after March 15, 1996.

(d) *Reliance on prior guidance*—(1) *Notice 89–102*. Taxpayers may rely on Notice 89–102, 1989–2 C.B. 436, to the extent they acted in reliance on that Notice prior to April 22, 1992. Such reliance must be reasonable and transactions with respect to which taxpayers rely must be consistent with the overriding policies of section 597, as expressed in the legislative history.

(2) *Notice FI–46–89*—(i) *In general*. Notice FI–46–89 was published in the FEDERAL REGISTER on April 23, 1992 (57 FR 14804). Taxpayers may rely on the provisions of §§1.597–1 through 1.597–6 of that notice to the extent they acted in reliance on those provisions prior to December 21, 1995. Such reliance must be reasonable and transactions with respect to which taxpayers rely must be consistent with the overriding policies of section 597, as expressed in the legislative history, as well as the overriding policies of notice FI–46–89.

(ii) *Taxable Transfers*. Any taxpayer described in this paragraph (d) that, under notice FI–46–89, would be a New Entity or Acquiring with respect to a Taxable Transfer on or after April 22, 1992, and before December 21, 1995, may apply the rules of that notice with respect to such transaction.

[T.D. 8641, 60 FR 66104, Dec. 21, 1995]

§ 1.597–8 Transitional rules for Federal financial assistance.

(a) *Scope*. This section provides transitional rules for the tax consequences of Federal financial assistance received or accrued on or after May 10, 1989, if the assistance payment relates to an acquisition that occurred before that date.

(b) *Transitional rules*. The tax consequences of any payment of Federal financial assistance received or accrued on or after May 10, 1989, are governed by the applicable provisions of section 597 that were in effect prior to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (''FIRREA'') if either—

(1) The payment—

(i) Is pursuant to an acquisition of a bank or domestic building and loan association before May 10, 1989,

(ii) Is provided pursuant to an assistance agreement executed before May 10, 1989,

(iii) Is provided to a party to that agreement or to such other party as the Commissioner may determine appropriate by letter ruling or other written guidance, and

(iv) Would, if provided before May 10, 1989, have been governed by applicable provisions of section 597 that were in effect prior to FIRREA; or

(2) The payment—

(i) Represents a prepayment of (or a payment in lieu of) a fixed or contingent right to Federal financial assistance that would have satisfied the conditions of paragraphs (b)(1)(i), (ii) and (iv) of this section, and

(ii) Is provided to a party described in paragraph (b)(1)(iii) of this section

(c) *Definition of Federal financial assistance.* Federal financial assistance for purposes of this section has the meaning prescribed by section 597(c) as amended by FIRREA.

(d) *Examples.* The following examples illustrate the provisions of this section:

Example 1. X corporation acquired Y, a domestic building and loan association on September 10, 1988. Pursuant to a written agreement executed at the time of the acquisition, Y received Federal financial assistance that included a note bearing a market rate of interest, the right to future payments if certain assets were sold at a loss, and the right to future payments if the income produced by certain assets was less than an agreed upon amount. On December 1, 1991, an agreement was executed in which Y relinquished its rights to Federal financial assistance under the September 10, 1988 agreement in return for a lump sum payment. The lump sum payment represented a prepayment of the principal and accrued but unpaid interest for the note, and the rights to the contingent future loss and income payments. The entire prepayment is excluded from the income of Y because it is a prepayment of Federal financial assistance and the assistance (i) would have been provided pursuant to an acquisition that occurred before May 10, 1989, would have been provided pursuant to an assistance agreement executed before May 10, 1989, and would, if it had been provided prior to May 10, 1989, have been governed by a pre-FIRREA version of section 597; and (ii) the prepayment is paid to a party to the assistance agreement.

Example 2. The facts are the same as those in *Example 1,* except that the note bears an above market rate of interest and part of the lump sum represents a premium payment for the note. The portion of the lump sum allocable to the premium payment is also excluded from the income of Y because the payment represents the present value of the right to future Federal financial assistance in the form of interest.

Example 3. The facts are the same as those in *Example 1,* except that a portion of the lump sum payment represents compensation for additional expenses Y may incur in the future because of termination of the September 10, 1988 agreement. The portion of the lump sum payment allocable to the compensation for additional expenses must be included in the income of Y because it is not a prepayment of Federal financial assistance provided for by a written agreement entered into prior to May 10, 1989.

Example 4. The facts are the same as those in *Example 1,* except that instead of a new assistance agreement, the September 10, 1988 assistance agreement was modified on December 1, 1991. The modified agreement provided new Federal financial assistance in addition to the amounts previously agreed to. None of the new Federal financial assistance is governed by this regulation because the new assistance was not provided for by a written agreement entered into prior to May 10, 1989. The modification does not, however, affect the tax treatment of assistance provided for by the agreement prior to its modification.

(e) *Effective date.* This section is effective April 23, 1992 for assistance received or accrued on or after May 10, 1989 in connection with acquisitions before that date.

[T.D. 8406, 57 FR 14795, Apr. 23, 1992. Redesignated and amended by T.D. 8471, 58 FR 18149, Apr. 8, 1993]

BANK AFFILIATES

§ 1.601–1 Special deduction for bank affiliates.

(a) The special deduction described in section 601 is allowed:

(1) To a holding company affiliate of a bank, as defined in section 2 of the Banking Act of 1933 (12 U.S.C. 221a), which holding company affiliate holds, at the end of the taxable year, a general voting permit granted by the Board of Governors of the Federal Reserve System.

(2) In the amount of the earnings or profits of such holding company affiliate which, in compliance with section 5144 of the Revised Statutes (12 U.S.C. 61), has been devoted by it during the taxable year to the acquisition of readily marketable assets other than bank stock.

(3) Upon certification by the Board of Governors of the Federal Reserve System to the Commissioner that such an amount of the earnings or profits has been so devoted by such affiliate during the taxable year

No deduction is allowable under section 601 for the amount of readily marketable assets in excess of what is required by section 5144 of the Revised Statutes (12 U.S.C. 61) to be acquired by such affiliate, or in excess of the taxable income for the taxable year computed without regard to the special deductions for corporations provided in part VIII (section 241 and following), subchapter B, chapter 1 of the Code. Nor may the aggregate of the deductions allowable under section 601 and the credits allowable under the corresponding provision of any prior income tax law for all taxable years exceed the amount required to be devoted under such section 5144 to the acquisition of readily marketable assets other than bank stock.

(b) Every taxpayer claiming a deduction provided for in section 601 shall attach to its return a supplementary statement setting forth all the facts and information upon which the claim is predicated, including such facts and information as the Board of Governors of the Federal Reserve System may prescribe as necessary to enable it, upon the request of the Commissioner subsequent to the filing of the return, to certify to the Commissioner the amount of earnings or profits devoted to the acquisition of such readily marketable assets. A certified copy of such supplementary statement shall be forwarded by the taxpayer to the Board of Governors at the time of the filing of the return. The holding company affiliate shall also furnish the Board of Governors such further information as the Board shall require. For the requirements with respect to the amount of such readily marketable assets which must be acquired and maintained by a holding company affiliate to which a voting permit has been granted, see section 5144(b) and (c) of the Revised Statutes (12 U.S.C. 61).

NATURAL RESOURCES

Deductions

§ 1.611–0 Regulatory authority.

Sections 1.611–1 through 1.614–8, inclusive, are prescribed under the authority granted the Secretary or his delegate by section 611(a) of the Code to prescribe regulations under which a reasonable allowance for depletion and depreciation of improvements shall be allowed, according to the peculiar conditions in each case, in the case of mines, oil and gas wells, other natural deposits and timber.

[T.D. 6965, 33 FR 10692, July 26, 1968]

§ 1.611–1 Allowance of deduction for depletion.

(a) *Depletion of mines, oil and gas wells, other natural deposits, and timber*—(1) *In general.* Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. In the case of standing timber, the depletion allowance shall be computed solely upon the adjusted basis of the property. In the case of other exhaustible natural resources the allowance for depletion shall be computed upon either the adjusted depletion basis of the property (see section 612, relating to cost depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

(2) See § 1.611–5 for methods of depreciation relating to improvements connected with mineral or timber properties.

(3) See paragraph (d) of this section for definition of terms.

(b) *Economic interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber.

An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. For an exception in the case of certain mineral production payments, see section 636 and the regulations thereunder. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

(2) No depletion deduction shall be allowed the owner with respect to any timber, coal, or domestic iron ore that such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber, coal, or iron ore, if such disposal is considered a sale of timber, coal, or domestic iron ore under section 631 (b) or (c).

(c) *Special rules*—(1) *In general.* For the purpose of the equitable apportionment of depletion among the several owners of economic interests in a mineral deposit or standing timber, if the value of any mineral or timber must be ascertained as of any specific date for the determination of the basis for depletion, the values of such several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral or timber as a whole.

(2) *Leases.* In the case of a lease, the deduction for depletion under section 611 shall be equitably apportioned between the lessor and lessee. In the case of a lease or other contract providing for the sharing of economic interests in a mineral deposit or standing timber, such deduction shall be computed by each taxpayer by reference to the adjusted basis of his property determined in accordance with sections 611 and 612, or computed in accordance with section 613, if applicable, and the regulations thereunder.

(3) *Life tenant and remainderman.* In the case of property held by one person for life with remainder to another person, the deduction for depletion under section 611 shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(4) *Mineral or timber property held in trust.* If a mineral property or timber property is held in trust, the allowable deduction for depletion is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income from such property allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depletion in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depletion reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(i) If under the trust instrument of local law the income of a trust computed without regard to depletion is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(ii) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depletion in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside

income for a depletion reserve pursuant to discretionary authority to do so in the governing instrument

No effect shall be given to any allocation of the depletion deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depletion.

(5) *Mineral or timber property held by estate.* In the case of a mineral property or timber property held by an estate the deduction for depletion under section 611 shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of income of the estate from such property which is allocable to each.

(d) *Definitions.* As used in this part, and the regulations thereunder, the term:

(1) *Property* means—(i) in the case of minerals, each separate economic interest owned in each mineral deposit in each separate tract or parcel of land or an aggregation or combination of such mineral interests permitted under section 614 (b), (c), (d), or (e); and (ii) in the case of timber, an economic interest in standing timber in each tract or block representing a separate timber account (see paragraph (d) of §1.611–3). For rules with respect to waste or residue of prior mining, see paragraph (c) of §1.614–1. When, in the regulations under this part, either the word *mineral* or *timber* precedes the word *property*, such adjectives are used only to classify the type of *property* involved. For further explanation of the term *property*, see section 614 and the regulations thereunder.

(2) *Fair market value* of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

(3) *Mineral enterprise* is the mineral deposit or deposits and improvements, if any, used in mining or in the production of oil and gas, and only so much of the surface of the land as is necessary for purposes of mineral extraction. The value of the mineral enterprise is the combined value of its component parts.

(4) *Mineral deposit* refers to minerals in place. When a mineral enterprise is acquired as a unit, the cost of any interest in the mineral deposit or deposits is that proportion of the total cost of the mineral enterprise which the value of the interest in the deposit or deposits bears to the value of the entire enterprise at the time of its acquisition.

(5) *Minerals* includes ores of the metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits, except minerals derived from sea water, the air, or from similar inexhaustible sources. It includes but is not limited to all of the minerals and other natural deposits subject to depletion based upon a percentage of gross income from the property under section 613 and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7261, 38 FR 5467, Mar. 1, 1973]

§ 1.611–2 Rules applicable to mines, oil and gas wells, and other natural deposits.

(a) *Computation of cost depletion of mines, oil and gas wells, and other natural deposits.* (1) The basis upon which cost depletion is to be allowed in respect of any mineral property is the basis provided for in section 612 and the regulations thereunder. After the amount of such basis applicable to the mineral property has been determined for the taxable year, the cost depletion for that year shall be computed by dividing such amount by the number of units of mineral remaining as of the taxable year (see subparagraph (3) of this paragraph), and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year (see subparagraph (2) of this paragraph). In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

(2) As used in this paragraph, the phrase *number of units sold within the taxable year:*

(i) In the case of a taxpayer reporting income on the cash receipts and disbursements method, includes units for

which payments were received within the taxable year although produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year, and

(ii) In the case of a taxpayer reporting income on the accrual method, shall be determined from the taxpayer's inventories kept in physical quantities and in a manner consistent with his method of inventory accounting under section 471 or 472

The phrase does not include units with respect to which depletion deductions were allowed or allowable prior to the taxable year.

(3) *The number of units of mineral remaining as of the taxable year* is the number of units of mineral remaining at the end of the year to be recovered from the property (including units recovered but not sold) plus the *number of units sold within the taxable year* as defined in this section.

(4) In the case of a natural gas well where the annual production is not metered and is not capable of being estimated with reasonable accuracy, the taxpayer may compute the cost depletion allowance in respect of such property for the taxable year by multiplying the adjusted basis of the property by a fraction, the numerator of which is equal to the decline in rock pressure during the taxable year and the denominator of which is equal to the expected total decline in rock pressure from the beginning of the taxable year to the economic limit of production. Taxpayers computing depletion by this method must keep accurate records of periodical pressure determinations.

(5) If an aggregation of two or more separate mineral properties is made during a taxable year under section 614, cost depletion for each such property shall be computed separately for that portion of the taxable year ending immediately before the effective date of the aggregation. Cost depletion with respect to the aggregated property shall be computed for that portion of the taxable year beginning on such effective date. The allowance for cost depletion for the taxable year shall be the sum of such cost depletion computations. For purposes of this paragraph, each such portion of the taxable year shall be considered as a taxable year. Similar rules shall be applied where a separate mineral property is properly removed from an existing aggregation during a taxable year. See section 614 and the regulations thereunder for rules relating to the effective date of an aggregation of mineral interests and for rules relating to the adjusted basis of an aggregation.

(6) The apportionment of the deduction among the several owners of economic interests in the mineral deposit or deposits will be made as provided in paragraph (c) of § 1.611–1.

(b) *Depletion accounts of mineral property.* (1) Every taxpayer claiming and making a deduction for depletion of mineral property shall keep a separate account in which shall be accurately recorded the cost or other basis provided by section 1012, of such property together with subsequent allowable capital additions to each account and all the other adjustments required by section 1016.

(2) Mineral property accounts shall thereafter be credited annually with the amounts of the depletion so computed in accordance with section 611 or 613 and the regulations thereunder; or the amounts of the depletion computed in shall be credited to depletion reserve accounts. No further deductions for cost depletion shall be allowed when the sum of the credits for depletion equals the cost or other basis of the property, plus allowable capital additions. However, depletion deductions may be allowable thereafter computed upon a percentage of gross income from the property. See section 613 and the regulations thereunder. In no event shall percentage depletion in excess of cost or other basis of the property be credited to the improvements account or the depreciation reserve account.

(c) *Determination of mineral contents of deposits.* (1) If it is necessary to estimate or determine with respect to any mineral deposit as of any specific date the total recoverable units (tons, pounds, ounces, barrels, thousands of cubic feet, or other measure) of mineral products reasonably known, or on good evidence believed, to have existed in place as of that date, the estimate or determination must be made according to the method current in the industry

and in the light of the most accurate and reliable information obtainable. In the selection of a unit of estimate, preference shall be given to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the deposit for the purposes of valuation and depletion shall include as to both quantity and grade:

(i) The ores and minerals *in sight, blocked out, developed,* or *assured,* in the usual or conventional meaning of these terms with respect to the type of the deposits, and

(ii) *Probable* or *prospective* ores or minerals (in the corresponding sense), that is, ores or minerals that are believed to exist on the basis of good evidence although not actually known to occur on the basis of existing development. Such *probable* or *prospective* ores or minerals may be estimated:

(*a*) As to quantity, only in case they are extensions of known deposits or are new bodies or masses whose existence is indicated by geological surveys or other evidence to a high degree of probability, and

(*b*) As to grade, only in accordance with the best indications available as to richness.

(2) If the number of recoverable units of mineral in the deposit has been previously estimated for the prior year or years, and if there has been no known change in the facts upon which the prior estimate was based, the number of recoverable units of mineral in the deposit as of the taxable year will be the number remaining from the prior estimate. However, for any taxable year for which it is ascertained either by the taxpayer or the district director from any source, such as operations or development work prior to the close of the taxable year, that the remaining recoverable mineral units as of the taxable year are materially greater or less than the number remaining from the prior estimate, then the estimate of the remaining recoverable units shall be revised, and the annual cost depletion allowance with respect to the property for the taxable year and for subsequent taxable years will be based upon the revised estimate until a change in the facts requires another revision. Such revised estimate will not, however, change the adjusted basis for depletion.

(d) *Determination of fair market value of mineral properties, and improvements, if any.* (1) If the fair market value of the mineral property and improvements at a specified date is to be determined for the purpose of ascertaining the basis, such value must be determined, subject to approval or revision by the district director, by the owner of such property and improvements in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments or subsequent improvements in methods of extraction and treatment of the mineral product. The district director will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties and improvements, bona fide offers, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property and improvements was in question, the amount at which the property and improvements may have been inventoried or appraised in probate or similar proceedings, and disinterested appraisals by approved methods.

(2) If the fair market value must be ascertained as of a certain date, analytical appraisal methods of valuation, such as the present value method will not be used:

(i) If the value of a mineral property and improvements, if any, can be determined upon the basis of cost or comparative values and replacement value of equipment, or

(ii) If the fair market value can reasonably be determined by any other method.

(e) *Determination of the fair market value of mineral property by the present value method.* (1) To determine the fair market value of a mineral property and improvements by the present value method, the essential factors must be determined for each mineral deposit. The essential factors in determining the fair market value of mineral deposits are:

(i) The total quantity of mineral in terms of the principal or customary unit (or units) paid for in the product marketed,

(ii) The quantity of mineral expected to be recovered during each operating period,

(iii) The average quality or grade of the mineral reserves,

(iv) The allocation of the total expected profit to the several processes or operations necessary for the preparation of the mineral for market,

(v) The probable operating life of the deposit in years,

(vi) The development cost,

(vii) The operating cost,

(viii) The total expected profit,

(ix) The rate at which this profit will be obtained, and

(x) The rate of interest commensurate with the risk for the particular deposit.

(2) If the mineral deposit has been sufficiently developed, the valuation factors specified in subparagraph (1) of this paragraph may be determined from past operating experience. In the application of factors derived from past experience, full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, cost of development, production, interest rate, and selling price of the product marketed during the expected operating life of the mineral deposit. Mineral deposits for which these factors cannot be determined with reasonable accuracy from past operating experience may also be valued by the present value method; but the factors must be deduced from concurrent evidence, such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits, the intensity of mineralization, the oil-gas ratio, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the deposit, and any other evidence tending to establish a reasonable estimate of the required factors.

(3) Mineral deposits of different grades, locations, and probable dates of extraction should be valued separately. The mineral content of a deposit shall be determined in accordance with paragraph (c) of this section. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or reasonably to be expected for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate determined as above. The operating life of oil and gas wells is also influenced by the natural decline in pressure and flow, and by voluntary or enforced curtailment of production. The operating cost includes all current expense of producing, preparing, and marketing the mineral product sold (due consideration being given to taxes) exclusive of allowable capital additions, as described in §§ 1.612–2 and 1.612–4, and deductions for depreciation and depletion, but including cost of repairs. This cost of repairs is not to be confused with the depreciation deduction by which the cost of improvements is returned to the taxpayer free from tax. In general, no estimates of these factors will be approved by the district director which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

(4) The value of each mineral deposit is measured by the expected gross income (the number of units of mineral recoverable in marketable form multiplied by the estimated market price per unit) less the estimated operating cost, reduced to a present value as of the date for which the valuation is made at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at that date of the improvements and of the capital additions, if any, necessary to realize the profits. The degree of risk is generally lowest in cases where the factors of valuation are fully supported by the operating record of the mineral enterprise before the date

for which the valuation is made. On the other hand, higher risks ordinarily attach to appraisals upon any other basis.

(f) *Revaluation of mineral property not allowed.* No revaluation of a mineral property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner.

(g) *Statement to be attached to return when valuation, depletion, or depreciation of mineral property or improvements are claimed.* (1) For the first taxable year ending before December 31, 1967, for which a taxpayer asserts a value for any mineral property or improvement as of a specific date or claims a deduction for depletion, or depreciation, there shall be attached to the return of the taxpayer for such taxable year a statement setting forth, in complete, summary form, the pertinent information required by this paragraph with respect to each such mineral property or improvement (including oil and gas properties or improvements). The summary statement shall be deemed a part of the income tax return to which it relates. In addition to such summary statement, the taxpayer must assemble, segregate and have readily available at his principal place of business, all the supporting data (listed in subparagraphs (2), (3), and (4) of this paragraph) which is used in compiling the summary statement. For taxable years after such first taxable year, and ending before December 31, 1967, the taxpayer need attach to his return only an explanation of the changes, if any, in the information previously furnished. For example, when a taxpayer has filed adequate maps with the district director he may be relieved of filing further maps of the same area, if all additional information necessary for keeping the maps up-to-date is filed each year. In any case in which any of the information required by this paragraph has been previously filed by the taxpayer (including information furnished in accordance with corresponding provisions of prior regulations), such information need not be filed again, but a statement should be attached to the return of the taxpayer indicating clearly when and in what form such information was previously filed. For provisions relating to the data which shall be submitted with returns for taxable years ending on or after December 31, 1967, see subparagraph (5) of this paragraph.

(2) The information referred to in subparagraph (1) of this paragraph is as follows:

(i) An adequate map showing the name, description, location, date of surveys, and identification of the deposit or deposits;

(ii) A description of the character of the taxpayer's property, accompanied by a copy of the instrument or instruments by which it was acquired;

(iii) The date of acquisition of the property, the exact terms and dates of expiration of all leases involved, and if terminated, the reasons therefor;

(iv) The cost of the mineral property and improvements, stating the amount paid to each vendor, with his name and address;

(v) The date as of which the mineral property and improvements are valued, if a valuation is necessary to establish the basis as provided by section 1012;

(vi) The value of the mineral property and improvements on that date with a statement of the precise method by which it was determined;

(vii) An allocation of the cost or value among the mineral property, improvements and the surface of the land for purposes other than mineral production;

(viii) The estimated number of units of each kind of mineral at the end of the taxable year, and also at the date of acquisition, if acquired during the taxable year or at the date as of which any valuation is made, together with an explanation of the method used in the estimation, the name and address of the person making the estimate, and an average analysis which will indicate the quality of the mineral valued, including the grade or gravity in the case of oil;

(ix) The number of units sold and the number of units for which payment was received or accrued during the year for which the return is made (in the case of newly developed oil and gas deposits it is desirable that this information be furnished by months);

(x) The gross amount received from the sale of mineral;

(xi) The amount of depreciation for the taxable year and the amount of cost depletion for the taxable year;

(xii) The amounts of depletion and depreciation, if any, stated separately, which for each and every prior year:

(*a*) Were allowed (see section 1016(a)(2)),

(*b*) Were allowable, and

(*c*) Would have been allowable without reference to percentage or discovery depletion;

(xiii) The fractions (however measured) of gross production from the deposit or deposits to which the taxpayer and other persons are entitled together with the names and addresses of such other persons; and

(xiv) Any other data which will be helpful in determining the reasonableness of the valuation asserted or of the deductions claimed.

(3) In the case of oil and gas properties, the following information with respect to each property is required in addition to that information set forth in subparagraph (2) of this paragraph:

(i) The number of acres of producing oil or gas land and, if additional acreage is claimed to be proven, the amount of such acreage and the reasons for believing it to be proven;

(ii) The number of wells producing at the beginning and end of the taxable year;

(iii) The date of completion of each well finished during the taxable year;

(iv) The date of abandonment of each well abandoned during the taxable year;

(v) Maps showing the location of the tracts or leases and of the producing and abandoned wells, dry holes, and proven oil and gas lands (the maps should show depth, initial production, and date of completion of each well, etc., to the extent that these data are available);

(vi) The number of pay sands and average thickness of each pay sand or zone;

(vii) The average depth to the top of each of the different pay sands;

(viii) The annual production of the deposit or of the individual wells, if the latter information is available, from the beginning of its productivity to the end of the taxable year, the average number of wells producing during each year, and the initial daily production of each well (the extent to which oil or gas is used for fuel on the premises should be stated with reasonable accuracy);

(ix) All available data regarding change in operating conditions, such as unit operation, proration, flooding, use of air-gas lift, vacuum, shooting, and similar information, which have a direct effect on the production of the deposit; and

(x) Available geological information having a probable bearing on the oil and gas content; information with respect to edge water, water drive, bottom hole pressures, oil-gas ratio, porosity of reservoir rock, percentage of recovery, expected date of cessation of natural flow, decline in estimated potential, and characteristics similar to characteristics of other known fields.

(4) For rules relating to an additional statement to be attached to the return when the depletion deduction is computed upon a percentage of gross income from the property, see §1.613–6.

(5) A taxpayer who claims a total deduction of more than $200 for depletion of mines, oil and gas wells, or other natural deposits for the taxable year ending on or after December 31, 1967, and before December 31, 1968, shall submit with his return for such taxable year a filled-out Form M (Mines and Other Natural Deposits—Depletion Data) or Form O (Oil and Gas Depletion Data). See section 6011(a). For the purpose of this subparagraph, the determination under section 631(c) of gain or loss upon the disposition of coal or domestic iron ore with a retained economic interest shall not be regarded as the claiming of a deduction for depletion. Such forms shall be filed for any subsequent taxable year if the Commissioner determines that the forms are required for such year. Where

appropriate, both Form M and Form O shall be filed. Forms M and O shall be deemed to be part of the return to which they relate. If a taxpayer mines more than one mineral, a separate Form M shall be filed for each such mineral. If a taxpayer has both domestic and foreign properties, separate forms shall be filed for each country in which a taxpayer's properties are located. All data relating to a taxpayer's domestic oil and gas properties shall be summarized on a single Form O, and data relating to a taxpayer's domestic mineral properties (other than oil and gas properties) shall be summarized on a single Form M for each mineral. Similarly, all data relating to a taxpayer's oil and gas properties in a specific foreign country shall be summarized on a single Form O, and data relating to a taxpayer's mineral properties (other than oil and gas properties) in a specific foreign country shall be summarized on a single Form M for each mineral. In addition, the taxpayer shall assemble, segregate, and have readily available at his principal place of business, the data listed in subparagraphs (2), (3), and (4) of this paragraph.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6938, 32 FR 17518, Dec. 7, 1967; T.D. 7170, 37 FR 5373, Mar. 15, 1972]

§ 1.611–3 Rules applicable to timber.

(a) *Capital recoverable through depletion allowance in case of timber*. In general, the capital remaining in any year recoverable through depletion allowances is the basis provided by section 612 and the regulations thereunder. For the method of determining fair market value and quantity of timber, see paragraphs (d), (e), and (f) of this section. For capitalization of carrying charges, see section 1016(a)(1)(A). Amounts paid or incurred in connection with the planting of timber (including planting for Christmas tree purposes) shall be capitalized and recoverable through depletion allowances. Such amounts include, for example, expenditures made for the preparation of the timber site for planting or for natural seeding and the cost of seedlings. The apportionment of deductions between the several owners of economic interests in standing timber will be made as provided in paragraph (c) of § 1.611–1.

(b) *Computation of allowance for depletion of timber for taxable year*. (1) The depletion of timber takes place at the time timber is cut, but the amount of depletion allowable with respect to timber that has been cut may be computed when the quantity of cut timber is first accurately measured in the process of exploitation. To the extent that depletion is allowable in a particular taxable year with respect to timber the products of which are not sold during such year, the depletion so allowable shall be included as an item of cost in the closing inventory of such products for such year.

(2) The depletion unit of the timber for a given timber account in a given year shall be the quotient obtained by dividing (i) the basis provided by section 1012 and adjusted as provided by section 1016, of the timber on hand at the beginning of the year plus the cost of the number of units of timber acquired during the year plus proper additions to capital, by (ii) the total number of units of timber on hand in the given account at the beginning of the year plus the cost of the number of units of timber acquired during the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. The number of units of timber of a given timber account cut during any taxable year multiplied by the depletion unit of that timber account applicable to such year shall be the amount of depletion allowable for the taxable year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on such basis, in which case the amount allowable on account of depletion for a given month will be determined in the manner outlined herein for a given year. The total amount of the allowance for depletion in any taxable year shall be the sum of the amounts allowable for the several timber accounts. For a description of timber accounts, see paragraphs (c) and (d) of this section.

(3) When a taxpayer has elected to treat the cutting of timber as a sale or exchange of such timber under the provisions of section 631(a), he shall reduce the timber account containing such timber by an amount equal to the adjusted depletion basis of such timber. In computing any further gain or loss on such timber, see paragraph (e) of § 1.631–1.

(c) *Timber depletion accounts on books.* (1) Every taxpayer claiming or expecting to claim a deduction for depletion of timber property shall keep accurate ledger accounts in which shall be recorded the cost or other basis provided by section 1012 of the property and land together with subsequent allowable capital additions in each account and all other adjustments provided by section 1016 and the regulations thereunder.

(2) In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total cost or value shall be allocated to each after proper provision for immature timber growth. See paragraph (d) of this section. The timber accounts shall be credited each year with the amount of the charges to the depletion accounts computed in accordance with paragraph (b) of this section or the amount of the charges to the depletion accounts shall be credited to depletion reserve accounts. When the sum of the credits for depletion equals the cost or other basis of the timber property, plus subsequent allowable capital additions, no further deduction for depletion will be allowed.

(d) *Aggregating timber and land for purposes of valuation and accounting.* (1) With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts. In general, each such account shall include all of the taxpayer's timber which is located in one *block.* A block may be an operation unit which includes all the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance, or in which the logs or other products will probably be sold in a log or other market, the block may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. Blocks may also be established by geographical or political boundaries or by logical management areas. Timber acquired under cutting contracts should be carried in separate accounts and shall not constitute part of any block. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the district director on audit, the taxpayer may divide the timber in a given block into two or more accounts. For example, timber owned on February 28, 1913, and that purchased subsequently may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts. Individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts. Blocks may be divided into two or more accounts based on the character of the timber or its accessibility, or scattered tracts may be included in separate accounts. If such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(2) The timber accounts mentioned in subparagraph (1) of this paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in subparagraph (1) of this paragraph, the land in a given *block* may be carried in a single land account or may be divided into two or more accounts on the basis of its character or accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(3) The total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively. In cases in which immature timber growth is a factor, a reasonable portion of the total value or cost shall be allocated to such immature timber, and when the timber becomes merchantable such value or cost shall be recoverable through depletion allowances.

(4) Each of the several land and timber accounts carried on the books of the taxpayer shall be definitely described as to their location on the ground either by maps or by legal descriptions.

(5) For good and substantial reasons satisfactory to the district director, or as required by the district director on audit, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts.

(e) *Determination of quantity of timber*. Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, log scale, cords, or other units) of timber reasonably known, or on good evidence believed, to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, whichever date is applicable in determining the basis for cost depletion. This estimate shall state as nearly as possible the number of units which would have been found present by careful estimate made on the specified date with the object of determining 100 percent of the quantity of timber which the area covered by the specific account would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, as the result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work, it is ascertained either by the taxpayer or the district director that there remain on the ground, available for utilization, more or less units of timber at the close of the taxable year (or at the close of the month if the taxpayer keeps his depletion accounts on a monthly basis) than remain in the timber account or accounts on the basis of the original estimate, then the original estimate (but not the basis for depletion) shall be revised. The depletion unit shall be changed when such revision has been made. The annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which the revision is made and all subsequent taxable years until a change in facts requires another revision.

(f) *Determination of fair market value of timber property*. (1) If the fair market value of the property at a specified date is the basis for depletion deductions, such value shall be determined, subject to approval or revision by the district director upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, and methods of exploitation, in degree of utilization, etc. Such factors as the following will be given due consideration:

(i) Character and quality of the timber as determined by species, age, size, condition, etc.;

(ii) The quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber;

(iii) Accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation and the climate and the state of industrial development of the locality); and

(iv) The freight rates by common carrier to important markets.

(2) The timber in each particular case will be valued on its own merits and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned in this paragraph, will be coistent with that of other similar timber in the region. The district director will give weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares,

royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors.

(g) *Revaluation of timber property not allowed.* No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The depletion unit shall be revised when such a revaluation of a timber property has been made and the annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which such revision is made and for all subsequent taxable years.

(h) *Reporting and recordkeeping requirements*—(1) *Taxable years beginning before January 1, 2002.* A taxpayer claiming a deduction for depletion of timber for a taxable year beginning before January 1, 2002, shall attach to the income tax return of the taxpayer a filled-out Form T (Timber) for the taxable year covered by the income tax return, including the following information—

(i) A map where necessary to show clearly timber and land acquired, timber cut, and timber and land sold;

(ii) Description of, cost of, and terms of purchase of timberland or timber, or cutting rights, including timber or timber rights acquired under any type of contract;

(iii) Profit or loss from sale of land, or timber, or both;

(iv) Description of timber with respect to which claim for loss, if any, is made;

(v) Record of timber cut;

(vi) Changes in each timber account as a result of purchase, sale, cutting, reestimate, or loss;

(vii) Changes in improvements accounts as the result of additions to or deductions from capital and depreciation, and computation of profit or loss on sale or other disposition of such improvements;

(viii) Operation data with respect to raw and finished material handled and inventoried;

(ix) Statement as to application of the election under section 631(a) and pertinent information in support of the fair market value claimed thereunder;

(x) Information with respect to land ownership and capital investment in timberland; and

(xi) Any other data which will be helpful in determining the reasonableness of the depletion or depreciation deductions claimed in the return.

(2) *Taxable years beginning after December 31, 2001.* A taxpayer claiming a deduction for depletion of timber on a return filed for a taxable year beginning after December 31, 2001, shall attach to the income tax return of the taxpayer a filled-out Form T (Timber) for the taxable year covered by the income tax return. In addition, the taxpayer must retain records sufficient to substantiate the right of the taxpayer to claim the deduction, including a map, where necessary, to show clearly timber and land acquired, timber cut, and timber and land sold for as long as their contents may become material in the administration of any internal revenue law.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8989, 67 FR 20031, Apr. 24, 2002; T.D. 9040, 68 FR 4921, Jan. 31, 2003]

§ 1.611–4 Depletion as a factor in computing earnings and profits for dividend purposes.

For rules with respect to computation of earnings and profits where depletion is a factor in the case of corporations, see paragraph (c)(1) of § 1.312–6.

§ 1.611–5 Depreciation of improvements.

(a) *In general.* Section 611 provides in the case of mines, oil and gas wells,

other natural deposits, and timber that there shall be allowed as a deduction a reasonable allowance for depreciation of improvements. Such allowance shall include exhaustion, wear and tear, and obsolescence. The deduction allowed under section 611 shall be determined under the provisions of section 167 and the regulations thereunder. For purposes of section 167 the unit of production method may, under appropriate circumstances, be considered a reasonable method under section 167(a), and therefore, not subject to the limitations prescribed by section 167(b).

(b) *Special rules for mines, oil and gas wells, other natural deposits and timber.* (1) For principles governing the apportioning of depreciation allowances under sections 611 and 167 in the case of property held by one person for life with remainder to another or in the case of property held in trust or by an estate, see § 1.167(h)–1.

(2) A reasonable allowance for depreciation on account of obsolescence or decay shall be required in an appropriate case during periods when the improvement is not used in production or is used in producing at a rate below its normal capacity. This rule is applicable whether or not the taxpayer uses the unit of production method.

(3) See sections 615 and 616 and the regulations thereunder for special rules for treatment of allowances for depreciation of improvements with respect to the exploration and development of a mine or other natural deposit (other than oil or gas).

(4) In the case of operating oil or gas properties, the deduction for depreciation shall be allowed for those costs of improvements such as machinery, tools, equipment, pipes, and other similar items and the costs of installation which are not treated as a deductible expense under section 263(c). See § 1.612–4.

(c) *Accounting and recordkeeping.* See § 1.167(a)–7 for accounting and recordkeeping requirements for taxpayers claiming deductions under section 611 and this section.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3655, Mar. 24, 1964; T.D. 6836, 30 FR 8902, July 15, 1965]

§ 1.612–1 Basis for allowance of cost depletion.

(a) *In general.* The basis upon which the deduction for cost depletion under section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section 1011 for the purpose of determining gain upon the sale or other disposition of such property except as provided in paragraph (b) of this section. The adjusted basis of such property is the cost or other basis determined under section 1012, relating to the basis of property, adjusted as provided in section 1016, relating to adjustments to basis, and the regulations under such sections. In the case of the sale of a part of such property, the unrecovered basis thereof shall be allocated to the part sold and the part retained.

(b) *Special rules.* (1) The basis for cost depletion of mineral or timber property does not include:

(i) Amounts recoverable through depreciation deductions, through deferred expenses, and through deductions other than depletion, and

(ii) The residual value of land and improvements at the end of operations

In the case of any mineral property the basis for cost depletion does not include amounts representing the cost or value of land for purposes other than mineral production. Furthermore, in the case of certain mineral properties, such basis does not include exploration or development expenditures which are treated under section 615(b) or 616(b) as deferred expenses to be taken into account as deductions on a ratable basis as the units of minerals benefited thereby are produced and sold. However, there shall be included in the basis for cost depletion of oil and gas property the amounts of capitalized drilling and development costs which, as provided in § 1.612–4, are recoverable through depletion deductions. In the case of timber property, the basis for cost depletion does not include amounts representing the cost or value of land.

(2) Where a taxpayer elects to treat the cutting of timber as a sale or exchange of such timber, the basis for cost depletion shall be the fair market value of such timber as of the first day

of the taxable year in which such timber is cut and such value shall be considered for such taxable year and all subsequent taxable years as the cost of such timber for all purposes for which such cost is a necessary factor. See section 631(a).

(c) *Cross references.* In cases where the valuation, revaluation, or mineral content of deposits is a factor, see paragraphs (c), (d), (e), and (f) of § 1.611–2. In cases where the valuation, revaluation, or quantity of timber is a factor, see paragraphs (e), (f), and (g) of § 1.611–3. For definitions of the terms *property*, *fair market value*, *mineral enterprise*, *mineral deposit,* and *minerals,* see paragraph (d) of § 1.611–1. For rules with respect to treatment of depletion accounts on taxpayers' books, see paragraph (b) of § 1.611–2 in the case of mineral property, and paragraph (c) of § 1.611–3 in the case of timber property.

§ 1.612–2 Allowable capital additions in case of mines.

(a) *In general.* Expenditures for improvements and for replacements, not including expenditures for ordinary and necessary maintenance and repairs, shall ordinarily be charged to capital account recoverable through depreciation deductions. Expenditures for equipment (including its installation and housing) and for replacements thereof, which are necessary to maintain the normal output solely because of the recession of the working faces of the mine and which:

(1) Do not increase the value of the mine, or

(2) Do not decrease the cost of production of mineral units, or

(3) Do not represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made shall be deducted as ordinary and necessary business expenses.

(b) *Special rule.* For special provisions applicable to treatment of expenditures for certain exploration and development costs (other than for the acquisition, restoration, or betterment of improvements) with respect to minerals other than oil or gas, see sections 615 and 616 and the regulations thereunder.

§ 1.612–3 Depletion; treatment of bonus and advanced royalty.

(a) *Bonus.* (1) If a bonus in addition to royalties is received upon the grant of an economic interest in a mineral deposit, or standing timber, there shall be allowed to the payee as a cost depletion deduction in respect of the bonus an amount equal to that proportion of his basis for depletion as provided in section 612 and § 1.612–1 which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the payee's basis for depletion and the remainder of the basis is recoverable through depletion deductions as the royalties are thereafter received. (But see paragraph (e) of this section.) For example, a taxpayer leases mineral property to another reserving a one-eighth royalty and in addition receives a bonus of $10,000. Assuming that the taxpayer's basis with respect to the mineral property is $21,000 and that the royalties expected to be received are estimated to total $20,000, the depletion on the bonus would be $7,000:

[$21,000 (basis) × $10,000 (bonus)] ÷ $30,000 (bonus plus estimated royalties).

The remaining $14,000 of basis will be recovered through depletion as the royalties are received.

(2) If the grant of an economic interest in a mineral deposit or standing timber with respect to which a bonus was received expires, terminates, or is abandoned before there has been any income derived from the extraction of mineral or cutting of timber, the payee shall adjust his capital account by restoring thereto the depletion deduction taken on the bonus and a corresponding amount must be returned as income in the year of such expiration, termination, or abandonment.

(3) In the case of the payor, payment of the bonus constitutes a capital investment made for the acquisition of an economic interest in a mineral deposit or standing timber recoverable through the depletion allowance. See paragraph (c)(5)(ii) of § 1.613–2 in cases in which percentage depletion is used.

(b) *Advanced royalties.* (1) If the owner of an operating interest in a mineral

deposit or standing timber is required to pay royalties on a specified number of units of such mineral or timber annually whether or not extracted or cut within the year, and may apply any amounts paid on account of units not extracted or cut within the year against the royalty on the mineral or timber thereafter extracted or cut, the payee shall compute cost depletion on the number of units so paid for in advance of extraction or cutting and shall treat the amount so determined as an allowable deduction for depletion from the gross income of the year in which such payment or payments are made. No deduction for depletion by such payee shall be claimed or allowed in any subsequent year on account of the extraction or cutting in such year of any mineral or timber so paid for in advance and for which deduction has once been made. (But see paragraph (e) of this section.)

(2) If the right to extract minerals or to cut timber against which the advanced royalties may be applied expires, terminates, or is abandoned before all such minerals or timber have been extracted or cut, the payee shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of any units of mineral or timber paid for in advance but not extracted or cut, and a corresponding amount must be returned as income for the year of such expiration, termination or abandonment. (But see paragraph (e) of this section.)

(3) The payor shall treat the advanced royalties paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. For purposes of the preceding sentence, in the case of mineral sold before production the mineral product is considered to be sold when the mineral is produced (i.e., when a mineral product first exists). However, in the case of advanced mineral royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision, the payor, at his option, may instead treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued. See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount. For purposes of the preceding sentence, in the case of a lease which is subject to renewal or extension, the period for which it can be renewed or extended shall be treated as part of the term of the original lease. For special rules applicable when the payor is a sublessor of coal or domestic iron ore, see paragraph (b)(3) of §1.631–3. Every taxpayer who pays or accrues advanced royalties resulting from a minimum royalty provision must make an election as to the treatment of all such advanced royalties in his return for the first taxable year ending after December 31, 1939, in which the advanced royalties are paid or accrued. The taxpayer's treatment of the advanced royalties for the first year shall be deemed to be the exercise of the election. Accordingly, a failure to deduct the advanced royalties for that year will constitute an election to have all the advanced royalties treated as deductions for the year of the sale of the mineral product in respect of which the advanced royalties are paid or accrued. See section 7807(b)(2). For additional rules relating to elections in the case of partners and partnerships, see section 703(b) and the regulations thereunder. the provisions of this subparagraph do not allow as deductions from gross income amounts disallowed as deductions under other provisions of the Code, such as section 461 (relating to general rule for taxable year of deduction), section 465 (relating to deductions limited to amount at risk in case of certain activities), or section 704(d) (relating to limitation on allowance to partners of partnership losses).

(4) The application of subparagraphs (2) and (3) of this paragraph may be illustrated by the following examples:

Example 1. B leased certain mineral lands from A under a lease in which A reserved a royalty of 10 cents a ton on minerals mined

and sold by B. The lease also provided that B had to pay an annual minimum royalty of $10,000 representing the amount due on 100,000 tons of the particular mineral whether or not B mined and sold that amount. It was further provided that, if B did not mine and sell 100,000 tons in any year, he could mine and sell in any subsequent year the amount of mineral on which he had paid the royalty without the payment of any additional royalty. However, this right of recoupment was limited to minerals mined and sold in any later year in excess of the 100,000 tons represented by the $10,000 minimum royalty required to be paid for that later year. Assume that in 1956 B paid A the minimum royalty of $10,000, but mined and sold only 60,000 tons of the mineral and that in 1957 he abandoned the lease without any further production. Since the $10,000 represents royalties on 100,000 tons of mineral and only 60,000 tons were mined and sold, A must restore in 1957 to his capital account the depletion deductions taken in 1956 on $4,000 on account of the 40,000 tons paid for in advance but not mined and sold, and must also return the corresponding amount as income in 1957.

Example 2. Assume that B, under the lease in example 1, paid the $10,000 minimum royalty and mined no minerals in 1956 but that in 1957 B mined and sold 200,000 tons of mineral. If this is B's first such expenditure, B has an option, for the purpose of computing taxable income under section 63, to deduct in 1956 the $10,000 paid in that year although no mineral was mined, or to take the deduction in 1957 when the mineral, for which the $10,000 was paid in 1956, was mined and sold. (For treatment under percentage depletion, see example in paragraph (c)(5)(iii) of § 1.613–2.)

(c) *Delay rental.* (1) A delay rental is an amount paid for the privilege of deferring development of the property and which could have been avoided by abandonment of the lease, or by commencement of development operations, or by obtaining production.

(2) Since a delay rental is in the nature of rent it is ordinary income to the payee and not subject to depletion. The payor may at his election deduct such amount as an expense, or under section 266 and the regulations thereunder, charge it to depletable capital account.

(d) *Percentage depletion deduction with respect to bonus and advanced royalty.* In lieu of the allowance based on cost depletion computed under paragraphs (a) and (b) of this section, the payees referred to therein may be allowed a depletion deduction in respect of any bonus or advanced royalty for the taxable year in an amount computed on the basis of the percentage of gross income from the property as provided in section 613 and the regulations thereunder. However, for special rules applicable to certain bonuses and advanced royalties received in connection with oil or gas properties, see paragraph (j) of § 1.613A–3.

(e) *Cross reference.* In the case of bonuses and advanced royalties received in connection with a contract of disposal of timber covered by section 631(b) or coal or iron ore covered by section 631(c), see that section and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7523, 42 FR 63641, Dec. 19, 1977; T.D. 8348, 56 FR 21938, May 13, 1991]

§ 1.612–4 Charges to capital and to expense in case of oil and gas wells.

(a) *Option with respect to intangible drilling and development costs.* In accordance with the provisions of section 263(c), intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of oil and gas properties may at his option be chargeable to capital or to expense. This option applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. Such expenditures have for convenience been termed intangible drilling and development costs. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if such amounts are depletable income to the recipient, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are, all amounts paid for labor,

fuel, repairs, hauling, and supplies, or any of them, which are used:

(1) In the drilling, shooting, and cleaning of wells,

(2) In such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells, and

(3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Included in this option are all costs of drilling and development undertaken (directly or through a contract) by an operator of an oil and gas property whether incurred by him prior or subsequent to the formal grant or assignment to him of operating rights (a leasehold interest, or other form of operating rights, or working interest); except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within this option. In the excepted cases, costs of the project undertaken, including depreciable equipment furnished, to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.

(b) *Recovery of optional items, if capitalized.* (1) Items returnable through depletion: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depletion insofar as they are not represented by physical property. For the purposes of this section the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(2) Items returnable through depreciation: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depreciation insofar as they are represented by physical property. Such expenditures are amounts paid for wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract, such costs shall be allocated between the foregoing classes of items specified in subparagraphs (1) and (2) for the purpose of determining the depletion and depreciation allowances.

(4) Option with respect to cost of nonproductive wells: If the operator has elected to capitalize intangible drilling and development costs, then an additional option is accorded with respect to intangible drilling and development costs incurred in drilling a nonproductive well. Such costs incurred in drilling a nonproductive well may be deducted by the taxpayer as an ordinary loss provided a proper election is made in the return for the first taxable year beginning after December 31, 1942, in which such a nonproductive well is completed. Such election with respect to intangible drilling and development costs of nonproductive wells is a new election, and, when made, shall be binding for all subsequent years. Any taxpayer who incurs optional drilling and development costs in drilling a nonproductive well must make a clear statement of election under this option in the return for the first taxable year beginning after December 31, 1942, in which such nonproductive well is completed. The absence of a clear indication in such return of an election to deduct as ordinary losses intangible drilling and development costs of nonproductive wells shall be deemed to be an election to recover such costs through depletion to

the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property.

(c) *Nonoptional items distinguished.* (1) Capital items: The option with respect to intangible drilling and development costs does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The option does not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable through depreciation.

(2) Expense items: Expenditures which must be charged off as expense, regardless of the option provided by this section, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of oil or gas.

(d) *Manner of making election.* The option granted in paragraph (a) of this section to charge intangible drilling and development costs to expense may be exercised by claiming intangible drilling and development costs as a deduction on the taxpayer's return for the first taxable year in which the taxpayer pays or incurs such costs; no formal statement is necessary. If the taxpayer fails to deduct such costs as expenses in such return, he shall be deemed to have elected to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property.

(e) *Effect of option and election.* This section does not grant a new option under paragraph (a) of this section or new election under paragraph (b) of this section. Section 3 of the Act of October 23, 1962 (Public Law 87–863, 76 Stat. 1142) granted any taxpayer who had exercised an option to capitalize intangible drilling and development costs under Regulations 111, § 29.23(m)–16 (1939 Code) or Regulations 118, § 39.23(m)–16 (1939 Code) a new option for the first taxable year ending after October 22, 1962, to deduct such costs as expenses. Unless he has exercised the new option granted by such Act, any taxpayer who exercised an option or made an election under the regulations described in the preceding sentence is, by such option or election, bound with respect to all intangible drilling and development costs (whether made before January 1, 1954, or after December 31, 1953) in connection with oil and gas properties. See section 7807(b)(2). Any taxpayer who has not made intangible drilling and development expenditures in any taxable year beginning after December 31, 1942, prior to his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, must exercise the option granted in paragraph (a) of this section in the return for the first taxable year in which the taxpayer pays or incurs such expenditures. If such return is required by law (including extensions thereof) to be filed before November 1, 1965, the option under paragraph (a) of this section, or the election under paragraph (b) of this section, may be exercised or changed not later than November 1, 1965. The exercise of or change in such option or election shall be effective with respect to the earliest taxable year to which the option or election is applicable in respect of which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from such exercise or change is not prevented by any law or rule of law on the date such option is exercised or such election is made. Any such option or election shall be binding upon the taxpayer for the first taxable year for which it is effective and for all subsequent taxable years.

[T.D. 6836, 30 FR 8902, July 15, 1965]

§ 1.612–5 Charges to capital and to expense in case of geothermal wells.

(a) *Option with respect to intangible drilling and development costs.* In accordance with the provisions of section 263(c), intangible drilling and development costs incurred by an operator

(one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of a geothermal deposit (as defined in section 613(e)(3) and the regulations thereunder) may at the operator's option be chargeable to capital or to expense. This option applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of geothermal steam or hot water. Such expenditures have for convenience been termed intangible drilling and development costs. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if such amounts are depletable income to the recipient, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used:

(1) In the drilling, shooting, and cleaning of wells,

(2) In such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells, and

(3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of geothermal steam or hot water.

In general, this option applies only to expenditures for those drilling and developing items which in themselves do *not* have a salvage value. For the purpose of *this* option, labor, fuel, repairs, hauling, supplies, etc. are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Included in this option are all costs of drilling and development undertaken (directly or through a contract) by an operator of a geothermal property whether incurred by the operator prior or subsequent to the formal grant or assignment of operating rights (a leasehold interest, or other form of operating rights, or working interest); except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within this option. In the excepted cases, costs of the project undertaken, including depreciable equipment furnished, to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.

(b) *Recovery of optional items, if capitalized*. (1) Items recoverable through depletion: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are recoverable through depletion insofar as they are not represented by physical property. For the purposes of this section the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are recoverable through depletion.

(2) Items recoverable through depreciation: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are recoverable through depreciation insofar as they are represented by physical property. Such expenditures are amounts paid for wages, fuel, repairs, hauling, supplies, etc. used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract, such costs shall be allocated between the foregoing classes of items specified in paragraphs (b)(1) and (2) of this section for the purpose of determining the depletion and depreciation allowances.

(4) Option with respect to cost of nonproductive wells: If the operator has elected to capitalize intangible

drilling and development costs; then an additional option is accorded with respect to intangible drilling and development costs incurred in drilling a nonproductive well. Such costs incurred in drilling a nonproductive well may be deducted by the taxpayer as an ordinary loss provided a proper election is made in the taxpayer's original or amended return for the first taxable year ending on or after October 1, 1978, in which such a nonproductive well is completed. The taxpayer must make a clear statement of election under this option in the return or amended return. The election may be revoked by the filing of an amended return that does not contain such a statement. The absence of a clear indication in such return of an election to deduct as ordinary losses intangible drilling and development costs of nonproductive wells shall be deemed to be an election to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the exent that they are represented by physical property. Upon the expiration of the time for filing a claim for credit or refund of any overpayment of tax imposed by chapter 1 of the Code with respect to the first taxable year ending on or after October 1, 1978 in which a nonproductive well is completed, the taxpayer is bound for all subsequent years by his exercise of the option to deduct intangible drilling and development costs of nonproductive wells as an ordinary loss or his deemed election to recover such costs through depletion or depreciation.

(c) *Nonoptional items distinguished*—(1) *Capital Items:* The option with respect to intangible drilling and development costs does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The option does not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for treating geothermal steam or hot water. These are capital items and are recoverable through depreciation.

(2) *Expense items:* Expenditures which must be charged off as expense, regardless of the option provided by this section, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of geothermal steam or hot water.

(d) *Manner of making election.* The option granted in paragraph (a) of this section to charge intangible drilling and development costs to expense may be exercised by claiming intangible drilling and development costs as a deduction on the taxpayer's original or amended return for the first taxable year ending on or after October 1, 1978, in which the taxpayer pays or incurs such costs with respect to a geothermal well commenced on or after that date. No formal statement is necessary. The exercise of the option may be revoked by the filing of an amended return that does not claim such a deduction. If the taxpayer fails to deduct such costs as expenses in any such return, he shall be deemed to have elected to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property. Upon the expiration of the time for filing a claim for credit or refund of any overpayment of tax imposed by chapter 1 of the Code with respect to the first taxable year ending on or after October 1, 1978, in which the taxpayer pays or incurs intangible drilling and development costs with respect to a goethermal well commenced on or after that date, the taxpayer is bound by his exercise of the option to charge such costs to expense or his deemed election to recover such costs through depletion or depreciation for that year and for all subsequent years.

(e) *Effective date.* The option granted by paragraph (a) of this section is available only for taxable years ending on or after October 1, 1978, with respect

to geothermal wells commenced on or after that date.

(Secs. 263, 9805, Internal Revenue Code of 1954 (92 Stat. 3201, 26 U.S.C. 362; 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7806, 47 FR 4061, Jan. 28, 1982]

§ 1.613–1 Percentage depletion; general rule.

(a) *In general.* In the case of a taxpayer computing the deduction for depletion under section 611 with respect to minerals on the basis of a percentage of gross income from the property, as defined in section 613(c) and §§ 1.613–3 and 1.613–4, the deduction shall be the percentage of the gross income as specified in section 613(b) and § 1.613–2. The deduction shall not exceed 50 percent (100 percent in the case of oil and gas properties for taxable years beginning after December 31, 1990) of the taxpayer's taxable income from the property (computed without regard to the allowance for depletion). The taxable income shall be computed in accordance with § 1.613–5. In no case shall the deduction for depletion computed under this section be less than the deduction computed upon the cost or other basis of the property provided in section 612 and the regulations thereunder. The apportionment of the deduction between the several owners of economic interests in a mineral deposit will be made as provided in paragraph (c) of § 1.611–1. For rules with respect to ''gross income from the property'' and for definition of the term ''mining,'' see §§ 1.613–3 and 1.613–4. For definitions of the terms ''property,'' ''mineral deposit,'' and ''minerals,'' see paragraph (d) of § 1.611–1.

(b) *Denial of percentage depletion in case of oil and gas wells.* Except as otherwise provided in section 613A and the regulations thereunder, in the case of oil or gas which is produced after December 31, 1974, and to which gross income is attributable after that date, the allowance for depletion shall be computed without regard to section 613.

[T.D. 8348, 56 FR 21938, May 13, 1991, as amended by T.D. 8437, 57 FR 43899, Sept. 23, 1992]

§ 1.613–2 Percentage depletion rates.

(a) *In general.* Subject to the provisions of paragraph (b) of this section and as provided in section 613(b), in the case of mines, wells, or other natural deposits, a taxpayer may deduct as an allowance for depletion under section 611 the percentages of gross income from the property as set forth in subparagraphs (1), (2), and (3) of this paragraph.

(1) *Without regard to situs of deposits.* The following rates are applicable to the minerals listed in this subparagraph regardless of the situs of the deposits from which the minerals are produced:

(i) 27½ percent—Gas wells, oil wells.

(ii) 23 percent—Sulfur, uranium.

(iii) 15 percent—Ball clay, bentonite, china clay, metal mines,[1] sagger clay, rock asphalt, vermiculite.

(iv) 10 percent—Asbestos,[1] brucite, coal, lignite, perlite, sodium chloride, wollastonite.

(v) 5 percent—Brick and tile clay, gravel, mollusk shells (including clam shells and oyster shells), peat, pumice, sand, scoria, shale, stone (except dimension or ornamental stone). If from brine wells—Bromine, calcium chloride, magnesium chloride.

(2) *Production from United States deposits.* A rate of 23 percent is applicable to the minerals listed in this subparagraph if[2] produced from deposits within the United States:[3]

Anorthosite.[2]	Ilmenite.
Asbestos.	Kyanite.
Bauxite.	Mica.
Beryl.[3]	Olivine.
Celestite.	Quartz crystals (radio grade).
Chromite.	Rutile.
Corundum.	Block Steatite talc.
Fluorspar.	Zircon.
Graphite.	

Ores of the following metals—

[1] Not applicable if the rate prescribed in subparagraph (2) of this paragraph is applicable.

[2] The rate prescribed in this subparagraph does not apply except to the extent that alumina and aluminum compounds are extracted therefrom.

[3] Applicable only for taxable years beginning before January 1, 1964.

Antimony.	Platinum.
Beryllium.[4]	latinum group metals.
Bismuth.	Tantalum.
Cadmium.	Thorium.
Cobalt.	Tin.
Columbium.	Titanium.
Lead	Tungsten.
Lithium.	Vanadium.
Manganese.	Zinc.
Mercury.	
Nickel.	

(3) *Other minerals*. A rate of 15 percent is applicable to the minerals listed in this subparagraph regardless of the situs of the deposits from which the minerals are produced, provided the minerals are not used or sold for use by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. If, however, such minerals are sold or used for the purposes described in the preceding sentence, a rate of 5 percent is applicable to any of such minerals unless sold on bid in direct competition with a bona fide bid to sell any of the minerals listed in subdivision (iii) of subparagraph (1) of this paragraph, in which case the rate is 15 percent. In addition, the provisions of this subparagraph are not applicable with respect to any of the minerals listed herein if the rate prescribed in subparagraph (2) of this paragraph is applicable.

Aplite.	Clay, refractory and fire.[6]
Barite.	Diatomaceous earth.
Bauxite.	Dolomite.
Beryl.[5]	Fedlspar.
Borax.	Flake Graphite.
Calcium carbonates.	

(4) For purposes of this section, the term *all other minerals* does not include (i) soil, sod, dirt, turf, water, or mosses; or (ii) minerals from sea water, the air, or similar inexhaustible sources. However, the term *all other minerals* is not limited in meaning to the minerals listed in section 613(b), but includes all other minerals (except those to which a specific percentage rate applies under subparagraphs (1), (2), (3), (4), and (5) of section 613(b)): For example, gypsum, novaculite, natural mineral pigments, quartz sand and quartz pebbles, graphite and kyanite (if section 613(b)(2)(B) does not apply), and anorthosite to the extent that alumina and aluminum compounds are not extracted therefrom. The 15–percent rate applies to such *all other minerals* when used or sold for use by the mine owner or operator for purposes other than as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. When any such minerals are used or sold for use by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes, the 5–percent rate applies except that, when sold for such use by the mine owner or operator on a bid in direct competition with a bona fide bid to sell a mineral listed in section 613(b)(3), the 15-percent rate applies. For example, limestone sold on a bid in direct competition with a bona fide bid to sell rock asphalt for road building purposes may be entitled to a 15-percent rate. In every case the taxpayer must establish to the satisfaction of the district director that there was a bona fide bid to sell a mineral listed under section 613(b)(3) by a person other than the taxpayer, and that the mineral sold by the taxpayer was sold on a bid in direct competition with such bona fide bid to sell such other material.[7]

Fluorspar	Potash.
Fullers earth.	Quartzite.
Barnet.	Slate.
Gilsonite.	Soapstone.
Granite	Spodumene.
Lepidolite.	Stone (dimension or ornamental).[7]
Limestone.	Talc (including pyrophyllite).
Magnesite.	Thernardite.
Magnesium carbonates	Tripoli.
Marble.	Trona.
Mica	All other minerals
Phosphate rock.	

(b) *Definition of terms*. (1) For purposes of this section, the minerals indicated below shall have the following meanings:

[4] Applicable only for taxable years beginning after December 31, 1963.

[5] Applicable only for taxable years beginning before January 1, 1964.

[6] Not applicable for taxable years beginning after December 31, 1960.

[7] The 15-percent rate is applicable only to stone used or sold for use by the mine owner or operator as dimension stone or ornamental stone.

(i) Clay, brick and tile—Clay used or sold for use in the manufacture of common brick, drain and roofing tile, sewer pipe, flower pots, and kindred products (other than clay specifically identified as a clay for which a 15 percent rate of percentage allowance is provided).

(ii) Clay, refractory and fire—Clay which has a pyrometric cone equivalent of 19 or higher.

(iii) Pumice—All pumice including pumicite.

(iv) Scoria—Only scoria produced from natural deposits.

(2) For purposes of this section, the term *United States* means the States and the District of Columbia. See section 7701(a)(9).

(3) For purposes of this section, the term *dimension stone* means blocks and slabs of natural stone, subsequently cut to definite shapes and sizes and used or sold for such uses as building stone (excluding rubble), monumental stone, paving blocks, curbing and flagging. For purposes of this section, *ornamental stone* means blocks and slabs of natural stone, subsequently cut to definite shapes and sizes and used or sold for use for making ornaments or statues.

(c) *Rules for application of paragraph (a) of this section.* (1) In no case may the allowance for depletion computed upon the basis of a percentage of gross income from the property exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For rules relating to the computation of such taxable income, see § 1.613–5.

(2) In cases in which there are produced from a mineral property two or more minerals, each entitled to a different percentage depletion rate under section 613(b) and this section or any of which is entitled to cost depletion only, the percentage depletion allowance is the sum of the results obtained by applying the percentage applicable to each mineral (zero, if not entitled to percentage depletion) to the *gross income from the property* attributable to such mineral. The sum so computed is subject to the limitation provided in section 613(a) and § 1.613–1, that is, 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). Such taxable income (computed in accordance with § 1.613–4) is the total taxable income resulting from the sale of all minerals produced from the mineral property (as defined in section 614 and the regulations thereunder). The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Pyrite, an iron sulfide, may be sold for either its sulfur content or its iron content, or both. Sulfur is entitled to a percentage depletion deduction based on 23 percent of gross income from the property whereas the percentage depletion deduction for iron is based on 15 percent of such gross income. Therefore, in the case of a taxpayer who sells pyrite for both its sulfur and iron content, 23 percent of his gross income from sulfur plus 15 percent of his gross income from iron would be his maximum allowable percentage depletion deduction. However, this maximum deduction would be subject to the limitation provided for in section 613(a), *i.e.,* 50 percent of *taxable income from the property (computed without allowance for depletion*), such taxable income being the overall taxable income resulting from the sale of both minerals contained in the deposit.

Example 2. Oil and gas are produced from a single mineral property of a taxpayer who operates a retail outlet for the sale of oil products within the meaning of section 613A(d)(2). The taxpayer is not entitled to percentage depletion on the gross income attributable to the oil, but is entitled to percentage depletion on the gross income attributable to gas which is regulated gas under section 613A(b)(2)(B). Accordingly, the taxpayer's maximum allowable percentage depletion deduction would be zero percent of gross income from the property with respect to oil, plus 22 percent (see section 613A(b)(1)) of gross income from the property with respect to gas. This maximum deduction would be subject to the limitation provided for in section 613(a), *i.e.*, 50 percent of *taxable income from the property (computed without allowance for depletion),* such taxable income being the overall taxable income resulting from the sale of both oil and gas. However, in the case of oil or gas production which qualifies for percentage depletion under section 613A(c), see the special allocation rules contained in section 613A(c)(7) (C) and (E) and § 1.613A–4.

(3) Except as provided in section 613(d) and the regulations thereunder relating to special rules for determining rates of depletion for taxable years ending after December 31, 1953, to which the Internal Revenue Code of 1939 applies:

(i) The percentage rates set forth in this section are applicable only for taxable years beginning after December 31, 1953, and ending after August 16, 1954; and

(ii) The percentage rates set forth in 26 CFR (1939) 39.23(m)–5 (Regulations 118) are applicable for taxable years beginning before January 1, 1954, or ending before August 17, 1954.

(4) Percentage depletion is not allowable with respect to the income from a disposal of coal (including lignite) or domestic iron ore (as defined in paragraph (e) of § 1.631–3) with a retained economic interest to the extent that such income is treated as from a sale of coal or iron ore under section 631(c) and § 1.631–3. Rents or royalties paid or incurred by a taxpayer with respect to coal (including lignite) or domestic iron ore shall be excluded by such taxpayer in determining *gross income from the property* without regard to the treatment under section 631(c) of such rents and royalties in the hands of the recipient.

(5)(i) In all cases there shall be excluded in determining the *gross income from the property* an amount equal to any rents or royalties (which are depletable income to the payee) which are paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from *gross income from the property*. The following example illustrates this rule:

Example. A leases coal-bearing lands to B on condition that B will annually pay a royalty of 25 cents a ton on coal mined and sold by B. During the year 1956, B mines and sells f.o.b. mine 100,000 tons of coal for $600,000. In computing *gross income from the property* for the year 1956, B will exclude $25,000 (100,000 tons × $0.25) in computing his allowable percentage depletion deduction. B's allowable percentage depletion deduction (without reference to the limitation based on taxable income from the property) for the year 1956 will be $57,500 (($600,000 − $25,000) × 10 percent).

(ii) If bonus payments have been paid in respect of the property in any taxable year or any prior taxable years, there shall be excluded in determining the *gross income from the property*, an amount equal to that part of such payments which is allocable to the product sold (or otherwise giving rise to gross income) for the taxable year. For purposes of the preceding sentence, bonus payments include payments by the lessee with respect to a production payment which is treated as a bonus under section 636(c). Such a production payment is equally allocable to all mineral from the mineral property burdened thereby. The following examples illustrate the provisions of this subdivision:

Example 1. In 1956, A leases oil bearing lands to B, receiving $200,000 as a bonus and reserving a royalty of one-eighth of the proceeds of all oil produced and sold. It is estimated at the time the lease is entered into that there are 1,000,000 barrels of oil recoverable. In 1956, B produces and sells 100,000 barrels for $240,000. In computing his *gross income from the property* for the year 1956, B will exclude $30,000 (⅛ of $240,000), the royalty paid to A, and $20,000 (100,000 bbls. sold/1,000,000 bbls. estimated to be available × $200,000 bonus), the portion of the bonus allocable to the oil produced and sold during the year. However, in computing B's taxable income under section 63, the $20,000 attributable to the bonus payment shall not be either excluded or deducted from B's gross income computed under section 61. (See paragraph (a)(3) of § 1.612–3.)

Example 2. In 1971, C leases to D oil bearing lands estimated to contain 1,000,000 barrels of oil, reserving a royalty of one-eighth of the proceeds of all oil produced and sold and a $500,000 production payment payable out of 50 percent of the first oil produced and sold attributable to the seven-eighths operating interest. In 1972, D produces and sells 100,000 barrels of oil. In computing his *gross income from the property* for the year 1972, D will exclude, in addition to the royalty paid to C, $50,000 (100,000 bbls. sold/1,000,000 bbls. estimated to be available × $500,000 treated under section 636(c) as a bonus), the portion of the production payment allocable to the oil produced and sold during the taxable year. However, in computing D's taxable income under section 63, the $50,000 attributable to the retained production payment shall not be either excluded or deducted from D's gross income computed under section 61.

(iii) If advanced royalties have been paid in respect of the property in any taxable year, the amount excluded from *gross income from the property* of the payor for the current taxable year on account of such payment, shall be an amount equal to the deduction for such taxable year taken on account of such payment pursuant to paragraph (b)(3) of § 1.612–3.

Example. If B in example 2 in paragraph (b)(4) of § 1.612–3, elects to deduct in 1956 the

$10,000 paid to A in that year, he must exclude the same amount from *gross income from the property* in 1956; however, if B elects to defer the deduction until 1957 when he mined and sold the mineral, he must exclude the $10,000 from *gross income from the property* in 1957.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9306, July 27, 1965; T.D. 7170, 37 FR 5374, Mar. 15, 1972; T.D. 7261, 38 FR 5467, Mar. 1, 1973; T.D. 7487, 42 FR 24263, May 13, 1977]

§ 1.613–3 Gross income from the property.

Oil and gas wells. In the case of oil and gas wells, *gross income from the property*, as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or filed price of the oil or gas before conversion or transportation.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6965, 33 FR 10692, July 26, 1968; T.D. 8474, 58 FR 25557, Apr. 27, 1993]

§ 1.613–4 Gross income from the property in the case of minerals other than oil and gas.

(a) *In general.* The rules contained in this section are applicable to the determination of gross income from the property in the case of minerals other than oil and gas and the rules contained in § 1.613–3 are not applicable to such determination, notwithstanding provisions to the contrary in § 1.613–3. The term *gross income from the property*, as used in section 613(c)(1), means, in the case of a mineral property other than an oil or gas property, gross income from mining. *Gross income from mining* is that amount of income which is attributable to the extraction of the ores or minerals from the ground and the application of mining processes, including mining transportation. For the purpose of this section, *ordinary treatment processes* (applicable to the taxable years beginning before January 1, 1961) and *treatment processes considered as mining* (applicable to the taxable years beginning after December 31, 1960) will be referred to as *mining processes*. Processes, including packaging and transportation, which do not qualify as mining will be referred to as *nonmining processes*. Also for the purpose of this section, transportation which qualifies as *mining* will be referred to as *mining transportation* and transportation which does not qualify as *mining* will be referred to as *nonmining transportation*. See paragraph (f) of this section for the definition of the term *mining* and paragraph (g) of this section for rules relating to nonmining processes.

(b) *Sales prior to the application of nonmining processes including nonmining transportation.* (1) Subject to the adjustments required by paragraph (e)(1) of this section, gross income from mining means (except as provided in subparagraph (2) of this paragraph) the actual amount for which the ore or mineral is sold if the taxpayer sells the ore or mineral:

(i) As it emerges from the mine, prior to the application of any process other than a mining process or any transportation, or

(ii) After application of only mining processes, including mining transportation, and before any nonmining transportation

If the taxpayer sells his ore or mineral in more than one form, and if only mining processes are applied to the ore or mineral, gross income from mining is the actual amount for which the various forms of the ore or mineral are sold, after any adjustments required by paragraph (e)(1) of this section. For example, if, at his mine or quarry, a taxpayer sells several sizes of crushed gypsum and also sells gypsum fines produced as an incidental byproduct of his crushing operations, without applying any nonmining processes, gross income from mining will ordinarily be the total amount for which such crushed gypsum and fines are actually sold. See paragraphs (f) and (g) of this section for provisions defining mining and nonmining processes for various minerals.

(2) In the case of sales between members of a controlled group (including sales as to which the district director exercises his authority under section 482 and the regulations thereunder), the prices for such sales (which shall be

deemed to be the actual amount for which the ore or mineral is sold) shall be determined, if possible, by use of the representative market or field price method, as described in paragraph (c) of this section; otherwise such prices shall be determined by the appropriate pricing method as provided in paragraph (d)(1) of this section. For the definitions of the terms *controlled* and *group*, see paragraph (j) (1) and (2) of this section.

(c) *Cases where a representative market or field price for the taxpayer's ore or mineral can be ascertained*—(1) *General rule*. If the taxpayer processes the ore or mineral before sale by the application of nonmining processes (including nonmining transportation), or uses it in his operations, gross income from mining shall be computed by use of the representative market or field price of an ore or mineral of like kind and grade as the taxpayer's ore or mineral after the application of the mining processes actually applied (if any), including mining transportation (if any), and before any nonmining transportation, subject to any adjustments required by paragraph (e)(1) of this section. See paragraph (e)(2)(i) of this section for certain other situations in which this paragraph shall apply. The objective in computing gross income from mining by the representative market or field price method is to ascertain, on the basis of an analysis of actual competitive sales by the taxpayer or others, the dollar figure or amount which most nearly represents the approximate price at which the taxpayer, in light of market conditions, could have sold his ores or minerals if, prior to the application of nonmining processes, the taxpayer had sold the quantities and types of ores and minerals to which he applied nonmining processes. If it is possible to determine a market or field price under the provisions of this paragraph, and if that price is determined to be representative, the taxpayer's gross income from mining shall be determined on the basis of that price and not under the provisions of paragraph (d) of this section. The taxpayer's own actual sales prices for ores or minerals of like kind and grade shall be taken into account when establishing market or field prices, provided that those sales are determined to be representative.

(2) *Criteria for determining whether an ore or mineral is of like kind and grade as the taxpayer's ore or mineral*. An ore or mineral will be considered to be of like kind and grade as the taxpayer's ore or mineral if, in common commercial practice, it is sufficiently similar in chemical, mineralogical, or physical characteristics to the taxpayer's ore or mineral that it is used, or is commercially suitable for use, for essentially the same purposes as the uses to which the taxpayer's ore or mineral is put. Whether an ore or mineral is of like kind and grade as the taxpayer's ore or mineral will generally be determined by reference to industrial or commercial specifications and by consideration of chemical and physical data relating to the minerals and deposits in question. The fact that the taxpayer applies slightly different size reduction processes, or the fact that the taxpayer uses slightly different benefication processes, or the fact that the taxpayer sells his ore or mineral for different purposes, will not, in itself, prevent another person's ore or mineral from being considered to be of like kind and grade as the taxpayer's ore or mineral. On the other hand, the fact that the taxpayer's ore or mineral is suitable for the same general commercial use as another person's ore or mineral will not cause the two ores or minerals to be considered to be of like kind and grade if the desirable natural constituents of the two ores or minerals are markedly different substances. For example, anthracite coal will not be considered to be of like kind as bituminous coal merely because both types of coal can be used as fuel. Similarly, bituminous coal which does not possess coking qualities will not be considered to be of like grade as bituminous coking coal. However, in the case of a taxpayer who mines and uses his bituminous coal in the production of coke, all bituminous coals in the same marketing area will be considered to be of like kind, and all such bituminous coals having the same or similar coking quality suitable for commercial use by coke producers will be considered to be of like grade as the coal mined and used by the taxpayer

Fine distinctions between various grades of minerals are to be avoided unless those distinctions are clearly shown to have genuine commercial significance.

(3) *Factors to be considered in determining the representative market or field price for the taxpayer's ore or mineral.* In determining the representative market or field price for the taxpayer's ore or mineral, consideration shall be given only to prices of ores or minerals of like kind and grade as the taxpayer's ore or mineral and with which, under commercially accepted standards, the taxpayer's ore or mineral would be considered to be in competition if it were sold under the conditions described in paragraph (b)(1) of this section. A weighted average of the competitive selling prices of ores or minerals of like kind and grade as the taxpayer's, beneficiated only by mining processes, if any, in the relevant markets, although not determinative of the representative market or field price, is an important factor in the determination of that price. The taxpayer's own competitive sales prices for minerals which have been subjected only to mining processes shall be taken into account in computing such a weighted average. For purposes of the preceding sentence, if the district director has exercised his authority under section 482 and the regulations thereunder and has determined the appropriate price with respect to specific sales transactions by the taxpayer, that price shall be deemed to be a competitive sales price for those transactions. Sales or purchases, including the taxpayer's, of ores or minerals of like kind and grade as the taxpayer's, will be taken into consideration in determining the representative market or field price for the taxpayer's ore or mineral only if those sales or purchases are the result of competitive transactions. The identity of the taxpayer's relevant markets (including their accessibility to the taxpayer), and the representative market or field price within those markets, are necessarily factual determinations to be made on the basis of the facts and circumstances of each individual case. For the purpose of determining the representative market or field price for the taxpayer's ore or mineral, exceptional, insignificant, unusual, tie-in, or accommodation sales shall be disregarded. Except as provided above, representative market or field prices shall not be determined by reference to prices established between members of a controlled group. See paragraph (j) of this section for the definitions of the terms *controlled* and *group*.

(4) *Use of prices of mineral of different grade.* If there is no representative market or field price for a mineral of like kind and grade as the taxpayer's, representative market or field prices for an ore or mineral which is of like kind but which is not of like grade as his ore or mineral may be used, with appropriate adjustments for differences in mineral content. Representative market or field prices of an ore or mineral of like kind but not of like grade may be used only if such adjustments are readily ascertainable. For example, it may be appropriate in a particular case to establish the representative market or field price for an ore having 50 percent X mineral content by reference to the representative market or field price for the same kind of ore having 60 percent X mineral content with an appropriate adjustment for the differences in the valuable mineral content of the two ores, any differences in processing costs attributable to impurities, and any other relevant factors.

(5) *Information to be furnished by a taxpayer computing gross income from mining by use of a representative market or field price.* A taxpayer who computes his gross income from mining pursuant to the provisions of this paragraph shall attach to his return a summary statement indicating the prices used by him in computing gross income from mining under this paragraph and the source of his information as to those prices, and the relevant supporting data shall be assembled, segregated, and made readily available at the taxpayer's principal place of business.

(6) *Limitation on gross income from mining computed under the provisions of this paragraph.* It shall be presumed that a price is not a representative market or field price for the taxpayer's ore or mineral if the sum of such price plus the total of all costs of the nonmining processes (including nonmining

transportation) which the taxpayer applies to his ore or mineral regularly exceeds the taxpayer's actual sales price of his product. For example, if on a regular basis the total of all costs of nonmining processes applied by the taxpayer to coal for the purpose of making coke is $12 per ton, and if the taxpayer's actual sale price for such coke is $18 per ton, a price of $7 per ton would not be a representative market or field price for the taxpayer's coal which is used for making coke. In order to rebut the presumption set forth in the first sentence of this subparagraph, it must be established that the loss on nonmining operations is directly attributable to unusual, peculiar and nonrecurring factors rather than to the use of a market or field price which is not representative. For example, the first sentence of this subparagraph shall not apply if the taxpayer establishes in an appropriate case that the loss on nonmining operations is directly attributable to an event such as a fire, flood, explosion, earthquake, or strike.

(d) *Cases where a representative market or field price cannot be ascertained*—(1) *General rule.* (i) If it is impossible to determine a representative market or field price as described in paragraph (c) of this section then, except as provided in subdivision (ii) of this subparagraph, gross income from mining shall be computed by use of the proportionate profits method as set forth in subparagraph (4) of this paragraph. A method of computing gross income from mining under the provisions of this paragraph shall not be deemed to be a method of accounting for purposes of paragraph (e) of § 1.446–1.

(ii)(*a*) The Office of the Assistant Commissioner (Technical) may determine that a method of computation is more appropriate than the proportionate profits method or the method being used by the taxpayer. The taxpayer may request such a determination (see (*d*) of this subdivision (ii)). If the taxpayer is using a method of computation which has been determined by the Office of Assistant Commissioner (Technical) to be more appropriate than the proportionate profits method, such method shall continue to be used until it is determined by the Office of Assistant Commissioner (Technical) that either the proportionate profits method or another method is more appropriate.

(*b*) The proportionate profits method is more appropriate than the method being used under (*a*) if, under the particular facts and circumstances, the method being used under (*a*) consistently fails to clearly reflect gross income from mining and the proportionate profits method more clearly reflects gross income from mining for the taxable year.

(*c*) An alternative method (a method other than the method being used under (*a*) (if any) and the proportionate profits method) is more appropriate than the method being used under (*a*) (if any) and the proportionate profits method if, under the particular facts and circumstances, the latter methods consistently fail to clearly reflect gross income from mining, and the alternative method being considered more clearly reflects gross income from mining on a consistent basis than the method being used under (*a*) (if any) and the proportionate profits method. When determining whether a method of computation clearly reflects gross income from mining, it is relevant to compare the gross income from mining produced by such method with the gross income from mining, on an equivalent amount of production, which results from the computation methods used by competitors. When determining the acceptability of proposed alternative methods, primary consideration will be given to computation methods based upon representative charges for ores, minerals, products, or services. See paragraph (c) of this section for principles determining the representative character of a charge.

(*d*) Application for permission to compute gross income from mining by use of an alternative method shall be made by submitting a request to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Technical), Washington, DC 20224.

(*e*) Among the alternative methods of computation to which consideration will be given, provided that the requirements of this subdivision (ii) are

met, are the methods listed in subparagraphs (5), (6), and (7) of this paragraph. The order in which these methods are listed is not significant, and the listing of these methods does not preclude a request to make use of a method which is not listed.

(iii) Approval and continued use of any method of computation under this paragraph depends upon all the facts and circumstances in each case, and shall be subject to such terms and conditions as may be necessary in the opinion of the Commissioner to reflect clearly the gross income from mining. Accordingly, the use of such a method for any taxable year shall be subject to review and change.

(2) *Costs to be used in computing gross income from mining by use of methods based on the taxpayer's costs.* In determining the taxpayer's gross income from mining by use of methods based on the taxpayer's costs, only costs actually paid or incurred shall be taken into consideration. In general, if the taxpayer has consistently employed a reasonable method of determining the costs of the various individual phases of his mining and nonmining processes (such as extraction, loading for shipment, calcining, packaging, etc.), such method shall not be disturbed. The amount of any particular item to be taken into account shall, for taxable years beginning after November 30, 1968, be the amount used in determining the taxpayer's income for tax purposes. For example, the depreciation lives, methods, and records used for tax purposes, if different from those used for book purposes, shall be the basis for determining the amount of depreciation to be used. However, a taxpayer may continue to use a reasonable method for determining those costs on the basis of the amounts computed for cost control or similar financial or accounting books and records if that method has been used consistently and is applied to the determination of all those costs.

(3) *Treatment of particular items in computing gross income from the mining by use of methods based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from mining by use of methods based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced therefrom, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relating to purchased transportation to the customer and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. As an example, where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from

the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to those plants or mills in excess of 50 miles (or of that greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to that excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding sentence shall apply only to taxable years beginning after November 30, 1968.

(ii) In determining gross income from mining by use of methods based on the taxpayer's costs, a process shall not be considered as a mining process to the extent it is applied to ores, minerals, or other materials with respect to which the taxpayer is not entitled to a deduction for depletion under section 611. The costs of such nondepletable ores, minerals, or materials; the costs of the processes (including blending, size reduction, etc.) applied thereto; and the transportation costs thereof, if any, shall be considered as nominating costs in determining gross income from mining. If a mining process is applied to an admixture of depletable and nondepletable material, the cost of the process and the cost of transportation, if any, attributable to the nondepletable material shall be considered as nonmining costs in determining gross income from mining. Accordingly, all profits attributable thereto are treated as nonmining profits. In the absence of other methods which clearly reflect the cost attributable to the processing and transportation, if any, of the nondepletable admixed material, that cost shall be deemed to be that proportion of the costs which the tonnage of nondepletable material bears to the total tonnage of both depletable and nondepletable material.

(iii) In determining gross income from mining by use of methods based on the taxpayer's costs:

(*a*) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(*b*) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(*c*) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from mining by the use of methods based on the taxpayer's costs, the principles set forth in paragraph (c) of §1.613–5 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

(v) See paragraph (e)(1) of this section for provisions excluding certain allowances from the taxpayer's gross sales and costs of his first marketable product or group of products.

(4) *Proportionate profits method.* (i) The objective of the *proportionate profits method* of computation is to ascertain gross income from mining by applying the principle that each dollar of the total costs paid or incurred to produce, sell, and transport the first marketable product or group of products (as defined in subdivision (iv) of this subparagraph) earns the same percentage of profit. Accordingly, in the proportionate profits method no ranking of costs is permissible which results in excluding or minimizing the effect of any costs incurred to produce, sell, and transport the first marketable product or group of products. For purposes of this subparagraph, members of a controlled group shall be treated as divisions of a single taxpayer. See paragraph (j) of this section for the definitions of the terms *controlled* and *group*.

(ii) The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales (actual or constructive) of his first marketable product or group of products (after making the adjustments required

by paragraph (e) of this section) by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the first marketable product or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the first marketable product or group of products (after making the adjustments required by this paragraph and paragraph (e) of this section). The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, section 39.23(m)–1 (e)(3) (1939 Code). The proportionate profits method of computation may be illustrated by the following equation:

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{Gross sales} = \text{Gross income from mining}$$

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall, in the absence of a specific provision of this section providing an apportionment method, be apportioned to mining and to nonmining by use of a method which is reasonable under the circumstances. One method which may be reasonable in a particular case is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which may reasonably be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes. On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c)(4) of § 1.613–5.

(iv) As used in this section, the term *first marketable product or group of products* means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. Sales between members of a controlled group (as defined in paragraph (j) of this section) shall not be considered in making a determination under this subdivision. The first marketable product or group of products does not include any product which results from additional manufacturing or other nonmining processes applied to the product or products first marketed in significant quantities by the taxpayer or others in the taxpayer's marketing area. For example, if a cement manufacturer sells his own finished cement in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement, in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an integrated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further, if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v)(*a*) As used in this subparagraph, the term *gross sales (actual or constructive)* means the total of the taxpayer's actual competitive sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or

retained for use in his own subsequent operations, subject to the adjustments required by paragraph (e) of this section. See (*b*) of this subdivision in the case of actual sales between members of controlled groups and in the case of constructive sales. A *constructive sale* occurs when a miner-manufacturer is deemed, for percentage depletion purposes, to be selling the first marketable product or group of products to himself.

(*b*) In the case of sales between members of a controlled group as to which the district director has exercised his authority under section 482 and the regulations thereunder and has determined the appropriate price with respect to specific sales transactions, that price shall be deemed, for those transactions, to be the actual amount for which the first marketable product or group of products is sold for purposes of this subdivision (v). In the case of all other sales between members of a controlled group, and in the case of constructive sales, the prices for such sales shall be determined by use of the principles set forth in paragraph (c) of this section, subject to the adjustments required by paragraph (e) of this section. In the case of constructive sales, see paragraph (c)(4) of this section for rules relating to information to be furnished by the taxpayer.

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

Example 1. (a) Facts. A is engaged in the mining of a mineral to which section 613 applies and in the application thereto of nonmining processes. During 1968, A incurred extraction costs of $35,000; other mining costs of $56,000; $150,000 for manufacturing costs; $46,000 for other nonmining processes; and $14,000 for the company president's salary and similiar costs resulting from both nonmining and mining processes. During that year, A produced and sold 70,000 tons of his first marketable product for an actual gross sales price of $420,000, after the adjustments required by paragraph (e) of this section. A representative market or field price for A's mineral before the application of nonmining processes cannot be established.

(*b*) *Computation. (1*) The computation of A's gross income from mining by use of the proportionate profits method involves two steps. The first step is to apportion A's costs to mining and to nonmining. A apportions the company president's salary and similiar costs to mining and to nonmining in the manner described in the second and third sentences of subdivision (iii) of this subparagraph, and apportions his remaining costs as follows:

Cost	Mining	Nonmining	Total
Extraction	$35,000	.....	$35,000
Other mining processes	56,000	.....	56,000
Manufacturing	.....	$150,000	150,000
Other nonmining processes	.....	46,000	46,000
Subtotal	91,000	196,000	287,000
President's salary and similar costs	4,439	9,561	14,000
Total costs	95,439	205,561	301,000

(*2*) The second step is to apply the proportionate profits fraction so as to compute A's gross income from mining. To do this, A first computes his gross sales of his first marketable group of products, in this case $420,000. A multiplies his actual gross sales of $420,000 by the proportionate profits fraction, whose numerator consists of his total mining costs ($95,439) and whose denominator consists of his total costs ($301,000). Thus, A's gross income from mining is $133,170 (*i.e.,* 95,439/301,000ths of A's actual gross sales of $420,000).

Example 2. B, who leases a mineral property from C, is engaged in the mining of a mineral to which section 613 applies and in the application thereto of nonmining processes. Pursuant to the terms of the lease, B is required to pay C 10 cents for each ton of mineral which B mines. During 1971, B extracted 100,000 tons of mineral. He sold his first marketable product for an actual gross sales price of $225,000 after the adjustments required by paragraph (e) of this section. A representative market or field price for B's mineral before the application of nonmining processes cannot be established. During 1971, with respect to the 100,000 tons of mineral extracted, B incurred mining costs of $50,000 and nonmining costs of $100,000, and paid $10,000 to C as C's royalty. Since the royalty payment is considered to be C's share of the gross income from mining under section 613(a), it is not considered to be either a mining cost or a nonmining cost of B. B's gross income from mining is $65,000 under the proportionate profits method, determined as follows: The $225,000 gross receipts must be multiplied by the proportionate profits fraction which is $50,000 mining costs over $150,000 total costs ($50,000 + $100,000 nonmining costs). Since the resulting $75,000 is the total gross income from mining with respect to the property, it must be allocated between B's lease interest and C's royalty interest. The $10,000 paid to C must be subtracted from the $75,000 leaving $65,000 which represents B's gross income from mining. C's

gross income from mining is the royalty he received or $10,000.

(5) *Representative schedule method.* The *representative schedule method* is a pricing formula which uses representative finished product prices, penalties, charges and adjustments, established in arms-length transactions between unrelated parties, to determine the market or field price for a crude mineral product. The representative character of a price, penalty, charge, or adjustment shall be determined by applying the principles set forth in paragraph (c) of this section. The representative schedule method is principally intended for use in those industries in which such a schedule-type pricing method is in general use to determine the price paid to unintegrated mineral producers for their crude mineral product. For example, if unintegrated producers of copper concentrate in a particular field or market customarily sell their product at prices which are determined in accordance with a schedule-type pricing formula, consideration will be given to the determination of concentrate prices for integrated copper producers in accordance with the same pricing formula. The representative schedule method shall not be used if it is impossible to determine one or more of the elements in the representative schedule formula by reference to prices, penalties, charges, or adjustments established in representative transactions between unrelated parties. See paragraph (c) of this section for principles determining the representative character of a charge.

(6) *Method using prices outside the taxpayer's market.* Under the *other market method* the taxpayer uses representative market or field prices established outside his markets, provided that conditions there are substantially the same as in his markets. For example, it may be appropriate in a particular case to establish the representative market or field price for pellets containing 60 percent iron which are produced and used in market area X by reference to the representative market or field price for pellets containing 60 percent iron which are produced and sold in adjacent market area Y, provided that conditions in the two marketing areas are shown to be substantially the same.

(7) *Rate of return on investment method.* [Reserved]

(e) *Reductions of sales price in computing gross income from mining*—(1) *Discounts.* If a taxpayer computes gross income from mining under the provisions of paragraph (b)(1) of this section, trade discounts and, for taxable years beginning after November 30, 1968, cash discounts actually allowed by the taxpayer shall be subtracted from the sale price of the taxpayer's ore or mineral. If a taxpayer computes gross income from mining under the provisions of paragraph (c) of this section, any such discounts actually allowed (if not otherwise taken into account) by the person or persons making the sales on the basis of which the representative market or field price for the taxpayer's ore or mineral is to be determined shall be subtracted from the sale price in computing such representative market or field price. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, such discounts actually allowed (if not otherwise taken into account) shall be subtracted from the gross sales (actual or constructive), and shall not be considered a cost, of the first marketable product or group of products. The provisions of this subparagraph shall apply to arrangements which have the same effect as trade or cash discounts, regardless of the form of the arrangements.

(2) *Purchased transportation to the customer.* (i) A taxpayer who computes gross income from mining under the provisions of paragraph (c) of this section and who sells his ore or mineral after the application of only mining processes but after nonmining transportation shall use as the representative market or field price his delivered price (if otherwise representative) reduced by costs paid or incurred by him for purchased transportation to the customer as defined in subdivision (iii) of this subparagraph. If the transportation by the taxpayer is not purchased transportation to the customer, or if the taxpayer does not sell the ore or mineral until after the application of nonmining processes, and if other producers in the taxpayer's marketing

area sell significant quantities of an ore or mineral of like kind and grade after the application of only mining processes but after purchased transportation to the customer, the representative delivered price at which the ore or mineral is sold by those other producers reduced by representative costs of purchased transportation to the customer paid or incurred by those producers shall be used by the taxpayer as the representative market or field price for his ore or mineral in applying paragraph (c) of this section. Furthermore, appropriate adjustments shall be made to take into account differences in mode of transportation and distance. When applying this subdivision, the representative market or field price so computed shall not exceed the taxpayer's delivered price less his actual costs of transportation to the customer. For purposes of this subdivision, any delivered price shall be adjusted as provided in subparagraph (1) of this paragraph.

(ii) If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the cost of purchased transportation to the customer (as defined in subdivision (iii) of this subparagraph) shall be excluded from the gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph), and from the denominator of the proportionate profits fraction, so as not to attribute profits to the cost of that transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of other methods of computation which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which is not purchased transportation to the customer as defined in subdivision (iii) of this subparagraph, see paragraph (d)(3)(i) of this section.

(iii) For purposes of this section, the term *purchased transportation to the customer* means, in general, nonmining transportation of the taxpayer's minerals or mineral products to the customer:

(*a*) Which is not performed in conveyances owned or leased directly or indirectly, in whole or in part, by the taxpayer,

(*b*) Which is performed solely to deliver the taxpayer's minerals or mineral products to the customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidental storage or handling), and

(*c*) With respect to which the taxpayer ordinarily does not earn any profit

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (j)(1) of this section) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b)(1) of §1.482–1). The term *purchased transportation to the customer* includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. A taxpayer will not be deemed ordinarily to earn a profit on transportation merely because charges for the transportation are included in the stated selling price, rather than being separately stated or segregated from other billing. A taxpayer will not be deemed ordinarily to earn a profit on transportation if the rates for the transportation constitute an arm's-length charge ordinarily paid by shippers of the same product in similar circumstances. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the term *purchased transportation to the customer* refers to transportation which conforms to the other requirements of this subdivision and which is performed to transport the taxpayer's first marketable product or group of products (as defined in paragraph (d)(4)(iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

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

Example 1. A is engaged in the mining of an ore of mineral M and in the production and sale of M concentrate. A retains a portion of his concentrate for use in his own nonmining operations. During 1968, A sold 100,000 tons of M concentrate of ore mined and processed by him, which sales constituted a significant portion of his total production. Eighty thousand tons of that concentrate were sold by A on the basis of a representative price (after adjustments required by subparagraph (1) of this paragraph) of $30 per ton f.o.b. mine or plant, resulting in gross income from mining of $2,400,000. The remaining 20,000 tons were sold by A, both directly and through terminals, on the basis of a delivered price (after adjustments required by subparagraph (1) of this paragraph) at City X of $40 per ton. The delivered price included $15 per ton cost of purchased transportation from the mine or plant to customers in City X. The representative market or field price of the concentrate sold by A on the basis of a delivered price is $25 per ton, determined by subtracting the cost of the purchased transportation to the customer ($15 per ton) from the delivered price for the concentrate ($40 per ton). Accordingly, A's gross income from mining with respect to the 20,000 tons of M concentrate sold on a delivered basis is $500,000. The representative market or field price for the concentrate retained by A and used in his own nonmining operations may be computed by reference to the weighted average price for both A's f.o.b. mine and A's delivered sales of concentrate, with the delivered sales prices reduced in the manner described above. On this basis, the representative market or field price for the retained concentrate is $29 per ton.

Example 2. B is engaged in the mining of an ore of mineral N and in the production of N concentrate. B retained all but an insignificant amount of his concentrate for use in his own nonmining operations. Other producers in B's marketing area sell significant amounts of N concentrate of like kind and grade, both on an f.o.b. mine or plant basis and on a delivered basis. In this case, the prices for both the f.o.b. and the delivered sales made by other producers (after any adjustments required by subparagraph (1) of this paragraph), after reduction of the delivered prices by the cost of purchased transportation to the customer, shall, if such prices are otherwise representative, be taken into account in establishing the representative market or field price for the N concentrate produced and used by B.

(f) *Definition of mining*—(1) *In general.* The term *mining* includes only:

(i) The extraction of ores or minerals from the ground;

(ii) Mining processes, as described in subparagraphs (2) through (6) of this paragraph; and

(iii) So much of the transportation (whether or not by common carrier) of ores or minerals from the point of extraction of the ores or minerals from the ground to the plants or mills in which the processes referred to in subdivision (ii) of this subparagraph are applied thereto as is not in excess of 50 miles, and, if the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over such greater distance as the Commissioner authorizes. See paragraph (h) of this section for rules relating to the filing of applications to treat as mining any transportation in excess of 50 miles.

(2) *Definition of mining processes.* (i) As used in subparagraph (1)(ii) of this paragraph, the term *mining processes* means, for taxable years beginning before January 1, 1961, the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, including the following processes (and the processes necessary or incidental thereto), and, for taxable years beginning after December 31, 1960, the following processes (and the processes necessary or incidental thereto):

(*a*) In the case of coal—cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

(*b*) In the case of sulfur recovered by the Frasch process—cleaning, pumping to vats, cooling, breaking, and loading for shipment;

(*c*) In the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and ores or minerals which are customarily sold in the form of a crude mineral product (as defined in subparagraph (3)(iv) of this paragraph):

(*1*) Where applied for the purpose of bringing to shipping grade and form (as defined in subparagraph (3)(iii) of this paragraph)—sorting, concentrating, sintering, and substantially equivalent processes, and

(*2*) Loading for shipment.

(*d*) In the case of lead, zinc, copper, gold, silver, uranium, or fluorspar ores, potash, and ores or minerals which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore or the mineral or minerals from other material from the mine or other natural deposit; and

(*e*) In the case of the following ores or minerals:

(*1*) The furnacing of quicksilver ores,

(*2*) The pulverization of talc,

(*3*) The burning of magnesite, and

(*4*) The sintering and nodulizing of phosphate rock.

(ii) The term *mining processes* also includes the following processes (and, except as otherwise provided in this subdivision, the processes necessary or incidental thereto):

(*a*) For taxable years beginning after December 31, 1960, in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

(*b*) For taxable years beginning after December 31, 1960, and before November 14, 1966, in the case of clay to which former section 613(b)(5)(B) applied, and for taxable years beginning after November 13, 1966, in the case of clay to which section 613(b) (5) or (6) (B) applies—crushing, grinding, and separating the clay from waste, but not including any subsequent process;

(*c*) For taxable years beginning after October 9, 1969, in the case of minerals (other than sodium chloride) extracted from brines pumped from a saline perennial lake (as defined in paragraph (b) of §1.613–2)—the extraction of such minerals from the brines, but in no case including any further processing or refining of such extracted minerals; and

(*d*) For taxable years beginning after December 30, 1969, in the case of oil shale (as defined in paragraph (b) of §1.613–2)—extraction from the ground, crushing, loading into the retort, and retorting, but in no case hydrogenation, refining, or any other process subsequent to retorting.

(iii) A process is *necessary* to another related process if it is prerequisite to the performance of the other process. For example, if the concentrating of low-grade iron ores to bring to shipping grade and form cannot be effectively accomplished without fine pulverization, such pulverization shall be treated as a process which is *necessary* to the concentration process. Accordingly, because concentration is a mining process, such pulverization is also a mining process. Furthermore, if mining processes cannot be effectively applied to a mineral without storage of the mineral while awaiting the application of such processes, such storage shall be treated as a process which is *necessary* to the accomplishment of such mining processes. A process is *incidental* to another related process if the cost thereof is insubstantial in relation to the cost of the other process, or if the process is merely the coincidental result of the application of the other process. For example, the sprinkling of coal, prior to loading for shipment, with dots of paper to identify the coal for tradename purposes will be considered incidental to the loading where the cost of that sprinkling is insubstantial in relation to the cost of the loading process. Also, where crushing of a crude mineral is treated as a mining process, the production of fines as a byproduct is ordinarily the coincidental result of the application of a mining process. If a taxpayer demonstrates that, as a factual matter, a particular process is necessary or incidental to a process named as a mining process in section 613(c)(4) of this paragraph, the necessary or incidental process will also be considered a mining process.

(iv) The term *mining* does not include purchasing minerals from another. Accordingly, the processes listed in this paragraph shall be considered as mining processes only to the extent that they are applied by a mine owner or operator to an ore or mineral in respect

of which he is entitled to a deduction for depletion under section 611. The application of these processes to purchased ores, minerals, or materials does not constitute mining.

(3) *Processes recognized as mining for ores or minerals covered by section 613(c)(4)(C).* (i) As used in section 613(c)(4)(C) and subparagraph (2)(i) (*c*) of this paragraph, the terms *sorting* and *concentrating* mean the process of eliminating substantial amounts of the impurities or foreign matter associated with the ores or minerals in their natural state, or of separating two or more valuable minerals or ores, without changing the physical or chemical identity of the ores or minerals. Examples of sorting and concentrating processes are hand or mechanical sorting, magnetic separation, gravity concentration, jigging, the use of shaking or concentrating tables, the use of spiral concentrators, the use of sluices or sluice boxes, sink-and-float processes, classifiers, hydrotators and flotation processes. Under section 613(c)(4)(C), sorting and concentration will be considered mining processes only where they are applied to bring an ore or mineral to shipping grade and form.

(ii) As used in section 613(c)(4)(C) and subparagraph (2)(i)(*c*) of this paragraph, the term *sintering* means the agglomeration of fine particles by heating to a temperature at which incipient, but not complete, fusion occurs. Sintering will be considered a mining process only where it is applied to an ore or mineral, or a concentrate of an ore or mineral, as an auxiliary process necessary to bring the ore or mineral to shipping form. A thermal action which is applied in the manufacture of a finished product will not be considered to be a mining process even though such thermal action may cause the agglomeration of fine particles by incipient fusion, and even though such action does not cause a chemical change in the agglomerated particles. For example, the sintering of finely ground iron ore concentrate, prior to shipment from the concentration plant, for the purpose of preventing the risk of loss of the finely divided particles during shipment is considered a mining process. On the other hand, for example, a heating process applied to expand or harden clay, shale, perlite, vermiculite, or other materials in the course of the manufacture of lightweight aggregate or other building materials is not considered to be a mining process.

(iii) As used in section 613(c)(4)(C) and this section, to *bring to shipping grade and form* means, with respect to taxable years beginning after December 31, 1960, to bring (by the application of mining processes at the mine or concentration plant) the quality or size of an ore or mineral to the stage or stages at which the ore or mineral is shipped to customers or used in nonmining processes (as defined in paragraph (g) of this section) by the taxpayer.

(iv) An ore or mineral is *customarily sold in the form of a crude mineral product,* within the meaning of section 613 (c)(4)(C), if a significant portion of the production thereof is sold or used in a nonmining process prior to the alteration of its inherent mineral content by some form of beneficiation, concentration, or ore dressing. An ore or mineral does not lose its classification as a crude mineral product by reason of the fact that, before sale or use in a nonmining process, the ore or mineral may be crushed or subjected to other processes which do not alter its inherent mineral content. Whether the portion of production sold or used in the form of a crude mineral product is a significant portion of the total production of an ore or mineral is a question of fact.

(4) *Type of processes recognized as mining for ores or minerals covered by section 613(c)(4)(D).* Cyanidation, leaching, crystallization, and precipitation, which are listed in section 613(c)(4)(D) as treatment processes considered as mining, and the processes (or combination of processes) which are substantially equivalent thereto, will be recognized as mining only to the extent that they are applied to the taxpayer's ore or mineral for the purpose of separation or extraction of the valuable mineral product or products from the ore, or for the purpose of separation or extraction of the mineral or minerals from other material extracted from the mine or other natural deposit. A process, no matter how denominated, will not be recognized as mining if the process beneficiates the ore or mineral to

the degree that such process, in effect, constitutes smelting, refining, or any other nonmining process within the meaning of paragraph (g) of this section. As used in section 613(c)(4)(D) and subparagraph (2)(i) (*d*) of this paragraph, the term *concentration* has the meaning set forth in the first two sentences of subparagraph (3)(i) of this paragraph.

(5) *Processes recognized as mining under section 613(c)(4)(I).* Under the authority granted the Secretary or his delegate in section 613(c)(4)(I), the processes which are described in subdivisions (i) through (iv) of this subparagraph, and the processes necessary or incidental thereto, are recognized as mining processes for taxable years beginning after December 31, 1960. The processes described in subdivisions (i) through (iv) of this subparagraph are in addition to the specific processes recognized as mining under section 613(c)(4). Such additional processes are:

(i) Crushing and grinding, but not fine pulverization (as defined in paragraph (g) (6) (v) of this section);

(ii) Size classification processes applied to the products of an allowable mining process;

(iii) Drying to remove free water, provided that such drying does not change the physical or chemical identity or composition of the mineral; and

(iv) Washing or cleaning the surface of mineral particles (including the washing of sand and gravel and the treatment of kaolin particles to remove surface stains), provided that such washing or cleaning does not activate or otherwise change the physical or chemical structure of the mineral particles.

(6) In the case of a process applied subsequent to a nonmining process, see paragraph (g)(2) of this section.

(g) *Nonmining processes*—(1) *General rule.* Unless they are otherwise provided for in paragraph (f) of this section as mining processes (or are necessary or incidental to processes listed therein), the following processes are not considered to be mining processes—electrolytic deposition, roasting, calcining, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, thermal action, and molding or shaping. See subparagraph (6) of this paragraph for definitions of certain of these terms.

(2) *Processes subsequent to nonmining processes.* Notwithstanding any other provision of this section, a process applied subsequent to a nonmining process (other than nonmining transportation) shall also be considered to be a nonmining process. Exceptions to this rule shall be made, however, in those instances in which the rule would discriminate between similarly situated producers of the same mineral. For example, roasting is specifically designated in subparagraph (1) of this paragraph as a nonmining process, but in the case of minerals referred to in section 613(c)(4)(C) sintering is recognized as a mining process. If certain impurities in an ore can only be removed by roasting in order to bring it to the same shipping grade and form as a competitive sintered ore of the same kind which requires no roasting, the subsequent sintering of the roasted ore will be treated as a mining process. In that case, however, the roasting of the ore will nonetheless continue to be treated as a nonmining process.

(3) *Transportation for the purpose of marketing or distribution; storage.* Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining. Nor shall transportation be considered as mining merely because, during the course of such transportation, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow. Similarly, storage or warehousing of manufactured products shall not be considered as mining. The preceding sentence shall apply even though, during the course of such storage or warehousing, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow.

(4) *Manufacturing, etc.* The production, packaging, distribution, and marketing of manufactured products, and the processes necessary or incidental thereto, are nonmining processes.

(5) *Transformation processes.* Processes which effect a substantial physical or chemical change in a crude mineral product, or which transform a crude mineral product into new or different mineral products, or into refined or manufactured products, are nonmining processes except to the extent that such processes are allowed as mining processes under section 613(c) or under paragraph (f) of this section.

(6) *Definitions.* As used in section 613(c)(5) and this section:

(i) The term *calcining* refers to processes used to expel the volatile portions of a mineral by the application of heat, as, for example, the burning of carbonate rock to produce lime, the heating of gypsum to produce calcined gypsum or plaster of Paris, or the heating of clays to reduce water of crystallization.

(ii) The term *thermal smelting* refers to processes which reduce, separate, or remove impurities from ores or minerals by the application of heat, as, for example, the furnacing of copper concentrates, the heating of iron ores, concentrates, or pellets in a blast furnace to produce pig iron, or the heating of iron ores or concentrates in a direct reduction kiln to produce a feed for direct conversion into steel.

(iii) The term *refining* refers to processes (other than mining processes designated in section 613(c)(4) or this section) used to eliminate impurities or foreign matter from smelted or partially processed metallic and nonmetallic ores and minerals, as, for example, the refining of blister copper. In general, a refining process is designed to achieve a high degree of purity by removing relatively small amounts of impurities or foreign matter from smelted or partially processed ores or minerals.

(iv) The term *polishing* refers to processes used to smooth the surface of minerals, as, for example, sawing applied to finish rough cut blocks of stone, sand finishing, buffing, or otherwise smoothing blocks of stone.

(v) The term *fine pulverization* refers to any grinding or other size reduction process applied to reduce the normal topsize of a mineral product to less than .0331 inches, which is the size opening in a No. 20 Screen (U.S. Standard Sieve Series). A mineral product will be considered to have a normal topsize of .0331 inches if at least 98 percent of the product will pass through a No. 20 Screen (U.S. Standard Sieve Series), provided that at least 5 percent of the product is retained on a No. 45 Screen (U.S. Standard Sieve Series). Compliance with the normal topsize test may also be demonstrated by other tests which are shown to be reasonable in the circumstances. The normal topsize test shall be applied to the product of the operation of each separate and distinct piece of size reduction equipment utilized (such as a roller mill), rather than to the final products for sale. Fine pulverization includes the repeated recirculation of material through crushing or grinding equipment to accomplish fine pulverization. Separating or screening the product of a fine pulverization process (including separation by air or water flotation) shall be treated as a nonmining process.

(vi) The term *blending with other materials* refers to processes used to blend different kinds of minerals with one another, as, for example, blending iodine with common salt for the purpose of producing iodized table salt.

(vii) The term *treatment effecting a chemical change* refers to processes which transform or modify the chemical composition of a crude mineral, as, for example, the coking of coal. The term does not include the use of chemicals to clean the surface of mineral particles provided that such cleaning does not make any change in the physical or chemical structure of the mineral particles.

(viii) The term *thermal action* refers to processes which involve the application of artificial heat to ores or minerals, such as, for example, the burning of bricks, the coking of coal, the expansion or popping of perlite, the exfoliation of vermiculite, the heat treatment of garnet, and the heating of shale, clay, or slate to produce lightweight aggregates. The term does not include drying to remove free water.

(h) *Application to treat, as mining, transportation in excess of 50 miles.* If a taxpayer desires to include in the computation of his gross income from mining transportation in excess of 50 miles

from the point of extraction of the minerals from the ground, he shall file an original and one copy of an application for the inclusion of such greater distance with the Commissioner of Internal Revenue, Washington, DC 20224. The application must include a statement setting forth in detail the facts concerning the physical and other requirements which prevented the construction and operation of the plant (in which mining processes, as defined in paragraph (f) of this section, are applied) at a place nearer to the point of extraction from the ground. These facts must be sufficient to apprise the Commissioner of the exact basis of the application. If the taxpayer's return is filed prior to receipt of notice of the Commissioner's action upon the application, a copy of such application shall be attached to the return. If, after an application is approved by the Commissioner, there is a material change in any of the facts relied upon in such application, a new application must be submitted by the taxpayer.

(i) *Extraction from waste or residue. Extraction of ores or minerals from the ground* means not only the extraction of ores or minerals from a deposit, but also the extraction by mine owners or operators of ores or minerals from waste or residue of their prior mining. It is immaterial whether the waste or residue results from the process of extraction from the ground or from application of mining processes as defined in paragraph (f) of this section. However, extraction of ores or minerals from waste or residue which results from processes which are not allowable as mining processes is not treated as mining. *Extraction of ores or minerals from the ground* does not include extraction of ores or minerals by the purchaser of waste or residue or the purchaser of the rights to extract ores or minerals from waste or residue. The term *purchaser* does not apply to any person who acquires a mineral property, including waste or residue, in a tax-free exchange, such as a corporate reorganization, from a person who was entitled to a depletion allowance upon ores or minerals produced from such waste or residue, or from a person who would have been entitled to such depletion allowance had section 613(c)(3) been in effect at the time of the transfer. The term *purchaser* also does not apply to a lessee who has renewed a mineral lease if the lessee was entitled to a depletion allowance (or would have been so entitled had section 613(c)(3) been in effect at the time of the renewal) upon ores or minerals produced from waste or residue before renewal of the lease. It is not necessary, for purposes of the preceding sentence, that the mineral lease contain an option for renewal. The term *purchaser* does include a person who acquires waste or residue in a taxable transaction, even though such waste or residue is acquired merely as an incidental part of the entire mineral enterprise. For special rules with respect to certain corporate acquisitions referred to in section 381(a), see section 381(c)(18) and the regulations thereunder.

(j) *Definition of controlled group.* When used in this section:

(1) The term *controlled* includes any kind of control, direct or indirect, whether or not legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(2) The term *group* means the organizations, trades, or businesses owned or controlled by the same interests.

[T.D. 7170, 37 FR 5374, Mar. 15, 1972]

§ 1.613–5 Taxable income from the property.

(a) *General rule.* The term *taxable income from the property (computed without allowance for depletion*), as used in section 613 and this part, means *gross income from the property* as defined in section 613(c) and §§ 1.613–3 and 1.613–4, less all allowable deductions (excluding any deduction for depletion) which are attributable to mining processes, including mining transportation, with respect to which depletion is claimed. These deductible items include operating expenses, certain selling expenses, administrative and financial overhead, depreciation, taxes deductible under section 162 or 164, losses sustained, intangible drilling and development costs, exploration and development expenditures, etc. See paragraph

(c) of this section for special rules relating to discounts and to certain of these deductible items. Expenditures which may be attributable both to the mineral property upon which depletion is claimed and to other activities shall be properly apportioned to the mineral property and to such other activities. Furthermore, where a taxpayer has more than one mineral property, deductions which are not directly attributable to a specific mineral property shall be properly apportioned among the several properties. In determining the taxpayer's taxable income from the property, the amount of any particular item to be taken into account shall be determined in accordance with the principles set forth in paragraph (d)(2) and (3) of § 1.613–4.

(b) *Special rule; decrease in mining expenses resulting from gain recognized under section 1245(a)(1).* (1) If during any taxable year beginning after December 31, 1962, the taxpayer disposes of an item of section 1245 property (as defined in section 1245(a)(3)) which has been used in connection with a mineral property, then for the purpose of computing the taxable income from such mineral property for such taxable year, the allowable deductions taken into account with respect to expenses of mining (that is, expenses attributable to a mineral property other than an oil and gas property) shall be decreased by an amount equal to the portion of any gain recognized under section 1245(a)(1) (relating to treatment of gain from dispositions of certain depreciable property as ordinary income) which is properly allocable to such mineral property in respect of which the taxable income is being computed. The portion of such gain which is properly allocable to such mineral property shall bear the same ratio to the total of such gain as:

(i) The portion of the *adjustments reflected in the adjusted basis* (as such term is defined in paragraph (a)(2) of § 1.1245–2, relating to definition of recomputed basis) of such section 1245 property, which were allowable as deductions from the *gross income from the property* (as defined in section 613 (c) and § 1.613–3) in computing the taxable income from such mineral property, bears to

(ii) The total of the *adjustments reflected in the adjusted basis* of such section 1245 property.

(2) For the purposes of this paragraph, the adjustments reflected in the adjusted basis of the section 1245 property disposed of shall be deemed to have been taken into account in computing the taxable income from the mineral property for any taxable year notwithstanding that for the taxable year the allowance for depletion was determined without reference to percentage depletion under section 613.

(3) If the amount of gain described in subparagraph (1) of this paragraph allocable to a mineral property for a taxable year exceeds the allowable deductions otherwise taken into account in computing the taxable income from the mineral property for the taxable year, the excess may not be taken into account in computing the taxable income from the mineral property for any other taxable year.

(4) To the extent that the adjustments reflected in the adjusted basis of the section 1245 property are allocable to mineral property which the taxpayer no longer owns in the taxable year in which he disposes of the section 1245 property, the gain recognized under section 1245(a)(1) does not result in any tax benefit to the taxpayer under this paragraph since he has no taxable income from the mineral property for such year. However, if a taxpayer has, in the taxable year in which he disposes of an item of section 1245 property, only a portion of the original mineral property to which gain described in subparagraph (1) of this paragraph with respect to the section 1245 property is properly allocable, the entire amount of that gain shall nevertheless be taken into account in computing the taxable income of the remaining portion of the mineral property. Furthermore, the fact that a mineral property to which section 1245 gain is properly allocable is (in the taxable year in which the taxpayer disposes of an item of section 1245 property) no longer in existence merely because the mineral property has been made a part of an aggregation or has been deaggregated will not result in the loss of tax benefits under this section. Accordingly,

(i) If a taxpayer has made an aggregation of mineral properties (see section 614 and the regulations thereunder), the amount of any gain described in subparagraph (1) of this paragraph which is properly allocable to the aggregation shall include the portion of any gain which would be properly allocable to the mineral properties which existed separately prior to the aggregation and of which the aggregation is or was composed, if the prior mineral properties had not been aggregated; and

(ii) If a taxpayer has deaggregated a mineral property, the amount of any gain described in subparagraph (1) of this paragraph which is properly allocable to each of the resulting mineral properties shall include a part of the portion of any gain which would be properly allocable to the prior aggregation if the aggregation had not been deaggregated, the part properly allocable to each of the resulting properties being determined by allocating the gain between the resulting properties in the same manner as basis is allocated between them for tax purposes (see paragraph (a)(2) of § 1.614–6 and example 5 of subparagraph (7) of this paragraph).

(5) In any case in which it is necessary to determine the portion of any gain recognized under section 1245(a)(1) which is properly allocable to the mineral property in respect of which the taxable income is being computed, the taxpayer shall have available permanent records of all the facts necessary to determine with reasonable accuracy the amount of such portion. In the absence of such records, none of the gain recognized under section 1245(a)(1) shall be allocable to such mineral property.

(6) As used in this paragraph, the term *mineral property* has the meaning assigned to it by section 614 and § 1.614–1.

(7) The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, who uses the calendar year as his taxable year, operated and treated as separate properties mines Nos. 1 and 2. On January 1, 1963, A acquired a truck which was section 1245 property. During 1963 and 1964 the truck was used 25 percent of the time at mine No. 1 and 75 percent of the time at mine No. 2. For each such year the depreciation adjustments allowed in respect of the truck were $800 (the amount allowable). In computing the taxable income from mines Nos. 1 and 2 for each such year, $200 (25 percent of $800) of the depreciation adjustments was allocated by A to mine No. 1 and $600 (75 percent of $800) to mine No. 2. Thus, for the 2 years, the total of the depreciation adjustments on the truck was $1,600, of which $400 was allocated to mine No. 1 and $1,200 to mine No. 2. On January 1, 1965, A recognized upon sale of the truck a gain of $500 to which section 1245(a)(1) applied. During 1965, A did not recognize any other gain to which section 1245(a)(1) applied. In computing taxable income from the mines for 1965, the expenses otherwise required to be taken into account are reduced by $125 (that is $400/$1,600 of $500) for mine No. 1 and by $375 (that is $1,200/$1,600 of $500) for mine No. 2.

Example 2. The situation is the same as in example 1, except that the truck in question is used 25 percent of the time at mine No. 1, and 75 percent of the time in a nonmining business owned by A. Accordingly, in computing taxable income from A's mines for 1965, the expenses for mine No. 1 otherwise required to be taken into account are reduced by $125 (that is $400/$1,600 of $500), but no reduction is made in the expenses for mine No. 2, since the truck in question was not used in connection with that mineral property.

Example 3. The situation is the same as in example 1, except that the truck in question was used exclusively at mine No. 1 in 1963. On January 1, 1964, the truck was transferred to mine No. 2, and was used exclusively at mine No. 2 during the remaining period prior to its sale. However, A continued to own and operate mine No. 1. For the 2 years 1963 and 1964, the total of the depreciation adjustments on the truck was $1,600, of which $800 was allocated to mine No. 1 and $800 to mine No. 2. In computing taxable income from A's mines for 1965, the expenses for mines Nos. 1 and 2 otherwise required to be taken into account are reduced by $250 each (that is $800/$1,600 of $500). If A had sold mine No. 1 on January 1, 1964, no reduction in expenses would be allowable as a result of the operation of the truck at mine No. 1, since A would no longer have owned mine No. 1 in the year in which the truck was sold.

Example 4. On January 1, 1963, B, who uses the calendar year as his taxable year and who normally allocates depreciation costs to mines according to the percentage of time which the depreciable asset is used with respect to the mines, acquired a truck which was section 1245 property. During 1963 the truck was used exclusively on mine No. 1, which B operated and treated as a separate property. The depreciation adjustments allowed in respect of the truck for 1963 were $1,000 (the amount allowable), which amount was allocated to mine No. 1 in computing the

taxable income therefrom. On January 1, 1964, B acquired and began operating mine No. 2 and elected under section 614(c) to aggregate and treat as one property mines Nos. 1 and 2. During 1964 B used the truck 60 percent of the time for mine No. 1 and 40 percent of the time for mine No. 2. For 1964 the depreciation adjustments allowed in respect of the truck were $1,000 (the amount allowable), which amount was allocated to the aggregation of mines Nos. 1 and 2 in computing the taxable income therefrom. On December 31, 1964, B sold mine No. 2. For 1965 the depreciation adjustments allowed in respect to the truck were $1,000 (the amount allowable), which amount was allocated to mine No. 1 in computing the taxable income therefrom. On January 1, 1966, B recognized gain upon sale of the truck of $600 to which section 1245(a)(1) applied. In computing the taxable income from mine No. 1 for 1966, the expenses otherwise required to be taken into account are reduced by $600, since all the depreciation adjustments allowed with respect to the truck, including those allowed with respect to the use of the truck at mine No. 2 ($400 for 1964), relate to the same mineral property from which B had taxable income in 1966, the taxable year in which he sold the truck.

Example 5. On January 1, 1962, A, who uses the calendar year as his taxable year, elected under section 614(c) to aggregate and treat as one mineral property his operating mineral interests in mines Nos. 1 and 2. On January 1, 1963, A acquired a truck which was section 1245 property, to be used at both mine No. 1 and mine No. 2. A later elected (with the consent of the Commissioner) to deaggregate mines Nos. 1 and 2, and this deaggregation became effective on January 1, 1964. At the time of deaggregation, half of the tax basis of the aggregated property was allocated to mine No. 1, and the other half to mine No. 2. During each of the years 1963 and 1964, the truck was used 25 percent of the time on mine No. 1 and 75 percent of the time on mine No. 2, and the depreciation adjustments allowed in respect of the truck were $800 (the amount allowable). On January 1, 1965, A recognized upon sale of the truck a gain of $500 to which section 1245(a)(1) applied. In computing taxable income from A's mines for 1965, the expenses otherwise required to be taken into account are reduced by $187.50 (that is half of $250 for 1963 and $200/$800 of $250 for 1964) for mine No. 1 and by $312.50 (that is half of $250 for 1963 and $600/$800 of $250 for 1964) for mine No. 2.

(c) *Treatment of particular items in computing taxable income from the property.* In determining taxable income from the property under the provisions of paragraph (a) of this section:

(1) Trade or cash discounts (or allowances determined to have the same effect as trade or cash discounts) which are actually allowed to the taxpayer in connection with the acquisition of property, supplies, or services shall not be included in the cost of such property, supplies, or services.

(2) Intangible drilling and development costs which are deducted under section 263(c) and § 1.612–4 shall be subtracted from the gross income from the property.

(3) Exploration and development expenditures which are deducted for the taxable year under sections 615, 616, or 617 shall be subtracted from the gross income from the property.

(4)(i) Selling expenses, if any, paid or incurred with respect to a raw mineral product shall be subtracted from gross income from the property. See subdivision (iii) of this subparagraph for the definition of the term *raw mineral product*. For example, the selling expenses paid or incurred by a producer of raw mineral products with respect to products such as crude oil, raw gas, coal, iron ore, or crushed dolomite shall be subtracted from gross income from the property.

(ii) A reasonable portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property. Such reasonable portion shall be equivalent to the typical selling expenses which are incurred by unintegrated miners or producers in the same mineral industry so as to maintain equality in the tax treatment of unintegrated miners or producers in comparison with integrated miner-manufacturers or producer-manufacturers. If unintegrated miners or producers in the same mineral industry do not typically incur any selling expenses, then no portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property when determining the taxpayer's taxable income from the property.

(iii) For purposes of this subparagraph, a product will be considered to be a raw mineral product if (in the case of oil and gas) it is sold in the immediate vicinity of the well or if (in the case of minerals other than oil and gas)

it is sold under the conditions described in paragraph (b)(1) of § 1.613–4. In addition, a product will be considered to be a raw mineral product if only insubstantial value is added to the product by nonmining processes (or, in the case of oil and gas, by conversion or transportation processes). For example, in the case of a producer of crushed granite poultry grit, both bulk and bagged grit will be deemed to be a raw mineral product for purposes of the selling expense rule set forth in this subparagraph.

(iv) The term *selling expenses*, for purposes of this subparagraph, includes sales management salaries, rent of sales offices, sales clerical expenses, salesmen's salaries, sales commissions and bonuses, advertising expenses, sales traveling expenses, and similar expenses, together with an allocable share of the costs of supporting services, but the term does not include delivery expenses.

(5) Taxes which are taken as a credit rather than as a deduction or which are capitalized shall not be subtracted from the gross income from the property.

(6) Trade association dues paid or incurred by a producer of crude oil or gas or a raw mineral product shall be subtracted from the gross income from the property. See subparagraph (4) (iii) of this paragraph for the definition of the term *raw mineral product*. In addition, a reasonable portion of the trade association dues incurred by a producer of a refined, manufactured, or fabricated product shall also be subtracted from gross income from the property if the activities of the association relate to production, treatment and marketing of the crude oil or gas or raw mineral product. One reasonable method of allocating the trade association dues described in the preceding sentence is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes (or in the case of oil and gas, conversion and transportation processes) bear to each other. The foregoing rules shall apply even though one of the principal purposes of an association is to advise, promote, or assist in the production, marketing, or sale of refined, manufactured, or fabricated products. For example, a reasonable portion of the trade association dues paid to an association which promotes the sale of cement, refined petroleum, or copper products shall be subtracted from gross income from the property.

[T.D. 6955, 33 FR 6968, May 9, 1968. Redesignated by T.D. 7170, 37 FR 5374, Mar. 15, 1972, as amended by T.D. 7170, 37 FR 5381, Mar. 15, 1972]

§ 1.613–6 Statement to be attached to return when depletion is claimed on percentage basis.

In addition to the requirements set forth in paragraph (g) of § 1.611–2, a taxpayer who claims the percentage depletion deduction under section 613 for any taxable year shall attach to his return for such year a statement setting forth in complete, summary form, with respect to each property for which such deduction is allowable, the following information:

(a) All data necessary for the determination of the *gross income from the property*, as defined in §§ 1.613–3 from 1.613–4, including:

(1) Amounts paid as rents or royalties including amounts which the recipient treats under section 631(c),

(2) Proportion and amount of bonus excluded, and

(3) Amounts paid to holders of other interests in the mineral deposit.

(b) All additional data necessary for the determination of the *taxable income from the property (computed without the allowance for depletion*), as defined in § 1.613–5.

[T.D. 7170, 37 FR 5382, Mar. 15, 1972]

§ 1.613–7 Application of percentage depletion rates provided in section 613(b) to certain taxable years ending in 1954.

(a) *Election of taxpayer*. In the case of any taxable year ending after December 31, 1953, to which the Internal Revenue Code of 1939 is applicable, the taxpayer may elect in accordance with section 613(d) and this section to apply the appropriate percentage depletion rate specified in section 613 in respect of any mineral property (within the meaning of the 1939 Code). In the case of mines, wells, or other natural deposits listed in section 613(b), the election

may be made by the taxpayer irrespective of whether his depletion allowance with respect to the property for the taxable year was computed upon the basis of cost, discovery value, or upon a percentage of gross income from the property. Once made, the election shall be irrevocable with respect to the property for which it is exercised. The election may be made for any mineral property of the taxpayer and need not be made for all such properties. *Gross income from the property* and *net income from the property* shall have the same meaning as those terms are used in 26 CFR (1939) 39.23(m)–1 (Regulations 118).

(b) *Computation of depletion allowance.* The depletion allowance for any taxable year with respect to any property for which the taxpayer makes the election under section 613(d) shall be an amount equal to the sum of:

(1) That portion of a tentative allowance, computed under the provisions of the Internal Revenue Code of 1939 (without regard to paragraph (1) of section 613(d)), which the number of days in the taxable year prior to January 1, 1954, bears to the total number of days in such taxable year; plus

(2) That portion of a tentative allowance, computed by using the appropriate percentage depletion rate specified in section 613(b) (but otherwise computed under the provisions of the Internal Revenue Code of 1939), which the number of days in the taxable year after December 31, 1953, bears to the total number of days in such taxable year

In the case of any taxable year beginning after December 31, 1953, and ending before August 17, 1954, the depletion allowance with respect to any property for which the taxpayer makes the election under section 613(d) shall be computed under the provisions of the Internal Revenue Code of 1939, except that the appropriate percentage depletion rate specified in section 613(b) shall be used. In making such computation, *gross income from the property* and *net income from the property* shall be determined in the same manner as specified in paragraph (a) of this section.

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

Example 1. A is a taxpayer who reports income on the basis of a taxable year ending June 30. For the taxable year ended June 30, 1954, A had gross income from a uranium property in the amount of $100,000 and his depletion allowance was computed with reference to percentage depletion. His net income from this property, for purposes of limiting the depletion allowance, was $40,000. The 15-percent rate of depletion provided for in the Internal Revenue Code of 1939 for metal mines resulted in a depletion allowance for the taxable year of $15,000. Percentage depletion computed with reference to the 23-percent rate provided for uranium under section 613(b) is $23,000 ($100,000 times 23 percent). However, the allowance computed on this basis is limited to $20,000 (50 percent of A's net income from the property). If A exercises the election provided for in section 613(d) his depletion allowance for the taxable year is the aggregate of $7,561.64 (184/365 times $15,000) plus $9,917.80 (181/365 times $20,000) or $17,479.44

Example 2. Assume the same facts as in example 1 except that A's depletion allowance was computed on the basis of cost and amounted to $17,500. If the election is made, A's allowance for the taxable year is the aggregate of $8,821.92 (184/365 times $17,500) plus $9,917.80 (181/365 times $20,000) or $18,739.72.

(d) *Requirement for making election.* (1) The election under section 613(d) shall be made by filing a statement with the district director with whom the income tax return was filed for the taxable year to which the election is applicable. Such statement shall indicate that an election is being made under section 613(d), shall contain a recomputation of the depletion allowance and the tax liability for all taxable years affected by the exercise of the election, and shall be accompanied either by a claim for refund or credit or by an amended return or returns, whichever is appropriate.

(2) If the treatment of any item upon which a tax previously determined was based, or if the application of any provisions of the internal revenue laws with respect to such tax, depends upon the amount of income (e.g., charitable contributions, foreign tax credit, dividends received credit, and medical expenses), readjustment in these particulars will be necessary as part of any recomputation in conformity with the change in the amount of the income which results solely from the making of the election under section 613(d).

(e) *Administrative provisions; etc.* (1) Section 36(b) of the Technical Amendments Act of 1958 (72 Stat. 1633) provides as follows:

Sec. 36. Percentage depletion rates for certain taxable years ending in 1954. * * *

(b) *Statute of limitations, etc.; interest.* If refund or credit of any overpayment resulting from the application of the amendment made by subsection (a) of this section is prevented on the date of the enactment of this Act, or within 6 months from such date, by the operation of any law or rule of law (other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within 6 months from such date. No interest shall be paid on any overpayment resulting from the application of the amendment made by subsection (a) of this section.

(2) If refund or credit of any overpayment resulting from the application of section 613(d) is prevented on September 2, 1958, or on or before March 2, 1959, by the operation of any law or rule of law (other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed on or before March 2, 1959. If such refund or credit is not prevented on or before March 2, 1959, the time for filing claim therefor shall be governed by the rules of law generally applicable to credits and refunds.

(3) The amount of any refund or credit which is allowable by reason of section 613(d) shall not exceed the decrease in income tax liability resulting solely from the application of the percentage rates specified in section 613(b). No interest shall be allowed or paid on any overpayment resulting from the application of section 613(d).

(4) For purposes of this section the *decrease in income tax liability* shall be the amount by which the tax previously determined (as defined in section 3801(d) of the Internal Revenue Code of 1939) exceeds the tax as recomputed under section 613(d) and this section.

(f) *Adjustment to basis.* Proper adjustment shall be made to the basis of any property as required by section 113(b)(1) of the Internal Revenue Code of 1939 and 26 CFR (1939) 39.113(b)(*1*)–1(c) (Regulations 118) to reflect any change in the depletion allowance resulting from the application of section 613(d) of the Internal Revenue Code of 1954.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960. Redesignated by T.D. 7170, 37 FR 5374, Mar. 15, 1972]

§ 1.613A–0 Limitations on percentage depletion in the case of oil and gas wells; table of contents.

This section lists the paragraphs contained in §§ 1.613A–0 through 1.613A–7.

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[T.D. 8348, 56 FR 21938, May 13, 1991, as amended by T.D. 8437, 57 FR 43899, Sept. 23, 1992]

§ 1.613A–1 Post-1974 limitations on percentage depletion in case of oil and gas wells; general rule.

Except as otherwise provided in section 613A and the regulations thereunder, in the case of oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after such year, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613. In the case of a taxable year beginning before January 1, 1975, and ending after that date, the percentage depletion allowance (but not the cost depletion allowance) with respect to oil and gas wells for such taxable year shall be determined by treating the portion thereof in 1974 as if it were a short taxable year for purposes of section 613 and the portion thereof in 1975 as if it were a short taxable year for purposes of section 613A.

[T.D. 7487, 42 FR 24264, May 13, 1977]

§ 1.613A–2 Exemption for certain domestic gas wells.

(a) The allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to:

(1) Regulated natural gas (as defined in paragraph (c) of § 1.613A–7),

(2) Natural gas sold under a fixed contract (as defined in paragraph (d) of § 1.613A–7), and

(3) Any geothermal deposit in the United States or in a possession of the United States that is determined to be a gas well within the meaning of former section 613(b)(1)(A) (as in effect before enactment of the Tax Reduction Act of 1975) for taxable years ending

after December 31, 1974, and before October 1, 1978 (see section 613(e) for depletion on geothermal deposits thereafter),

(b) For taxable years ending after September 30, 1978, the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to any qualified natural gas from geopressured brine (as defined in paragraph (e) of § 1.613A–7), and 10 percent shall be deemed to be specified in section 613(b) for purposes of section 613(a).

(c) For special rules applicable to partnerships, S corporations, trusts, and estates, see paragraphs (e), (f), and (g) of § 1.613A–3.

(d) The provisions of this section may be illustrated by the following examples:

Example 1. A is a producer of natural gas which is sold by A under a contract in effect on February 1, 1975. The contract provides for an increase in the price of the gas sold under the contract to the highest price paid to a producer for natural gas in the area. The gas sold by A qualifies under section 613A(b)(1)(B) for percentage depletion as gas sold under a fixed contract until its price increases, but is presumed not to qualify thereafter unless A demonstrates by clear and convincing evidence that the price increase in no event takes increases in tax liabilities into account.

Example 2. B is a producer of natural gas which is sold by B under a contract in effect on February 1, 1975. The contract provides that beginning January 1, 1980, the price of the gas may be renegotiated. Such a provision does not disqualify gas from qualifying for the exemption under section 613A(b)(1)(B) with respect to the gas sold prior to January 1, 1980. However, gas sold on or after January 1, 1980, does not qualify for the exemption whether or not the price of the gas is renegotiated.

[T.D. 8348, 56 FR 21939, May 13, 1991, as amended by T.D. 8437, 57 FR 43899, Sept. 23, 1992; 58 FR 6678, Feb. 1, 1993]

§ 1.613A–3 Exemption for independent producers and royalty owners.

(a) *General rules.* (1) Except as provided in section 613A(d) and § 1.613A–4, the allowance for depletion under section 611 with respect to oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after that date, shall be computed in accordance with section 613 with respect to:

(i) So much of the taxpayer's average daily production (as defined in paragraph (f) of § 1.613A–7) of domestic crude oil (as defined in paragraphs (a) and (g) of § 1.613A–7) as does not exceed the taxpayer's depletable oil quantity (as defined in paragraph (h) of § 1.613A–7), and

(ii) So much of the taxpayer's average daily production of domestic natural gas (as defined in paragraphs (a) and (b) of § 1.613A–7) as does not exceed the taxpayer's depletable natural gas quantity (as defined in paragraph (i) of § 1.613A–7), and the applicable percentage (determined in accordance with the table in paragraph (c) of this section shall be deemed to be specified in section 613(b) for purposes of section 613(a).

(2) Except as provided in section 613A(d) and § 1.613A–4, the allowance for depletion under section 611 with respect to oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after that date and before January 1, 1984, shall be computed in accordance with section 613 with respect to:

(i) So much of the taxpayer's average daily secondary or tertiary production (as defined in paragraph (k) of § 1.613A–7) of domestic crude oil as does not exceed the taxpayer's depletable oil quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990), and

(ii) So much of the taxpayer's average daily secondary or tertiary production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990), and 22 percent shall be deemed to be specified in section 613(b) for purposes of section 613(a).

(3) For purposes of this section, there shall not be taken into account any production with respect to which percentage depletion is allowed pursuant to section 613A(b) or is not allowable

by reason of section 613A(c)(9), as in effect prior to the Revenue Reconciliation Act of 1990.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer, owns an oil producing property with 100,000 barrels of production to which income was attributable for 1975 and a gas producing property with 1,200,000,000 cubic feet of production to which income was attributable for 1975. Under section 613A(c)(4), the oil equivalent of 1,200,000,000 cubic feet of gas is 200,000 barrels, bringing A's total production of oil and gas to which income was attributable for 1975 to the equivalent of 300,000 barrels of oil. A's average daily production was 821.92 barrels (300,000 barrels ÷ 365 days) which is less than the depletable oil quantity (2,000 barrels) before reduuction for any election by A under section 613A(c)(4). Accordingly, A may make an election with respect to A's entire gas production and thereby be entitled to percentage depletion with respect to A's entire 1975 income from production of oil and gas. A's allowable depletion pursuant to section 613A(c) and A's oil and gas properties would be the amount determined under section 613(a) computed at the 22 percent rate specified in section 613A(c)(5), as in effect prior to the Revenue Reconciliation Act 1990, for 1975.

Example 2. B, a calendar year taxpayer, owns oil producing properties with 365,000 barrels of production to which income was attributable for 1975. B was a retailer of oil and gas for only the last 3 months of 1975. B's average daily production for 1975 was 1,000 barrels (365,000 barrels ÷ 365 days).

Example 3. C, a calendar year taxpayer, owns property X with 500,000 barrels of primary production to which income was attributable for 1975 and property Y with 200,000 barrels of primary production to which income was attributable for 1975. Property Y had been transferred to C on January 1, 1975, on which date it was a proven property. Therefore, the exemption under section 613A(c)(1) does not apply to C with respect to production from property Y. In determining C's depletable oil quantity for the year, the production from property Y is not taken into account. Thus, C's average daily prduction for 1975 was 1,369.86 barrels (500,000 barrels ÷ 365).

Example 4. D owns an oil property with producing wells X and Y on it. In 1975 D converts well X into an injection well. Prior to the application of the secondary process, it is estimated that without the application of the process the annual production from well X would have been 50x barrels of oil and from well Y would have been 100x barrels of oil. For the taxable year in which injection is commenced production from well X is 10x barrels and from well Y is 180x barrels. Fortyx barrels of oil [190x barrels of oil (actual production from the property)—150x barrels (estimate of primary production from the property)] qualify as secondary production.

Example 5. E, a calendar year taxpayer, owns a domestic oil well which produced 100,000 barrels of oil in 1980. The proceeds from the sale of 15,000 barrels of that production are not includible in E's income until 1981. The 15,000 barrels produced in 1980 are included in E's average daily production for 1981 and excluded from such production for 1980. The tentative quantity and the percentage depletion rate for 1981 are applicable to the 15,000 barrels of oil.

(b) *Phase-out table.* For purposes of section 613A(c)(3)(A)(i) and § 1.613A–7(h) (relating to depletable oil quantity)—

In the case of production after 1974 and to which gross income from the property is attributable for the calendar year:	The tentative quantity in barrels per day is:
1975	2,000
1976	1,800
1977	1,600
1978	1,400
1979	1,200
1980 and thereafter	1,000

(c) *Applicable percentage.* For purposes of section 613A(c)(1) and paragraph (a) of this section—

In the case of production after 1974 and to which gross income from the property is attributable for the calendar year:	The applicable percentage is:
1975	22
1976	22
1977	22
1978	22
1979	22
1980	22
1981	20
1982	18
1983	16
1984 and thereafter	15

(d) *Production in excess of depletable quantity*—(1) *Primary production.* (i) If the taxpayer's average daily production of domestic crude oil exceeds his depletable oil quantity, the allowance for depletion pursuant to section 613A(c)(1)(A) and paragraph (a)(1)(i) of this section with respect to oil produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable under section 613(a) for all of the taxpayer's oil produced from the property during

the taxable year (computed as if section 613 applied to all of the production at the rate specified in paragraph (c) of this section) as the amount of his depletable oil quantity bears to the aggregate number of barrels representing the average daily production of domestic crude oil of the taxpayer for such year.

(ii) If the taxpayer's average daily production of domestic natural gas exceeds his depletable natural gas quantity, the allowance for depletion pursuant to section 613A(c)(1)(B) and paragraph (a)(1)(ii) of this section with respect to natural gas produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable pursuant to section 613(a) for all of the taxpayer's natural gas produced from the property during the taxable year (computed as if section 613 applied to all of the production at the rate specified in paragraph (c) of this section) as the amount of his depletable natural gas quantity in cubic feet bears to the aggregate number of cubic feet representing the average daily production of domestic natural gas of the taxpayer for such year.

(2) *Secondary or tertiary production.* (i) If the taxpayer's average daily secondary or tertiary production of domestic crude oil exceeds his depletable oil quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990), the allowance for depletion pursuant to section 613A(c)(6)(A)(i), as in effect prior to the Revenue Reconciliation Act of 1990, and paragraph (a)(2)(i) of this section with respect to oil produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable pursuant to section 613(a) for all of the taxpayer's secondary or tertiary production of oil from the property during the taxable year (computed as if section 613 applied to all of the production at the rate specified in paragraph (a)(2) of this section) as the amount of his depletable oil quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990) bears to the aggregate number of barrels representing the average daily secondary or tertiary production of domestic crude oil of the taxpayer for such year.

(ii) If the taxpayer's average daily secondary or tertiary production of domestic natural gas exceeds his depletable natural gas quantity (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990), the allowance for depletion pursuant to section 613A(c)(6)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990, and paragraph (a)(2)(ii) of this section with respect to natural gas produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable pursuant to section 613(a) for all of the taxpayer's secondary or tertiary production of natural gas from the property during the taxable year (computed as if section 613 applied to all of the production at the rate specified in paragraph (a)(2) of this section) as the amount of his depletable natural gas quantity in cubic feet (determined without regard to section 613A(c)(3)(A)(ii), as in effect prior to the Revenue Reconciliation Act of 1990) bears to the aggregate number of cubic feet representing the average daily secondary or tertiary production of domestic natural gas of the taxpayer for such year.

(iii) This paragraph (d)(2) shall not apply after December 31, 1983.

(3) *Taxable income from the property.* If both oil and gas are produced from the property during the taxable year, then for purposes of section 613A(c)(7) (A) and (B) and paragraph (d) of this section the taxable income from the property, in applying the taxable income limitation in section 613(a), shall be allocated between the oil production and the gas production in proportion to the gross income from the property during the taxable year from each. If both gas with respect to which section 613A(b) and § 1.613A–2 apply and oil or gas with respect to which section 613A(c) and this section apply are produced from the property during the taxable year,

then for purposes of section 613A(d)(1) and paragraph (a) of § 1.613A–4 the taxable income from the property, in applying the taxable income limitation in section 613(a), shall also be so allocated. In addition, if both primary production and secondary or tertiary production (to which gross income from the property is attributable before January 1, 1984) are produced from the property during the taxable year and the total amount of production is in excess of the depletable quantity, then for purposes of paragraph (d) of this section the taxable income from the property, in applying the taxable income limitation in section 613(a), shall also be so allocated.

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

Example 1. A owns Y and Z oil producing properties. With respect to properties Y and Z, the percentage depletion allowable pursuant to section 613(a) (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5)) for 1975 was $100x and $200x, respectively. A's average daily production for 1975 was 4,000 barrels. A's allowable depletion pursuant to section 613A(c) with respect to property Y was $50x ($100x depletion × 2,000 depletable oil quantity/ 4,000 average daily production). A's allowable depletion pursuant to section 613A(c) with respect to property Z was $100x ($200x depletion × 2,000 depletable oil quantity/ 4,000 average daily production).

Example 2. B owns gas producing properties which had secondary gas production for 1975 of 3,285,000,000 cubic feet, which under section 613A(c)(4) is equivalent to 547,500 barrels of oil. B's average daily secondary production of gas for 1975 was equivalent to 1,500 barrels (547,500 barrels ÷ 365). B elected to have section 613A(c)(4) apply to the gas production. With respect to the production, the percentage depletion allowable pursuant to section 613(a) (computed at the rate specified in section 613A(c)(6)(A), as in effect prior to the Revenue Reconciliation Act of 1990) was $150x. B also owns an oil producing property which had primary oil production for 1975 of 365,000 barrels. B's average daily production of oil for 1975 was 1,000 barrels (365,000 ÷ 365). With respect to the oil property, the percentage depletion allowable pursuant to section 613(a) (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) was $100x. B's depletable oil quantity for 1975 was 500 barrels (2,000 barrels tentative quantity −1,500 barrels average daily secondary production). B's allowable depletion pursuant to section 613A(c) with respect to the oil property was $50x ($100x depletion × 500 depletable oil quantity/ 1,000 average daily production).

Example 3. Assume the same facts as in *Example 2* except that B's primary production was 6,000,000 cubic feet of natural gas daily rather than its equivalent under section 613A(c)(4) of 1,000 barrels of oil and that B elected to have that section apply to such gas. B's allowable depletion pursuant to section 613A(c) with respect to B's primary production is $50x, the same as in example 2.

Example 4. C is a partner with a one-third interest in Partnerships CDE and CFG with each partnership owning a single oil property. C's percentage depletion allowable under section 613(a) (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) for 1975 was $20x with respect to 495,000 barrels (his allocable share of Partnership CDE production) and $40x with respect to 600,000 barrels (his allocable share of Partnership CFG production). C's average daily production is 3,000 barrels (1,095,000 total production ÷ 365 days). C's allowable depletion pursuant to section 613A(c) with respect to C's share of the production of Partnership CDE is $13.33x ($20x depletion × 2,000 depletable oil quantity/ 3,000 average daily production). C's allowable depletion pursuant to section 613A(c) with respect to C's share of the production of Partnership CFG is $26.67x ($40x depletion × 2,000 depletable oil quantity/ 3,000 average daily production). See § 1.613A–3(e) for the rules on computing depletion in the case of a partnership.

Example 5. H owns a property which, during H's fiscal year which began on June 1, 1975, and ended on May 31, 1976, produced gas qualifying under section 613A(b) and oil qualifying under section 613A(c). For the fiscal year H's gross income from the property was $400x, of which $100x was from gas and $300x was from oil. For the oil his gross income from the property for the period beginning June 1, 1975, and ending December 31, 1975, was $100x and for the 1976 portion of the fiscal year was $200x. The percentage depletion allowance (before applying the 50 percent limitation of section 613(a) or the 65 percent limitation of section 613A(d)(1)) was $22x for the gas, $22x for the oil in 1975, and $44x for the oil in 1976. H's taxable income from the property for the fiscal year was $100x. In accordance with paragraph (d)(3) of this section, the taxable income from the property is allocated $25x to the gas:

$$\left[\begin{array}{c}\$100\text{x taxable income}\\ \text{from the property}\end{array}\left(\frac{\$100\text{x gross income from gas from the property}}{\$400\text{x total gross income from the property}}\right)\right]$$

$25x to the 1975 oil:

$$\left[\begin{array}{c}\$100\text{x taxable income}\\ \text{from the property}\end{array}\left(\frac{\$100\text{x gross income from 1975 oil from the property}}{\$400\text{x total gross income from the property}}\right)\right]$$

and $50x to the 1976 oil:

$$\left[\begin{array}{c}\$100\text{x taxable income}\\ \text{from the property}\end{array}\left(\frac{\$200\text{x gross income from 1976 oil from the property}}{\$400\text{x total gross income from the property}}\right)\right]$$

With the application of the 50 percent of taxable income from the property limitation, the allowable percentage depletion (computed without reference to section 613A) is limited to $12.50x for the gas, $12.50x for the oil in 1975, and $25x for the oil in 1976.

(e) *Partnerships*—(1) *General rule*. In the case of a partnership, the depletion allowance under section 611 with respect to production from domestic oil and gas properties shall be computed separately by the partners and not by the partnership. The determination of whether cost or percentage depletion is applicable is to be made at the partner level. The partnership must allocate to each partner the partner's proportionate share of the adjusted basis of each partnership oil or gas property in accordance with the provisions of paragraphs (e)(2) through (e)(6) of this section. This allocation of the adjusted basis of oil or gas property does not affect a partner's adjusted basis in his or her partnership interest.

(2) *Initial allocation of adjusted basis of oil or gas property among partners*—(i) *General rule*. Each partner shall be allocated his or her proportionate share of the adjusted basis of each partnership domestic oil or gas property. The initial allocation of adjusted basis is to be made as of the later of the date of acquisition of the oil or gas property by the partnership or January 1, 1975.

(ii) *Allocation methods*. Except as otherwise provided in paragraph (e)(5) of this section, the provisions of this paragraph (e)(2)(ii) govern the determination under paragraph (e)(2)(i) of this section of a partner's proportionate share of the adjusted basis of oil or gas property. Each partner's proportionate share is determined in accordance with the partner's proportionate interest in partnership capital at the time of the allocation unless both—

(A) The partnership agreement provides that a partner's share of the adjusted basis of one or more properties is determined in accordance with his or her proportionate interest in partnership income; and

(B) At the time of allocation under the partnership agreement the share of each partner in partnership income is reasonably expected to be substantially unchanged throughout the life of the partnership, other than changes merely to reflect the admission of a new partner, an increase in a partners' interest in consideration for money, property, or services, or a partial or complete withdrawal of an existing partner

If the requirements of paragraph (e)(2)(ii) (A) and (B) of this section are met, a partner's proportionate share is determined in accordance with his or

her proportionate interest in partnership income. The partners' shares of adjusted basis are determined on a property-by-property basis. Accordingly, the basis of one property may be allocated in proportion to capital and the basis of another property may be allocated in proportion to income. See §§ 1.613A–3(e)(5) and 1.704–1(b)(4)(v) for special rules concerning allocation of the adjusted basis of oil and gas properties.

(3) *Adjustments by partnership to allocated adjusted bases*—(i) *Capital expenditures by partnership.* Appropriate adjustments shall be made to the partners' adjusted bases in any domestic oil and gas property for any partnership capital expenditures relating to such property that are made after the initial allocation. These adjustments shall be allocated among the partners in accordance with the principles set forth in paragraph (e)(2)(ii) of this section.

(ii) *Admission of a new partner or increase in partner's interest*—(A) *In general.* Upon a contribution of money, other property, or services to the partnership by a new or existing partner (''contributing partner'') as consideration for an interest in the partnership, the partnership shall allocate, in accordance with paragraph (e)(3)(ii)(B) of this section, a share of the partnership's basis in each existing oil and gas property to the contributing partner, and each existing partner shall reduce, in accordance with paragraph (e)(3)(ii)(C) of this section, his or her share of the partnership's basis in such property.

(B) *Allocation of basis to contributing partner.* The partnership shall allocate to a contributing partner his or her proportionate share (determined under paragraph (e)(2)(ii) of this section in accordance with the partner's proportionate interest in partnership capital or income) of the partnership's adjusted basis in each existing partnership oil or gas property. For purposes of this allocation, the partnership's adjusted basis in such property equals the aggregate of its partner's adjusted bases in the property, as determined under paragraph (e)(3)(iii) of this section.

(C) *Reduction of existing partners' bases.* Each existing partner's basis in each existing partnership oil or gas property is reduced by the percentage of the partnership's aggregate basis in the property that is allocated to the contributing partner. Thus, if one-third of the partnership's aggregate basis in a property is allocated to a contributing partner because the contributing partner has a one-third interest in partnership capital, after the admission of the contributing partner each existing partner's basis (including the contributing partner's pre-existing basis if such partner is also an existing partner) in each property equals the partner's basis (prior to the admission) reduced by one-third.

(iii) *Determination of aggregate of partners' adjusted bases in the property*—(A) *In general.* To determine the aggregate of its partners' adjusted bases for purposes of this paragraph (e)(3), the partnership must determine each partner's adjusted basis under either paragraph (e)(3)(iii)(B) (written data) or paragraph (e)(3)(iii)(C) (assumptions) of this section. The partnership is permitted to determine the bases of some partners under paragraph (e)(3)(iii)(B) of this section and of others under paragraph (e)(3)(iii)(C) of this section. For this purpose, a partner's basis in an oil or gas property does not include any basis adjustment under section 743(b).

(B) *Written data.* A partnership may determine a partners' basis in an oil or gas property by using written data provided by a partner stating the amount of the partner's adjusted basis or depletion deductions with respect to the property unless the partnership knows or has reason to know that the written data is inaccurate. In determining depletion deductions, a partner must treat as actually deducted any amount disallowed and carried over as a result of the 65 percent-of-income limitation of section 613A(d)(1). If a partnership does not receive written data upon which it may rely, the partnership must use the assumptions provided in paragraph (e)(3)(iii)(C) of this section in determining a partner's adjusted basis in an oil or gas property.

(C) *Assumptions.* Except as provided in paragraph (e)(3)(iv)(B) of this section, a partnership that does not use written data pursuant to paragraph

(e)(3)(iii)(B) of this section to determine a partner's basis must use the following assumptions to determine the partner's adjusted basis in an oil and gas property:

(*1*) The partner deducted his or her share of deductions under section 263(c) in the first year in which the partner could claim a deduction for such amounts, unless the partnership elected to capitalize such amounts;

(*2*) The partner was not subject to the 65 percent-of-income limitation of section 613A(d)(1) with respect to the partner's depletion allowance under section 611; and

(*3*) The partner was not subject to the following limitations, with respect to the partner's depletion allowance under section 611, except to the extent a limitation applied at the partnership level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); the prohibition against claiming percentage depletion on transferred proven property under section 613A(c)(9), prior to its repeal; or the limitations of section 613A(d) (2), (3), and (4) (exclusion of retailers and refiners).

(iv) *Withdrawal of partner or decrease in partner's interest*—(A) *In general.* Upon a distribution of money or other property to a withdrawing partner as consideration for an interest in the partnership, the withdrawing partner's adjusted basis in each domestic oil or gas property that continues to be held by the partnership is allocated to the remaining partners in proportion to their proportionate interest in partnership capital or income after taking into account any increase or decrease as a result of the event giving rise to the reallocation. A similar rule shall apply in the case of a diminution of a continuing partner's interest in the partnership.

(B) *Special rule for determining a withdrawing partner's basis in the property.* If a partnership is required to determine a withdrawing partner's adjusted basis using the assumptions under paragraph (e)(3)(iii)(C) of this section, the partnership may rebut the assumption in paragraph (e)(3)(iii)(C)(*3*) of this section that the withdrawing partner was not subject to the limitations of sections 613A(d) (2), (3), and (4) exclusion of retailers and refiners) by demonstrating that the withdrawing partner was subject to the limitations of sections 613A(d) (2), (3), or (4).

(v) *Effective date.* The provisions of § 1.613A–3(e)(3) (i) through (iv) are effective for taxable years beginning after May 13, 1991. However, a partnership may elect to apply these provisions to taxable years beginning on or before May 13, 1991.

(4) *Determination of a partner's interest in partnership capital or income.* For purposes of this paragraph (e), a partner's interest in partnership capital or income is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. See the factors listed in § 1.704–1(b)(3)(ii).

(5) *Special rules on allocation of adjusted basis to partners.* An allocation or reallocation of the adjusted basis of oil or gas property is pursuant to this paragraph (e) of this section deemed to be in accordance with the partner's proportionate interest in partnership capital or income for purposes of this paragraph (e) where so provided in § 1.704–1(b)(4)(v). In addition, in connection with a revaluation described in § 1.704–1(b)(2)(iv)(*f*), the basis of an oil or gas property is allocated among the partners based on the principles used under § 1.704–1(b)(4)(i) of allocating tax items to take into account variations between the adjusted basis of the property and its fair market value. In the case of an oil or gas property contributed to a partnership by a partner, section 704(c) is taken into account in determining the partner's share of the adjusted basis.

(6) *Miscellaneous rules*—(i) Each partner must separately keep records of his or her share of the adjusted basis in each domestic oil or gas property of the partnership, adjust his or her share of such basis pursuant to section 1016 (including adjustments for any depletion allowed or allowable with respect to such property), and use that adjusted basis each year in the computation of his or her cost depletion or in the computation of his or her gain or loss on the disposition (including abandonment) of the property by the partnership.

(ii) The adjusted basis of a partner's interest in a partnership is decreased (but not below zero) pursuant to section 705(a)(3) by the amount of the depletion deduction allowed or allowable to the partner with respect to a domestic oil or gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to the partner under section 613A(c)(7)(D), as adjusted by the partner after the initial allocation. Section 705(a)(1)(C) does not apply to depletion deductions that are not included in a partner's distributive share under section 702. Accordingly, the adjusted basis of a partner's interest in a partnership is not increased under section 705(a)(1)(C) with respect to depletion of oil or gas properties. See § 1.705–1(a)(2)(iii).

(iii) Upon the disposition of an oil or gas property by the partnership, each partner must subtract the partner's adjusted basis in the property from his or her allocable portion of the amount realized from the sale of the property to determine gain or loss. The partner's allocable portion of amount realized must, except to the extent governed by section 704(c) (or related principles under § 1.704–1(b)(4)(i)), be determined in accordance with § 1.704–1(b)(4)(v). Except as otherwise provided (e.g., section 751), the sale of a partnership interest is not treated as a sale of an oil and gas property.

(iv) In the case of a transfer of an interest in a partnership, the transferor partner's adjusted basis in each partnership oil or gas property carries over to the transferee partner. If an election under section 754 (relating to optional adjustment to the basis of partnership property) is in effect, such basis is adjusted in accordance with section 743.

(v) For purposes of section 732 (relating to basis of distributed property other than money) and section 734(b) (relating to optional adjustment to basis of partnership property), the partnership's adjusted basis in oil and gas property is an amount equal to the aggregate of its partners' adjusted bases in the property as determined under the rules provided in paragraph (e)(3) of this section.

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

Example 1. A, B, and C have equal interests in capital in Partnership ABC. On January 1, 1992, the partnership acquired a producing domestic oil property. The partnership's basis in the property was $90x. The partnership allocated the adjusted basis of the property to each partner in proportion to the partner's interest in partnership capital. Accordingly, each partner was allocated an adjusted basis of $30x. Each partner must separately compute his or her depletion allowance. The amount of percentage depletion allowable for each partner for 1992 was $10x. On January 1, 1993, each partner's adjusted basis in the property was $20x ($30x minus $10x). On January 1, 1993, the oil property was sold for $150x. Each partner's gain was $30x ($50x allocable share of amount realized minus the partner's adjusted basis of $20x). Each partner must adjust the partner's adjusted basis in his or her partnership interest to reflect the gain.

Example 2. The facts are the same as in *Example 1* except that on January 1, 1993, the property was not sold but transferred by the partnership to partner A. A's basis in the property was $60x (the sum of A's, B's, and C's adjusted bases in the property).

Example 3. The facts are the same as in *Example 1* with the exception that in 1992 C was a retailer of oil and gas and was only entitled to a cost depletion deduction of $5x. C's gain from the sale of the mineral property on January 1, 1993, was $25x ($50x allocable share of amount realized minus C's adjusted basis of $25x ($30x minus $5x)).

Example 4. D, a calendar year taxpayer, is a partner in Partnership DEF which owns a domestic producing oil property. On January 1, 1993, the partnership's adjusted basis in the property was $900x. On January 1, 1993, D's adjusted basis in D's partnership interest was $300x and D's adjusted basis in the partnership's oil property was $300x. D's allowable percentage depletion for 1993 with respect to production from the oil property was $50x. On January 1, 1994, D's adjusted basis in D's partnership interest was $250x and D's adjusted basis in the partnership's oil property was $250x ($300x minus $50x).

Example 5. On January 1, 1990, G has an adjusted basis of $5x in partnership GH's proven domestic oil property, which is the sole asset of the partnership. On January 1, 1990 G sells G's partnership interest to I for $100x when the election under section 754 is in effect. I has a special basis adjustment for the oil property of $95x (the difference between I's basis, $100x, and I's share of the basis of the partnership property, $5x). I is not entitled to percentage depletion with respect to I's distributive share of the oil property income because I is a transferee of an interest

in a proven oil property. However, I is entitled to cost depletion and for this purpose I's interest in the oil property has an adjusted basis to I of $100x ($5x, plus I's special basis adjustment of $95x).

Example 6. On January 1, 1960, Partnership JK acquired a domestic producing oil property. On January 1, 1990, the partnership's adjusted basis in the property was zero. On January 1, 1990, L is admitted as a partner to the partnership. Since the partnership's adjusted basis in the oil property is zero, L's proportionate share of the basis in the property is also zero. L is not entitled to percentage depletion because L is a transferee of a proven oil property (see paragraph (g) of this section). Since the property's basis is zero, L is also not entitled to any cost depletion with respect to production from the property.

Example 7. (i) O and P have equal interests in capital in Partnership OP. On January 1, 1991, the partnership acquired an unproven domestic oil property X the basis of which is $200x to the partnership. The partnership allocates $100x of the basis of the property to each partner in accordance with each partner's proportionate interest in partnership capital. For the 1991 taxable year, O has a $10x cost depletion allowance and P has a $25x percentage depletion allowance. Accordingly, at the end of the 1991 taxable year, O's adjusted basis in the property is $90x, and P's adjusted basis in the property is $75x. On January 1, 1992, Q is admitted as an equal partner. The partnership does not use written data from the partners and must therefore assume that each partner was entitled to $25x depletion based on the assumptions provided in § 1.613A–3(e)(3)(iii). This would result in a $50x combined depletion allowance for the partners and an aggregate adjusted basis in the oil property of $150x. Accordingly, the partnership allocates $50x of the basis of the property to Q, one-third of the aggregate adjusted basis determined by the partnership. O and P must each reduce their basis in the property by one-third. Accordingly, after the admission of Q, O's adjusted basis in the property is $60x ($90x minus $30x), and P's adjusted basis in the property is $50x ($75x minus $25x).

(ii) Assume the same facts as in paragraph (i) of this *Example 7* except that O informs the partnership that its adjusted basis in the property is $90x (determined without regard to section 613A(d)(1)). The partnership uses the written data provided by O and determines the aggregate adjusted basis in the property to be $165x ($90x + $75x). Accordingly, the partnership allocates $55x (⅓ of $165x) of the basis of the property to Q, and O and P must each reduce their adjusted basis in the property by one-third, as in paragraph (i) of this *Example 7.* Thus, after the admission of Q, O's adjusted basis in the property is $60x and P's adjusted basis in the property is $50x.

(f) *S corporations.* For purposes of section 613A(c)(13), adjustments to shareholders' adjusted bases in any domestic oil or gas property to reflect capital expenditures by S corporations, the addition of a new shareholder or an increase in a shareholder's interest by reason of a contribution to the S corporation, the redemption of a shareholder's interest, or other appropriate transaction shall be made in accordance with principles similar to the principles under § 1.613A–3(e) applicable to the entry or withdrawal of a partner.

(g) *Trusts and estates.* (1) In the case of production from domestic oil and gas properties held by a trust or estate, the depletion allowance under section 611 shall be computed initially by the trust or estate. The determination of whether cost or percentage depletion is applicable shall be made at the trust or estate level, but such determination shall not result in the disallowance of cost depletion to a beneficiary of a trust or estate for whom cost depletion exceeds percentage depletion. The limitations contained in section 613A (c) and (d), other than section 613A(d)(1), shall be applied at the trust or estate level in its computation of percentage depletion pursuant to section 613A and shall also be applied by a beneficiary with respect to any percentage depletion apportioned to the beneficiary by the trust or estate. The limitation of section 613A(d)(1) shall be applied by each taxpayer (*i.e.*, trust, estate or beneficiary) only with respect to its allocable share of percentage depletion under section 611(b) (3) or (4). For purposes of adjustments to the basis of oil or gas properties held by a trust or estate, in the absence of clear and convincing evidence to the contrary, it shall be presumed that no beneficiary is affected by any section 613A (d) limitations or by the rules contained in section 613A(c)(8) and (9) (relating to businesses under common control and members of the same family and to transfers, respectively), as in effect prior to the Revenue Reconciliation Act of 1990, or has any oil or gas production from sources other than the trust or estate.

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

Example 1. A is the income beneficiary of a trust the only asset of which is a domestic producing oil property. The trust instrument requires that an amount which equals 10 percent of the gross income from the property be set aside annually as a reserve for depletion. In 1975 the property a had production of 1,095,000 barrels of oil. The trust's gross income from the property in 1975 was $30,000x. In that year, after setting aside $3,000x of income for the reserve for depletion, the trustee distributed the remaining income to A which represented 80 percent of the trust's net income. The percentage depletion computed by the trust with respect to the production (computed as if section 613 applied to all of the production at the rate specified in section 613A(c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) for 1975 was $6,600x. The trust's average daily production for 1975 was 3,000 barrels (1,095,000 ÷ 365 days). The trust's allowable depletion pursuant to section 613A(c) with respect to the production was $4,400x:

$$\left[\$6{,}600\text{x depletion}\left(\frac{2{,}000\text{ depletable oil quantity}}{3{,}000\text{ average daily production}}\right)\right]$$

Pursuant to §1.611–1(c)(4)(ii), the percentage depletion of $4,400x was apportioned between the trustee and A so that the trustee received $3,000x (an amount equal to the amount of income set aside for the reserve for depletion) and A received $1,400x of the depletion deduction. The $1,400x depletion received by A is attributable to 80 percent of the trust's depletable oil quantity, *i.e.,* 1,600 barrels per day.

Example 2. B, a retailer of oil and gas, is the income beneficiary of a trust the only asset of which is a domestic producing oil property. In 1975 the trustee distributed one-half of the trust's net income and accumulated the other one-half for the benefit of the remainderman. One-half of the percentage depletion computed by the trust with respect to the production from the property was apportioned to B. Since B is a retailer of oil and gas, B is not entitled to deduct any of the percentage depletion apportioned to B. However, B is entitled to take cost depletion with respect to one-half of the production from the oil property, notwithstanding the fact that depletion was computed at the trust level on the basis of percentage depletion.

(h) *Businesses under common control; members of the same family*—(1) *Component members of a controlled group.* For purposes of only the depletable quantity limitations contained in section 613A (c) and this section, component members of a controlled group of corporations (as defined in paragraph (1) of §1.613A–7) shall be treated as one taxpayer. Accordingly, the group shares the depletable oil (or natural gas) quantity prescribed for a taxpayer for the taxable year and the secondary production (to which gross income from the property is attributable before January 1, 1984) of a member of the group will reduce the other members' share of the group's depletable quantity.

(2) *Aggregation of business entities under common control.* If 50 percent or more of the beneficial interest in any two or more entities (*i.e.,* corporations, trust, or estates) is owned by the same or related persons (taking into account only each person who owns at least 5 percent of the beneficial interest in an entity and with respect to such person his or her entire interest) as defined in paragraph (m) (2) of §1.613A–7, the tentative quantity determined under the table in section 613A(c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) for a taxpayer for the taxable year shall be allocated among all such entities in proportion to their respective production. This paragraph (h)(2) shall not apply to component members of a controlled group of corporations (as defined in §1.613A–7 (1)). For purposes of determining ownership interest, an interest owned by or for a corporation, partnership, trust, or estate shall be considered as owned directly both by itself and proportionately by its shareholders, partners, or beneficiaries, as the case may be.

(3) *Allocation among members of the same family.* In the case of individuals who are members of the same family, the tentative quantity determined

under the table in section 613A (c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) for a taxpayer for the taxable year shall be allocated among such individuals in proportion to the respective production of barrels of domestic crude oil (and the equivalent in barrels to the cubic feet of natural gas determined under paragraph (h)(4)(ii) of this section) during the period in question by such individuals.

(4) *Special rules*. For purposes of section 613A (c)(8) and this section—

(i) The family of an individual includes only his spouse and minor children, and

(ii) Each 6,000 cubic feet of domestic natural gas shall be treated as 1 barrel of domestic crude oil.

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

Example 1. A owns 50 percent of the stock of Corporation M and 50 percent of the stock of Corporation N. Both corporations are calendar year taxpayers. For 1975 Corporation M's production of domestic crude oil was 8,000,000 barrels (365,000 of which was secondary production) and Corporation N's was 2,000,000 barrels (all of which was primary production). The tentative quantity (2,000 barrels per day) determined under the table in section 613A (c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) must be allocated between the two corporations in proportion to their respective barrels of production of domestic crude oil during the taxable year. Corporation M's allocable share of the tentative quantity is 1,600 barrels:

$$\left[2{,}000\left(\frac{8{,}000{,}000}{10{,}000{,}000}\right)\right]$$

and Corporation N's allocable share is 400 barrels:

$$\left[2{,}000\left(\frac{2{,}000{,}000}{10{,}000{,}000}\right)\right]$$

With respect to M's primary production, M's depletable oil quantity is 600 barrels (1,600 barrels − 1,000 barrels [365,000 secondary production ÷ 365 days]). N's depletable oil quantity, unaffected by M's secondary production, is 400 barrels.

Example 2. Assume the same facts as in *Example 1* except that Corporation M is a retailer and Corporation N is not selling its oil through Corporation M. Because Corporation M is a retailer, no portion of the tentative quantity is allocated to Corporation M. Accordingly, Corporation N's depletable oil quantity is the entire 2,000 barrels per day because section 613A (c), which contains the allocation requirements, is inapplicable to retailers.

Example 3. Corporations O and P are members of a controlled group and are treated as one taxpayer as provided in paragraph (h)(1) of this section. Corporation O owns oil properties A and B. Property A had primary production for 1975 of 800,000 barrels of oil. Property B had secondary production for 1975 of 365,000 barrels of oil. Corporation P owns oil property C which had primary production of 660,000 barrels for 1975. The allowable percentage depletion with respect to property B's secondary production was $360x. The controlled group's average daily production was 4,000 barrels [(800,000 + 660,000) ÷ 365]. The controlled group's depletable oil quantity was 1,000 barrels [2,000 tentative quantity − 1,000 average daily secondary production (365,000 ÷ 365)]. The allowable percentage depletion pursuant to section 613 (a) (computed as if section 613 applied to all of the production at the rate specified in section 613A (c)(5), as in effect prior to the Revenue Reconciliation Act of 1990) was $800x with respect to production from property A and $660x with respect to production from property C.

Corporation O's allowable depletion pursuant to section 613A (c) with respect to property B's secondary production (for which depletion is allowable before primary production) for 1975 was $360x. Corporation O's allowable depletion pursuant to section 613A (c) with respect to property A was $200x:

$$\left[\$800\text{x depletion}\left(\frac{1{,}000\text{ depletable oil quantity}}{4{,}000\text{ average daily production}}\right)\right]$$

Therefore, Corporation O's allowable depletion pursuant to section 613A (c) was $560x ($360x relating to property B plus $200x relating to property A). Corporation P's allowable depletion pursuant to section 613A (c) with respect to property C was $165x:

$$\left[\$660\text{x depletion}\left(\frac{\text{1,000 depletable oil quantity}}{\text{4,000 average daily production}}\right)\right]$$

(i) *Transfer of oil or gas property*—(1) *General rule*—(i) *In general*. Except as provided in paragraph (i)(2) of this section, in the case of a transfer (as defined in paragraph (n) of §1.613A–7) of an interest in any proven oil or gas property (as defined in paragraph (p) of §1.613A–7), paragraph (a)(1) of this section shall not apply to a transferee (as defined in paragraph (o) of §1.613A–7) with respect to production of crude oil or natural gas attributable to such interest, and such production shall not be taken into account for any computation by the transferee under this section.

(ii) *Examples*. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. On January 1, 1975, Individual A transfers proven oil properties to Corporation M in an exchange to which section 351 applies for shares of its stock. Since there is no allocation requirement pursuant to section 613A(c)(8) between A (the transferor) and Corporation M (the transferee), the transfer of the proven properties by A is a transfer for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990) and percentage depletion is not allowable to Corporation M with respect to such properties.

Example 2. On January 1, 1975, Corporation N sells proven oil property to Corporation O, its wholly-owned subsidiary. Because the transfer was made between corporations which are members of the same controlled group of corporations, Corporation O is entitled to percentage depletion with respect to production from the property so long as the tentative oil quantity is allocated between the two corporations. If Corporation N were a retailer, the tentative oil quantity would not be required to be allocated between the two corporations (see example 2 of §1.613A–3(h)(5)), and Corporation O would not be entitled to percentage depletion on the production from the property.

Example 3. B, owner of a proven oil property, died on January 1, 1975. Pursuant to the provisions of B's will, B's estate transferred the oil property on April 1, 1975, into a trust. On July 1, 1976, pursuant to a requirement in B's will, the trustee distributed the oil property to C. The transfer of the oil property by the estate to the trust and the later distribution of the property by the trust to C are transfers at death. Therefore, the trust was entitled to compute percentage depletion with respect to the production from the oil property when the property was owned by the trust and C is entitled to percentage depletion with respect to production from the oil property after the trust distributes the property to C.

Example 4. On January 1, 1975, property which produces oil resulting from secondary processes was transferred to D. The exemption under section 613A(c) applies to D because section 613A(c)(9) (relating to transfers of oil or gas property), as in effect in 1975, does not apply with respect to secondary production. In addition, even if at the time of the transfer the production from the property was primary and D applied secondary processes to the property transferred and obtained secondary production, D would be entitled to percentage depletion with respect to the secondary production.

Example 5. On July 1, 1975, E and F entered into a contract whereby F is given the privilege of drilling a well on E's unproven property, and if F does so F is to own the entire working interest in the property until F has recoverd all the costs of drilling, equipping, and operating the well. Thereafter, 50 percent of the working interest would revert to E. In accordance with the contract, 50 percent of the working interest reverted to E on July 1, 1976. F is entitled to percentage depletion because the transfer of the working interest to F occurred when the property was unproven on July 1, 1975, which is the date of the contract establishing F's right to the working interest. E is entitled to percentage depletion with respect to this working interest since the reversion of such interest with respect to which E was eligible for percentage depletion is not a transfer. However, if on the date of the contract E's property was proven (although not proven when E acquired the property), F would not be entitled to claim percentage depletion with respect to any of the working interest income. Nonetheless, E would still be entitled to percentage depletion with respect to E's working interest since the reversion of the interest is not a transfer.

Example 6. On January 1, 1975, G subleased an oil property to H, retaining a ⅛ royalty interest with the option to convert G's royalty into a 50-percent working interest. On July 1, 1975, the property was proven and on

July 1, 1976, G exercised G's option. G is entitled to claim percentage depletion with respect to G's working interest since the conversion of the royalty interest which is eligible for percentage depletion pursuant to section 613A(c) into an interest which constituted part of an interest previously owned by G is not a transfer pursuant to §1.613A–7(n)(8).

Example 7. I and J (both of whom are minors) are beneficiaries of a trust which owned a proven oil property. The oil property was transferred to the trust on January 1, 1975, by the father of I and J. For 1975, the trustee allocated all the income from the oil property to I. For 1976, the trustee allocated all the income from such property to J. On January 1, 1977, the trustee distributed the property to I and J as equal tenants in common. Since I, J, and their father are members of the same family within the meaning of section 613A(c)(8)(C), the transfer of the property to the trust by the father, the shifting of income between I and J, and the distribution of the oil property by the trust to I and J are not transfers for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990). However, the distribution of the oil property will constitute a transfer to each distributee on the date on which the distributee reaches majority under state law.

Example 8. In 1975, K transferred a proven oil property productive at 5,000 feet to L. Subsequent to the transfer, L drilled new wells on the property finding another reservoir at 10,000 feet. The two zones were combined under section 614 as a single property. L is not entitled to percentage depletion on the gross income attributable to the production from the productive zone at 5,000 feet, but is entitled to percentage depletion on the gross income attributable to the production from the productive zone at 10,000 feet because that zone was not part of the proven property until the date of development expenses by L, which is after the date of the transfer. Accordingly, L's maximum allowable percentage depletion deduction for 1975 would be zero percent of gross income from the property with respect to the production from 5,000 feet, plus 22 percent of gross income from the property with respect to the production from 10,000 feet. This maximum deduction would be subject to the limitation provided for in section 613(a), *i.e.*,50 percent of ''taxable income from the property (computed without allowance for depletion),'' such taxable income being the overall taxable income resulting from the sale of production from both zones, and would also be subject to the limitations provided in section 613A. The production from the productive zone at 5,000 feet is not taken into account in determining K's depletable oil quantity for the year.

Example 9. On July 1, 1975, M transferred an oil property with a fair market value of $100x to N. On February 1, 1976, N commenced production of oil from the property. The fair market value of the property on February 1, 1976, as reduced by actual costs incurred by N for equipment and intangible drilling and development costs, was $300x. Because the value of the property on transfer was not 50 percent or more of the value on February 1, 1976, the property transferred to N was not a proven property (see §1.613A–7(p)). However, if there had been only marginal production from the property so that the fair market value of the property on February 1, 1976, was $40x rather than $300x, the property transferred to N would have been a proven property provided the other requirements of a proven property were met.

Example 10. O is the owner of a remainder interest in a trust created January 1, 1970. On that date, the trust held oil and gas properties. On January 1, 1976, O's interest for the first time entitled O to the trust's income from oil and gas production from the properties. The reversion of the remainder interest to O is not a transfer (see §1.613A–7(n)(7)). Accordingly, the transfer of the interest in oil and gas property to O is deemed to have occurred on January 1, 1970, the date O's interest was created.

Example 11. On January 1, 1976, P, Q, and R entered into a partnership for the acquisition of oil and gas leases. It was agreed that the sharing of income will be divided equally among P, Q, and R. However, it was further agreed that with respect to the first production obtained from each property acquired P will receive 80 percent thereof and Q and R each will receive 10 percent thereof until $100x has been received by P. Assume these allocations have substantial economic effect under section 704 of the Code and the regulations thereunder. On February 1, 1976, Partnership PQR acquired an unproven property and production therefrom was shared pursuant to the partnership agreement. P is entitled to percentage depletion with respect to the production allocated to him since the transfer of right to the production is deemed to have been made on the date the partnership agreement became applicable to the specific property, at which time the property was unproven. See §1.613A–7(n) for rules relating to the definition of transfer. Similarly, when $100x has been obtained and Q and R each commence receiving 33⅓ percent of the revenue, Q and R are entitled to percentage depletion with respect to their entire interests. However, if the property had been proven when acquired by the partnership, P, Q, and R would not be entitled to claim any percentage depletion with respect to production from the property.

Example 12. On December 30, 1960, S placed producing oil property in trust for the benefit of S's nephew, T, and executed a trust

agreement which required the trustee of the trust to transfer the oil property to T on January 1, 1975. The trustee's transfer of the oil property to T on January 1, 1975, is deemed to have occurred on December 30, 1960 (see §1.613A–7(n)). Since the transfer is deemed to have occurred before January 1, 1975, section 613A(c) applies with respect to the production from the oil property. Moreover, if the trustee was not required to transfer the oil property on a specific date but was given discretion to select the date of transfer, the transfer of such property would still be deemed to have occurred on December 30, 1960. However, the result would be different if the trust agreement had provided that the trustee, at the trustee's discretion, may transfer the oil property to T on January 1, 1975, but is not under any obligation to transfer the property to T on January 1, 1975, or on any other date. Since the transfer was discretionary, the date of the actual transfer governs.

Example 13. On January 1, 1974, U acquired an oil property. On February 1, 1974, U granted V an option to purchase the oil property. V exercised V's option on March 2, 1975, and subsequently the oil property was conveyed to V. The date of the transfer was March 2, 1975, the day V exercised V's option (on which date both parties were bound).

Example 14. On July 1, 1974, W executed a deed conveying oil and gas property to X. W delivered the deed to X on January 1, 1975. Under state law, the mere execution of the deed without delivery did not give X any rights in the property. Title to the oil property passed to X on the date of delivery. Therefore, the date of transfer was January 1, 1975.

Example 15. Y, owner of a proven oil property, transferred Y's interest therein on July 25, 1975, to a revocable trust of which Y is treated as the owner under section 676. Y is not deemed a transferee and section 613A(c) applies to Y because immediately preceding the transfer Y was entitled to percentage depletion on the production from the property.

Example 16. On January 1, 1975, a proven oil property was transferred to Z; therefore, section 613A(c)(1) did not apply with respect to the production from such property. After Z's death, neither Z's estate nor its beneficiaries are entitled to percentage depletion with respect to the decedent's oil property since Z was a transferee of proven property.

Example 17. Partnership ABC, owner of proven oil and gas properties, admitted D as a partner in 1975 in consideration of cash. The shares of Partners A, B, and C of the partnership income were proportionately reduced so that D had a 25 percent interest in the income. D is not entitled to percentage depletion with respect to D's share of partnership oil and gas income because D is a transferee for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990). See §1.613A–7(n).

Example 18. On January 1, 1975, E and F formed Partnership EF to which E contributed proven oil property. For 1975, pursuant to the partnership agreement 70 percent of the mineral income from the property was allocated to E and 30 percent of the mineral income from the property was allocated F. F is not entitled to percentage depletion with respect to production from the property because F is a transferee of an interest in proven property. However, E is not a transferee of an interest in proven property because E was entitled to percentage depletion on the oil produced with respect to the property immediately before the transfer. Therefore, E is entitled to percentage depletion with respect to the income allocated to E. However, if in 1976 the partnership agreement were revised so that E's interest in the income was increased by 10 percent, E would not be entitled to percentage depletion with respect to the additional 10 percent interest because E is a transferee with respect thereto.

Example 19. G is the owner of a ⅓ interest in a partnership owning a proven oil property, and as such is entitled to ⅓ of the income from the property. G received a distribution on July 1, 1975, from the partnership of a ⅓ interest in the proven oil property. Although the transfer of such interest is a transfer for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990), G is still entitled to percentage depletion with respect to the ⅓ interest in the oil production from the property since G was entitled to percentage depletion on such production with respect to such property immediately before the transfer. If the entire property were distributed to G, G's percentage depletion allowance would still be based on only ⅓ of the oil produced.

Example 20. H and I contributed property X and property Y respectively to Partnership HI. The partnership agreement provides that all the gross income from property X is to be allocated to H and all the gross income from property Y is to be allocated to I. Assume these allocations have substantial economic effect under section 704 of the Code and the regulations thereunder. For 1975 H and I each received $100x gross income. Although the contributions of the properties by H and I are transfers for purposes of section 613A(c)(9) (as in effect prior to the Revenue Reconciliation Act of 1990), both H and I are entitled to percentage depletion with respect to the $100x income received since each was entitled to a percentage depletion allowance with respect to the property contributed immediately before the transfer. However, if no special allocation of income were made but H and I are to share equally in the income from both properties, each would be entitled to a depletion allowance based on only one-half of the production with respect to the

property he had contributed. If property X produces $100x of gross income from the property and property Y produces $200x of gross income from the property, H would be entitled to percentage depletion but only with respect to $50x (50 percent of $100x) of gross income from the property and I would be entitled to percentage depletion with respect to $100x (50 percent of $200x) of gross income from the property.

(2) *Transfers after October 11, 1990*—(i) *General rule*. Section 613A(c) (9) and (10), as in effect prior to the Revenue Reconciliation Act of 1990 (relating to prohibition of percentage depletion on transferred proven properties) has been repealed effective for transfers after October 11, 1990. Accordingly, a transferee of a proven oil or gas property transferred after October 11, 1990 is permitted to claim percentage depletion with respect to production from the property. For purposes of transfers of property occurring before October 12, 1990 under section 613A(c)(10), prior to its repeal, the disposition of stock after October 11, 1990 by a transferor will not result in a reduction in the depletable quantity of the transferee corporation under section 613A(c)(10)(F).

(ii) *Transfer*. The term ''transfer'' has the same meaning as under §1.613A–7(n).

(iii) *Transferee*. A person shall not be treated as a transferee with respect to a transferred property to the extent that such person held an interest in the property but was not entitled to a percentage depletion allowance on mineral produced with respect to the property immediately before the transfer. Thus, for example, if a taxpayer who is not entitled to claim percentage depletion on a proven property transfers the property to a partnership for an interest in the partnership, the taxpayer is not a transferee with respect to the property in the hands of the partnership.

(iv) *Effective date*. The provisions of paragraph (i)(2) of §1.613A–3 are effective for transfers occurring after May 13, 1991. However, a taxpayer may elect to apply these provisions to transfers occurring after October 11, 1990 and on or before May 13, 1991.

(v) *Examples*. The examples below illustrate the provisions of this subparagraph. The examples ignore the application of any restriction on percentage depletion other than the proven property transfer rule.

Example 1. On December 31, 1991, A transfers a proven oil property to B. B may claim percentage depletion with respect to production from the property regardless of whether production from the property was eligible for percentage depletion in A's hands (even if A were a retailer or refiner of oil or gas).

Example 2. On October 10, 1990, A transfers a proven oil property to B. B may not claim percentage depletion with respect to production from the property.

Example 3. On January 1, 1990, C purchases a proven oil property. Because C is a transferee of a proven property, production from the property is not eligible for percentage depletion in C's hands. On December 31, 1991, C contributes the property to Corporation M, an S corporation in which C owns 100 percent of the stock. The contribution of the property is a transfer, but C is not a transferee with respect to the property in the hands of the corporation. Accordingly, C may not claim percentage depletion with respect to production from the property. However, if prior to the contribution C had been entitled to claim percentage depletion with respect to production from the property, C would be entitled to claim percentage depletion with respect to production from the property after the contribution.

Example 4. On December 31, 1991, C contributes a proven oil property (with respect to which C is not entitled to claim percentage depletion) to Corporation N, an S corporation in which C owns 30 percent and D owns 70 percent of the stock. The contribution of the property is a transfer, but C is not a transferee with respect to the property in the hands of the corporation. Accordingly, C may not claim percentage depletion with respect to C's share of the production from the property. D is a transferee with respect to the property in the hands of Corporation N, and may claim percentage depletion with respect to D's share of production from the property.

Example 5. On December 31, 1991, D transfers a proven oil property (with respect to which D is not entitled to claim percentage depletion) to DE, an equal partnership between D and E. E is a transferee with respect to the property and may claim percentage depletion with respect to production from the property allocated to E under the DE partnership agreement. D is not a transferee with respect to the property, and may not claim percentage depletion with respect to production from the property allocated to D under the DE partnership agreement. However, if D had been entitled to claim percentage depletion with respect to production from the property, then D would be entitled to claim percentage depletion with respect

to production from the property in the hands of DE.

Example 6. On January 1, 1990, Corporation P contributes a proven property to Corporation O, its wholly owned subsidiary. Under §1.613A–7(n)(4), the contribution is not treated as a transfer, but only for so long as the tentative quantity is required under section 613A(c)(8) to be allocated between P and O. On December 31, 1991, P sells 90% of the O stock to an unrelated person; accordingly, the tentative quantity is no longer required under section 613A(c)(8) to be allocated between P and O. After the sale of O stock, production from the property in O's hands is eligible for percentage depletion because a transfer of a proven property is deemed to occur upon the transfer of the stock.

Example 7. On October 10, 1990, G transfers a proven oil property to his minor son, H. G had been entitled to claim percentage depletion with respect to production from the property. Under §1.613A–7(n)(5), H is permitted to claim percentage depletion for so long as G and H are related persons under section 613A(c)(8)(C). On December 31, 1991, H reaches majority and is no longer related to G under section 613A(c)(8)(C). H is entitled to continue to claim percentage depletion on production from the property because the property is treated as being transferred to H on December 31, 1991.

Example 8. On December 31, 1991, I sells a proven property to J, her husband. I had not been entitled to claim percentage depletion with respect to production from the property. Under §1.613A–7(n)(5), the sale is not a transfer because it is made between persons related under section 613A(c)(8). Accordingly, J may not claim percentage depletion with respect to production from the property. If, however, I had been entitled to claim percentage depletion with respect to production from the property, J would be entitled to claim percentage depletion with respect to production from the property.

Example 9. On December 31, 1991, L inherits a proven property from K. K had not been entitled to claim percentage depletion with respect to production from the property. Under §1.613A–7(n)(1), the inheritance is not a transfer. Accordingly, L may not claim percentage depletion with respect to production from the property. If, however, K had been entitled to claim percentage depletion with respect to production from the property, L would be entitled to claim percentage depletion with respect to production from the property.

Example 10. On December 31, 1991, Corporation R, a calendar year taxpayer, made an S election effective for the taxable year beginning January 1, 1992 and succeeding taxable years. Since Corporation R is deemed to have transferred its oil and gas properties on January 1, 1992, the shareholders of Corporation R are eligible to claim percentage depletion with respect to the production from the properties.

Example 11. Assume the same facts as in *Example 10* except that Corporation R makes the S election on December 31, 1989, effective for the taxable year beginning January 1, 1990 and succeeding taxable years. Since Corporation R is deemed to have transferred its oil and gas properties on January 1, 1990, the shareholders of Corporation R are not eligible to claim percentage depletion with respect to the production from the properties.

(j) *Percentage depletion with respect to bonuses and advanced royalties*—(1) *Amounts received or accrued after August 16, 1986*. In computing the percentage depletion allowance pursuant to section 613A(c) with respect to amounts received or accrued after August 16, 1986, there shall not be taken into account any advance royalty (to the extent that actual production during the taxable year is insufficient to earn such royalty), lease bonus, or other amount payable without regard to production, even though the amount may be taken into account for purposes of sections 61 and 612 (relating to definitions of gross income and cost depletion, respectively).

(2) *Amounts received or accrued before August 17, 1986*. (i) A lease bonus or advanced royalty received or accrued before August 17, 1986, with respect to oil or gas property shall be taken into account for purposes of percentage depletion in the taxable year such payment is includible in income. Percentage depletion shall be determined according to the depletion rate and depletable oil and natural gas limitations of section 613A(c)(1) and §1.613A–3(a) applicable on the date of such inclusion. The payee of the bonus or advanced royalty shall apply the depletable oil and natural gas quantity limitations by attributing a specific number of barrels of oil or cubic feet of natural gas to the lease bonus or advanced royalty. The determination of the number of barrels of oil or cubic feet of natural gas shall be based on the average price of oil or gas produced from the property during the taxable year. If oil or gas is not produced from the property during that year, or if the oil or gas is not sold before conversion or transportation from the premises, the number of barrels of oil or cubic feet of gas shall be based on a price (as of the date of the bonus or

advanced royalty) determined under the constructive pricing principles applicable under section 613(a), generally the representative market or field price. In the case where no oil or gas has been produced in such year, the constructive price applicable to the type of production expected to be produced from the property shall apply. However, if the first actual production from the property in a later year is different from the type of production upon which the conversion of the bonus or advanced royalty into barrels of oil or cubic feet of gas was based and the period of limitations on assessment has not expired (see section 6501) for the year in which the lease bonus or advanced royalty is includible in income, the taxpayer should promptly file an amended return, if necessary. In the amended return the conversion shall be recomputed taking into account the pricing applicable to the actual production. For purposes of paragraph (f) of § 1.613A–7, the number of barrels of oil or cubic feet of natural gas attributed to a lease bonus or advanced royalty is deemed to have been extracted on the date the bonus or advanced royalty is includible in the payee's income.

(ii) For purposes of applying the depletable oil and natural gas quantity limitations in taxable years after the year in which the advanced royalty payment is included in income, the payee of an advanced royalty which is recouped out of future production shall not include production which recoups the advanced royalty in such later years. The payor of a bonus or advanced royalty that is not recouped from future production may reduce the production to be taken into account for purposes of applying the depletable quantity limitations in each year in which the payor's gross income from the property is adjusted under § 1.613–2(c)(5)(ii) to reflect the bonus paid by an amount determined by dividing the portion of the bonus required to be excluded from the payor's gross income from the property by the price of oil or gas applicable to the payee for converting the bonus into barrels of oil or cubic feet of gas.

(iii) See § 1.612–3 (a)(2) and (b)(2) for rules relating to the requirement that certain depletion deductions allowed with respect to lease bonuses and advanced royalties be restored to income.

(k) *Special rules for fiscal year taxpayers.* In applying this section to a taxable year which is not a calendar year, each portion of such taxable year which occurs during a single calendar year shall be treated as if it were a short taxable year.

(l) *Information furnished by partnerships, trusts, estates, and operators.* Each partnership, trust, or estate producing domestic crude oil or natural gas, and each operator of a well from which domestic crude oil or natural gas was produced, shall provide each partner, beneficiary, or person holding a nonoperating interest, as the case may be, with all information in its possession necessary to determine the amount of his depletion deduction allowable with respect to such crude oil or natural gas. For example, for each property a partnership is required to provide each partner with partnership information relating to the partner's allocable share of gross income from the property, the partner's allocable share of operating expenses, the partner's allocable share of depreciation, the partner's share of allocated overhead, the partner's share of estimated reserves, the partner's share of production in barrels or cubic feet for the taxable year, the partner's original share of the partnership adjusted basis of properties producing domestic crude oil or domestic natural gas, the partner's allocable share of any adjustments made to the basis of such properties by the partnership, and the percentage by which existing partners must reduce their bases in a partnership oil or gas property upon entry of a partner by contribution. In addition, upon the disposition of an oil or gas property by the partnership, the partnership shall inform each partner of his allocable portion of the amount realized from the sale of the property.

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§ 1.613A–4 Limitations on application of § 1.613A–3 exemption.

(a) *Limitation based on taxable income.* (1) The aggregate amount of a taxpayer's deductions allowed pursuant to section 613A(c) for the taxable year shall not exceed 65 percent of the taxpayer's taxable income (reduced in the case of an individual by the zero bracket amount for taxable years beginning after December 31, 1976, and before January 1, 1987) for the year, adjusted to eliminate the effects of:

(i) Any depletion with respect to an oil or gas property (other than a gas property with respect to which the depletion allowance for all production is determined pursuant to section 613A(b)) for which percentage depletion would exceed cost depletion in the absence of the depletable quantity limitations contained in section 613A(c) (1) and (6) (as in effect prior to the Revenue Reconciliation Act of 1990) or the taxable income limitation contained in section 613A(d)(1);

(ii) Any net operating loss carryback to the taxable year under section 172;

(iii) Any capital loss carryback to the taxable year under section 1212; and

(iv) In the case of a trust, any distributions to its beneficiaries, except in the case of any trust where any beneficiary of such trust is a member of the family (as defined in section 267(c)(4)) of a settlor who created inter vivos and testamentary trusts for members of the family and such settlor died within the last 6 days of the 5th month in 1970, and the law in the jurisdiction in which such trust was created requires all or a portion of the gross or net proceeds of any royalty or other interest in oil, gas, or other mineral representing any percentage depletion allowance to be allocated to the principal of the trust.

The amount disallowed (as defined in paragraph (q) of § 1.613A–7) shall be carried over to the succeeding year and treated as an amount allowable as a deduction pursuant to section 613A(c) for such succeeding year, subject to the 65-percent limitation of section 613A(d)(1). For rules relating to corporations filing a consolidated return, see the regulations under section 1502. With respect to fiscal year taxpayers, except as provided in § 1.613A–1 for taxable years beginning before January 1, 1975, and ending after that date, the limitation shall be calculated on the entire fiscal year and not applied with respect to each short period included in a fiscal year. For purposes of basis adjustments and determining whether cost depletion exceeds percentage depletion with respect to the production from a property, any amount disallowed as a deduction after the application of this paragraph shall be allocated to the respective properties from which the oil or gas was produced in proportion to the percentage depletion otherwise allowable to such properties pursuant to section 613A(c). Accordingly, the maximum amount which may be allowable as a deduction pursuant to section 613A(c) after application of this paragraph (65 percent × adjusted taxable income) shall be allocated to properties for which percentage depletion pursuant to section 613A(c) would be allowed in the absence of the limitation contained in section 613A(d)(1) by application of the same proportion. However, once it is determined that after application of this paragraph cost depletion exceeds percentage depletion with respect to a property, the maximum amount determined under the preceding sentence shall be reallocated among the remaining properties, and the portion of the amount disallowed which is allocable to such property shall be the amount by which percentage depletion pursuant to section 613A(c) before application of this paragraph exceeds cost depletion. See example 1 of paragraph (a)(2) of this section. If the taxpayer becomes entitled to the deduction in a later year (*i.e.*, because the disallowed depletion does not exceed 65 percent of the taxpayer's taxable income for that year after taking account of any percentage depletion deduction otherwise allowable for that year), then the basis of the taxpayer's properties must be adjusted downward (but not below zero) by the amount of the deduction in proportion to the portion of the amount disallowed to the respective properties in the year of the disallowance. However, if the property in question was disposed of by the taxpayer prior to the beginning of such later year, the

amount of the deduction in such later year shall be reduced by the difference between the taxpayer's adjusted basis in the property at the time it is disposed of and the adjusted basis which the taxpayer would have had in the property in the absence of the 65-percent limitation.

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

Example 1. A owns producing oil properties M, N, and O. With respect to property M, the depletion allowable pursuant to section 613A(c) for 1975 without regard to section 613A(d)(1) was $60 × (cost depletion would have been $40 ×). With respect to property N, the depletion allowable pursuant to section 613A(c) for 1975 without regard to section 613A(d)(1) was $90 × (cost depletion would have been zero). With respect to property O, the depletion pursuant to section 613A(c) for 1975 without regard to section 613A(d)(1) was $50 × (cost depletion would have been $10X). A's taxable income (as adjusted under § 1.613A–4(a)(1)) for 1975 was $100 × ; accordingly, A's percentage depletion pursuant to section 613A(c) for 1975 must be reduced from $200 × to $65 × (65 percent × $100 × taxable income). Of that amount, $19.5 × :

$$\left[65\text{x dollars}\left(\frac{\$60\text{x}}{\$60\text{x}+\$90\text{x}+\$50\text{x}}\right)\right]$$

is tentatively allocated to property M, $29.25 × :

$$\left[65\text{x dollars}\left(\frac{\$90\text{x}}{\$90\text{x}+\$60\text{x}+\$50\text{x}}\right)\right]$$

is tentatively allocated to property N, and $16.25 × :

$$\left[65\text{x dollars}\left(\frac{\$50\text{x}}{\$50\text{x}+\$90\text{x}+\$60\text{x}}\right)\right]$$

is tentatively allocated to property O.

Since cost depletion of $40 × with respect to property M exceeded the percentage depletion of $19.5 × allowable on such property, A claimed the cost depletion. Accordingly, the only percentage depletion deduction allowable to A pursuant to section 613A(c) for 1975 is with respect to properties N and O. Therefore, the $65 × ceiling applies to the percentage depletion allowable on properties N and O. Of that amount, $41.79 × :

$$\left[65\text{x dollars}\left(\frac{\$90\text{x}}{\$90\text{x}+\$50\text{x}}\right)\right]$$

is allocated to property N, and $23.21 × :

$$\left[65\text{x dollars}\left(\frac{\$50\text{x}}{\$50\text{x}+\$90\text{x}}\right)\right]$$

is allocated to property O.

Accordingly, A is allowed a total depletion deduction of $105 × ($40 × cost depletion on property M + $41.79 × percentage depletion on property N + $23.21 × percentage depletion on property O). The amount disallowed to A under section 613A(d)(1) is $95 × ($200 × aggregate depletion allowable before application of section 613A(d)(1) − $105 × [$40 × cost depletion allowable on property M + $41.79 × percentage depletion allowable on property N after application of section 613A(d)(1) + $23.21 × depletion allowable on property O after application of section 613A(d)(1)]). For purposes of basis adjustments, $20 × ($60 × percentage depletion before limitation − $40 × cost depletion allowed) of the amount disallowed is allocated to property M. The balance of the amount disallowed of $75 × is allocated $48.21 × :

$$\left[75\text{x dollars}\left(\frac{\$90\text{x}}{\$90\text{x}+\$50\text{x}}\right)\right]$$

to property N, and

$$\left[75\text{x dollars}\left(\frac{50\text{x}}{\$50\text{x}+\$90\text{x}}\right)\right]$$

to property O.

Example 2. The amount disallowed to B as a deduction under this paragraph is $50x for 1975 and $125x for 1976 (including the $50x carried over from 1975). B may carry forward the $125x as a deduction to 1977 and subsequent years.

Example 3. C is a fiscal year taxpayer whose fiscal year ended on May 31, 1975. For purposes of applying the 65 percent of taxable income limitation, the period beginning January 1, 1975, and ending May 31, 1975, is treated as a short taxable year. The depletion allowable pursuant to section 613A(c) without regard to section 613A(d)(1) for such short taxable year was $80x and A's taxable income (as adjusted under § 1.613A–4(a)(1)) during such short taxable year was $100x. Only $65x (65 percent × $100x adjusted taxable income) of the deduction pursuant to section 613A(c) was deductible for such portion of 1975, in addition to any percentage depletion allowable for June 1, 1974, through December 31, 1974. With respect to the taxable year commencing June 1, 1975, and ending May 31, 1976, the 65 percent limitation is applied to the taxable income for the entire taxable year.

Example 4. Under the trust law of State X, a trustee is required to allocate 22 percent of gross mineral income to the principal of a trust for purposes of maintaining a reserve for depletion and the depletion deduction is entirely allocated to the trustee. In 1975 the gross income of a trust in State X the only assets of which were oil properties was $1,000. The trust's allowable percentage depletion pursuant to section 613A(c) without regard to section 613A(d)(1) was $220. The trust incurred expenses of $150 for the taxable year and made distributions to beneficiaries (who are not described in the exception for family members set forth in paragraph (a)(1)(iv) of this section) of $630 ($1,000 gross income −$220 allocated to principal −$150 expenses). The trust's deduction for personal exemption under section 642(b) is $300. For purposes of applying the 65 percent limitation, the trust's taxable income was $550 ($1,000 gross income −$150 expenses −$300 exemption). The limitation under section 613A(d)(1) was $357.50 (65% × $550 taxable income). Accordingly, the trust's percentage depletion allowance was unaffected by the 65 percent limitation.

Example 5. In 1980 the gross income of the estate of D was $1,000. The only assets of the estate were oil properties. The estate's adjusted basis in the oil properties was $0. The estate's allowable percentage depletion pursuant to section 613A(c) without regard to section 613A(d)(1) was $220. The estate incurred expenses of $150 for the taxable year and made distributions to beneficiaries of $425. The distributions thus equaled one half of the net income of the estate (ignoring depletion). Under section 611(b)(4), the percentage depletion is apportioned equally between the estate and its beneficiary. The distribution amount of $425 is deductible under section 661(a) in computing the taxable income of the estate. For purposes of applying the 65 percent limitation to the percentage depletion apportioned to the estate, the estate's taxable income was $0 ($1,000 gross income −$150 expenses −$425 distribution −$600 exemption). The limitation under section 613A(d)(1) was therefore also $0 (65% × $0 taxable income). Accordingly, the $110 amount is disallowed to the estate for the taxable year but may be carried forward by the estate as a deduction to 1981 and subsequent years. The beneficiaries shall apply the 65 percent limitation to the $110 percentage depletion apportioned to them based on their respective taxable incomes.

Example 6. In 1975 E sold an oil property for which E's adjusted basis was $20x. The amount disallowed for 1975 to E under section 613A(d) was $10x. The amount of the carryover under that section to 1976 was $0 ($10x disallowed amount −$10x [$20x adjusted basis of property on sale −$10x adjusted basis which taxpayer would have had in the property in the absence of the 65-percent limitation]). However, if the adjusted basis of the property on disposition had been $0, the amount of the carryover to 1976 would have been $10x ($10x disallowed amount −$0 adjusted basis of property on sale).

Example 7. In 1975 F owned producing properties M, N, O, P, Q, and R. With respect to property M, the allowable cost depletion was $100x (the allowable percentage depletion pursuant to section 613A(c) without regard to the depletable quantity and taxable income limitations contained in section 613A(c)(1), (6) and (d)(1) would have been $90x). With respect to property N, the allowable percentage depletion pursuant to section 613A(c) before applying section 613A(d)(1) was $80x (cost depletion would have been $0). With respect to property O, the allowable cost depletion was $60x (the allowable percentage depletion pursuant to section 613A(c) would have been $70x, except that the application of section 613A(d)(1) reduced allowable percentage depletion to less than $60x). With respect to property P, the allowable percentage depletion pursuant to section 613A(b) was $55x (cost depletion would have been $40x). With respect to property Q, which produces both gas subject to section 613A(b)(1)(B) and oil subject to section 613A(c), the allowable percentage depletion was $45x (cost depletion would have been $40x). With respect to property R, the allowable cost depletion was $40x (the allowable percentage depletion pursuant to section 613A(c) would have been $50x, except that the application of section 613A(c)(7)(A) reduced allowable percentage depletion to less than $40x). Under paragraph (a)(1)(i) of this section, for purposes of applying the 65 percent limitation under section 613A(d)(1), F's taxable income must be reduced by the allowable depletion with respect to property M (for which cost depletion exceeded percentage depletion even in the absence of section 613A(c)(1), (6), and (d)) and property P (for which all depletion is determined pursuant to section 613A(b)), but shall not be reduced by the allowable depletion with respect to properties N, O, Q, and R.

(b) *Retailers excluded.* (1) Section 613A(c) and § 1.613A–3 shall not apply in the case of any taxpayer who is a retailer as defined in paragraph (r) of § 1.613A–7.

(2) The application of this paragraph may be illustrated by the following examples (those that involve sales through retail outlets assume, unless otherwise stated, that the $5,000,000 gross receipts requirement section 613A(d)(2) is met):

Example 1. A, owner of producing oil and gas properties, also owns 5 percent in value of the stock of Corporation M, a retailer of

oil and gas. None of A's production is sold through Corporation M. Since A may benefit from Corporation M's sales of oil and gas through A's ownership interest in Corporation M, A is considered to be selling oil or natural gas through Corporation M, a related person. Accordingly, the exemption under section 613A(c) does not apply to A, even though none of A's production is sold through Corporation M.

Example 2. Assume the same facts as in *Example 1* except that A has gross receipts of $2 million from sales of oil for the taxable year from A's retail outlets and Corporation M has gross receipts of $4 million from sales of oil for the taxable year from its retail outlets. For purposes of the $5 million gross receipts requirement of section 613A(d)(2), A is treated as having gross receipts of $6 million. Accordingly, the exemption under section 613A(c) does not apply to A.

Example 3. Corporation N, a retailer of oil and gas, owns 5 percent in value of the stock of Corporation O, owner of producing oil and gas properties. None of Corporation O's production is sold through Corporation N. Since Corporation O has no direct or indirect ownership interest in Corporation N, and therefore does not benefit from Corporation N's sales of oil and gas, and since none of Corporation O's production is sold through Corporation N, the exemption under section 613A(c) applies to Corporation O.

Example 4. Corporation P, a producer of oil, owns 70 percent in value of the stock of Corporation Q. Corporation Q owns 30 percent in value of the stock of Corporation R. Corporation R owns 30 percent in value of the stock of Corporation S, a retailer of oil and gas. P indirectly owns 6.3 percent (70 percent × 30 percent × 30 percent) in value of the stock of Corporation S. Since P may benefit from Corporation S's sales of oil and gas through P's indirect ownership interest in Corporation S, P is not entitled to percentage depletion.

Example 5. B is the owner of certain oil and gas properties in Texas and is also the owner of a service station in Washington, DC, which B leases to Corporation T. None of B's production is sold to Corporation T. The exemption under section 613A(c) applies to B. However, if sales of B's production were made to Corporation T and the gross receipts from such sales of B's production to Corporation T exceed 5 million dollars, the exemption under section 613A(c) would not apply to B because B is selling oil or natural gas to a person given authority to occupy a retail outlet leased by the taxpayer, B.

Example 6. C has a ⅛ royalty interest and Corporation U has a ⅞ working interest in an oil property. Corporation V, a retailer of oil, owns 5 percent in value of the stock of Corporation U. C has no interest in either corporation. All of the production from the property is sold through Corporation V, C receiving from Corporation U ⅛ of its receipts therefrom. The exemption under section 613A(c) does not apply to Corporation U because Corporation U is selling oil of natural gas through Corporation V, a related person that is a retailer. However, the exemption applies to C because C, as owner of a nonoperating mineral interest, is not treated as an operator of a retail outlet merely because C's oil and gas is sold on C's behalf through a retail outlet operated by an unrelated person.

Example 7. D owns and operates retail grocery stores where refined oil may be purchased. D also owns oil and gas producing properties. If the sales of refined oil at each store location constitute less than 5 percent of the gross receipts from all sales made at that store, D is not considered a retailer by reason of such sales.

Example 8. Lessee E sells natural gas to lessor F directly from a wellhead gathering pipelines system for F's local agricultural use, in transactions incidental to the acquisition of a natural gas lease. The sales of natural gas to F are not sales through a retail outlet.

Example 9. Corporation W produces natural gas, some of which it sells at retail. For purposes of determining whether Corporation W is a retailer selling gas through a retail outlet within the meaning of §1.613A–7(r), the business office of Corporation W where a purchaser would normally contact the corporation with respect to its sales to the purchaser is considered the place at which those sales of natural gas are made.

Example 10. G, husband, is the sole owner and operator of a retail outlet which sells oil and gas. H, wife, owns producing oil and gas properties. G is not related to H for purposes of section 613A(d).

Example 11. I, husband, and J, wife, are community property owners of 10 percent in value of the stock of Corporation X which is a retailer of oil and gas. I and J are each treated as owning 5 percent of Corporation X. Therefore, neither I nor J qualify for the exemption under section 613A(c).

Example 12. Corporation Y, an electing small business corporation as defined in section 1371 (as in effect prior to the enactment of the subchapter S Revision Act of 1982), owns producing oil and gas properties. K, a retailer of oil and gas, is a 50 percent interest shareholder of Corporation Y. None of Corporation Y's production is sold through K. Corporation Y is eligible for percentage depletion.

Example 13. Corporation Z, a producer of natural gas, makes bulk sales of natural gas to industrial users. For purposes of determining whether Corporation Z is a retailer under §1.613A–7(r), the bulk sales are disregarded.

Example 14. L, a calendar year taxpayer, is the owner of a producing oil property. On September 1, 1976, L purchased a chain of

gasoline service stations. Therefore, L was a retailer of oil and gas for the last 122 days of 1976. L's gross income from the oil property for the taxable year was $150x and L's taxable income from the property was $30x. L is treated as a retailer with respect to $50x of gross income from the property ($150x × 122/366) and $10x of taxable income from the property ($30x × 122/366). Therefore, L is entitled to percentage depletion with respect to $100x of gross income from the property ($150x minus $50x). However, the allowable percentage depletion is limited by the 50 percent of taxable income from the property limitation to $10x (50 percent times $20x taxable income ($30x minus $10x)).

Example 15. Corporation M is a partner in Partnership MNO which is the owner of an operating interest in a producing oil property. Corporation P, a retailer of oil and gas, owns 5 percent in value of the stock of Corporation M. Partnership MNO sells its production to Corporation P. Corporation M is retailing oil through Corporation P, a related person, because its share of the oil is being sold on its behalf by the partnership through a retail outlet operated by a person related to Corporation M. Therefore, the exemption under section 613A(c) does not apply to Corporation M.

Example 16. AA and BB are beneficiaries of a trust which is a retailer of oil and gas. AA has an interest in the income of the trust for AA's lifetime which, actuarially determined, represents more than 5 percent of the beneficial interests in the trust. BB's interest in the trust, which entitles BB to 5 percent of the corpus of the trust 5 years after AA's death, represents less than 5 percent of the beneficial interests in the trust prior to AA's death and represents more than 5 percent after AA's death. The trust is a related person of AA but not BB while AA is alive. Accordingly, during AA's lifetime BB is not disqualified from the exemption provided by section 613A(c), but AA is.

Example 17. Assume the same facts as in *Example 16,* except that AA's interest in the income of the trust represents 4 percent of the beneficial interests in the trust. AA is disqualified from the exemption provided by section 613A(c) with respect to the income from the trust but not with respect to income from other sources.

(c) *Certain refiners excluded.* (1) Section 613A(c) and §1.613A–3 shall not apply in the case of any taxpayer who is a refiner as defined in paragraph (s) of §1.613A–7.

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

Example 1. Corporation M owns a refinery which has refinery runs in excess of 50,000 barrels on at least one day during the taxable year. Corporation M also owns a 5 percent interest in Corporation N, owner of producing oil and gas properties. None of Corporation N's production is sold to Corporation M. The exemption under section 613A(c) does not apply to Corporation N because Corporation M, a related person of Corporation N, engages in the refining of crude oil.

Example 2. A and B are equal partners in Partnership AB, which owns oil and gas producing properties. A owns a refinery which has refinery runs in excess of 50,000 barrels on at least one day during the taxable year and which buys all of Partnership AB's production. B has no ownership interest in any refinery. B is not a refiner.

[T.D. 8348, 56 FR 21946, May 13, 1991; 57 FR 4913, Feb. 10, 1992]

§ 1.613A–5 Election under section 613A(c)(4).

The election under section 613A(c)(4) is an annual election which the taxpayer may make by claiming percentage depletion deductions for the taxable year based upon such election. The election may be made, on an original or amended tax return or a claim for credit or refund, at any time prior to the expiration of the statutory period (including any extensions thereof) for the filing of a claim for credit or refund by the taxpayer. The election may be changed by the taxpayer by filing an amended return or a claim for credit or refund. The election allows the taxpayer to treat as his depletable natural gas quantity an amount equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer's depletable oil quantity to which the election applies. The election applies to secondary or tertiary production, as well as primary production, but in determining the taxpayer's depletable natural gas quantity with respect to secondary or tertiary production the taxpayer's depletable oil quantity shall be determined without regard to section 613A(c)(3)(A)(ii) with respect to production from secondary or tertiary processes.

[T.D. 7487, 42 FR 24264, May 13, 1977]

§ 1.613A–6 Recordkeeping requirements.

(a) *Principal value of property demonstrated.* In the case of a transfer (as defined in §1.613A–7(n)) after December 31, 1974, of an interest in an oil or gas property (as defined in §1.613A–7(p)),

the transferee (as defined in section 1.613A–7(o)) shall keep records showing the terms of the transfer, any geological and geophysical data in the possession of the transferee or other exploratory data with respect to the property transferred, and any other information which bears upon the question of whether at the time of the transfer the principal value of the property transferred had been demonstrated by prospecting, exploration, and discovery work.

(b) *Production from secondary or tertiary processes.* Every taxpayer who claims depletion with respect to oil or gas produced by secondary or tertiary processes (as defined in § 1.613A–7(k)) shall keep records of the secondary and tertiary processes applied and maintain records of the amount of production so resulting.

(c) *Retention of records.* The records required by this section shall be kept at all times available for inspection by authorized Internal Revenue officers or employees, and shall be retained so long as the contents may become material in the administration of any Internal Revenue law.

[T.D. 7487, 42 FR 24264, May 13, 1977]

§ 1.613A–7 Definitions.

For purposes of section 613A and the regulations thereunder—

(a) *Domestic.* The term *domestic*, as applied to oil and gas wells (or to production from such wells), refers to wells located in the United States or in a possession of the United States, as defined in section 638 and the regulations thereunder.

(b) *Natural gas.* The term *natural gas* means any product (other than crude oil as defined in paragraph (g) of this section) of an oil or gas well if a deduction for depletion is allowable under section 611 with respect to such product.

(c) *Regulated natural gas.* Natural gas is considered to be ''regulated'' only if all of the following requirements are met:

(1) The gas must be domestic gas produced and sold by the producer (whether for himself or on behalf of another person) before July 1, 1976,

(2) The price for which the gas is sold by the producer must not be adjusted to reflect to any extent the increase in liability of the seller for tax under chapter 1 of the Code by reason of the repeal of percentage depletion for gas,

(3) The sale of the gas must have been subject to the jurisdiction of the Federal Power Commission for regulatory purposes,

(4) An order or certificate of the Federal Power Commission must be in effect (or a proceeding to obtain such an order or certificate must have been instituted), and

(5) The price at which the gas is sold must be taken into account, directly or indirectly, in the issuance of the order or certificate by the Federal Power Commission. Price increases after February 1, 1975, are presumed to take increases in tax liabilities into account unless the taxpayer demonstrates to the contrary by clear and convincing evidence that the increases are wholly attributable to a purpose or purposes unrelated to the repeal of percentage depletion for gas (*e.g.*, where the record of the Federal Power Commission clearly establishes that the Commission did not take the repeal into account). Increases to reflect additional State and local real property or severance taxes, increases for additional operating costs (such as costs of secondary or tertiary processes), adjustments for inflation, increases for additional drilling and related costs, or increases to reflect changes in the quality of gas sold, are some examples of increases that are not attributable to the repeal of percentage depletion for gas. In the absence of a statement in writing by the Federal Power Commission that the price of the gas in question was not in fact regulated, the requirement of paragraph (c)(5) of this section is deemed to have been met in any case in which the Federal Power Commission issued an order or certificate approving the sale to an interstate pipeline company or, in a case in which it is established by the taxpayer that the Federal Power Commission has influenced the price of such gas, an order or certificate permitting the interstate transportation of such gas. In addition, an ''emergency'' sale of natural gas to an interstate pipeline, which, pursuant to the authority contained in 18 CFR 2.68, 2.70, 157.22, and 157.29, may be

made without prior order approving the sale, is deemed to have met the requirements of paragraph (c) (3), (4), and (5) of this section. For purposes of meeting the requirements under this paragraph, it is not necessary that the total gas production from a property qualify as ''regulated natural gas.'' The determination of whether mineral production is ''regulated natural gas'' shall be made with respect to each sale of the mineral or minerals produced.

(d) *Natural gas sold under a fixed contract.* The term *natural gas sold under a fixed contract* means domestic natural gas sold by the producer (whether for himself or on behalf of another person) under a contract, in effect on February 1, 1975, and at all times thereafter before such sale, under which the price for the gas during such period cannot be adjusted to reflect to any extent the increase in liabilities of the seller for tax under chapter 1 of the Code by reason of the repeal of percentage depletion for gas. The term may include gas sold under a fixed contract even though production sold under the contract had previously been treated as regulated natural gas. Price increases after February 1, 1975, are presumed to take increases in tax liabilities into account unless the taxpayer demonstrates to the contrary by clear and convincing evidence. Paragraph (c) of this section provides examples of increases which do not take increases in tax liabilities into account. However, if an adjustment provided for in the contract permits the possible increase in federal income tax liability of the seller to be taken into account to any extent, the gas sold under the contract after such an increase becomes permissible is not gas sold under a fixed contract. If the adjustment provided for in the contract provides for an increase in the price of the contract to the highest price paid to a producer for natural gas in the area, or if the price may be renegotiated, then gas sold under the contract after such an increase becomes permissible is presumed not to be sold under a fixed contract unless the taxpayer demonstrates by clear and convincing evidence that the price increase in no event takes increases in tax liabilities into account. For purposes of meeting the requirements of this paragraph, it is not necessary that the total gas production from a property qualify as ''natural gas sold under a fixed contract,'' for the determination of ''natural gas sold under a fixed contract'' is to be made with respect to each sale of each type of natural gas sold pursuant to each contract.

(e) *Qualified natural gas from geopressured brine.* The term ''qualified natural gas from geopressured brine'' means any natural gas which is determined in accordance with section 503 of the Natural Gas Policy Act of 1978 to be produced from geopressured brine and which is produced from any well the drilling of which began after September 30, 1978, and before January 1, 1984.

(f) *Average daily production.* (1) The term *average daily production* means the taxpayer's aggregate production of domestic crude oil or natural gas, as the case may be, which is extracted after December 31, 1974, and to which gross income from the property is attributable during the taxable year divided by the number of days in such year. As used in the preceding sentence the term *taxpayer* includes a small business corporation as defined in section 1371 (as in effect prior to the enactment of the subchapter S Revision Act of 1982) and the regulations thereunder. Notwithstanding the provisions of §1.612–3 and except as provided in §1.613A–3(j)(2), in computing the average daily production for a taxable year only oil or gas which has been actually produced by the close of such taxable year is taken into account. Average daily production does not include production resulting from secondary or tertiary processes to which gross income from the property is attributable before January 1, 1984.

(2) In the case of a fiscal-year taxpayer, paragraph (f)(1) of this section shall be applied separately to each short taxable year under section 613A(c)(11), as in effect prior to the Revenue Reconciliation Act of 1990.

(3) In the case of a taxpayer holding a partial interest in the production from any property (including an interest of a partner in property of a partnership or a net profit interest) such

taxpayer's production shall be considered to be that amount of such production determined by multiplying the total production (which is produced after December 31, 1974, and to which gross income from the property is attributable during the taxable year) of the property by the taxpayer's percentage participation in the gross revenues from the property during the year. However, the portion of trust (or estate) production allocable to a beneficiary shall not exceed that amount of the trust's (or estate's) depletable oil quantity determined by multiplying such quantity by the beneficiary's percentage interest in the trust's (or estate's) gross income from the property.

(g) *Crude oil*. For purposes of section 613A and the regulations thereunder, the term *crude oil* means—

(1) A mixture of hydrocarbons which existed in the liquid phase in natural underground reservoirs and which remains liquid at atmospheric pressure after passing through surface separating facilities,

(2) Hydrocarbons which existed in the gaseous phase in natural underground reservoirs but which are liquid at atmospheric pressure after being recovered from oil well (casinghead) gas in lease separators, and

(3) Natural gas liquid recovered from gas well effluent in lease separators or field facilities before any conversion process has been applied to such production.

(h) *Depletable oil quantity*. The taxpayer's depletable oil quantity, within the meaning of section 613A(c)(1)(A), shall be equal to the tentative quantity determined under the table contained in section 613A(c)(3)(B) and paragraph (b) of § 1.613A–3 (except that, in the case of determinations with respect to days prior to January 1, 1984, such quantity shall be reduced (but not below zero) by the taxpayer's average daily secondary or tertiary production for the taxable year).

(i) *Depletable natural gas quantity*. The taxpayer's depletable natural gas quantity, within the meaning of section 613A(c)(1)(B), shall be equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer's depletable oil quantity to which the taxpayer elects to have section 613A(c)(4) apply. The taxpayer's depletable oil quantity for any taxable year shall be reduced (in addition to any reduction required to be made under paragraph (h) of this section) by the number of barrels with respect to which an election under section 613A(c)(4) for natural gas has been made. See § 1.613A–5.

(j) *Barrel*. The term *barrel* means 42 United States gallons.

(k) *Secondary or tertiary production*. For purposes of section 613A the term *secondary or tertiary production* means the increased production of domestic crude oil or natural gas from a property at any time after the application of a secondary or tertiary process. The increased production is the excess of actual production over the maximum primary production which would have resulted during the taxable year if the secondary or tertiary process had not been applied. The increased production may be due to an increase in either the rate or the duration of recovery. A secondary or tertiary process is a process applied for the recovery of hydrocarbons in which liquids, gases, or other matter is injected into the reservoir to supplement or augment the natural forces required to move the hydrocarbons through the reservoir. However, no process which must be introduced early in the productive life of the mineral property in order to be reasonably effective (such as cycling of gas in the case of a gas-condensate reservoir) is a secondary or tertiary process. A process (such as fire flooding or miscible fluid injection) introduced early in the productive life of the mineral property will not be disqualified as a secondary or tertiary process if a later introduction of the process in the property would still have been reasonably effective.

(l) *Controlled group of corporations*. The term *controlled group of corporations* has the meaning given to such term by section 1563(a), except that section 1563(b)(2) shall not apply and except that ''more than 50 percent'' shall be substituted for '' at least 80 percent'' each place it appears in section 1563(a).

(m) *Related person*. (1) A person is a *related person* to another person, within the meaning of section 613A(d) (2) and (4), paragraphs (b) and (c) of § 1.613A–4,

and paragraphs (r) and (s) of this section, if either a significant ownership interest in such person is held by the other, or a third person has a significant ownership interest in both such persons. For purposes of determining a significant ownership interest, an interest owned by or for a corporation, partnership, trust, or estate shall be considered as owned directly both by itself and proportionately by its shareholders, partners, or beneficiaries, as the case may be. The term *significant ownership* means—

(i) With respect to any corporation, direct or indirect ownership of 5 percent or more in value of the outstanding stock of such corporation,

(ii) With respect to a partnership, direct or indirect ownership of 5 percent or more interest in the profits or capital of such partnership, and

(iii) With respect to an estate or trust, direct or indirect ownership of 5 percent or more of the beneficial interests in such estate or trust. The relative percentage ownership of beneficiaries of an estate or trust in the beneficial interests therein shall be determined under actuarial principles.

(2) A person is a ''related person'' to another person, within the meaning of section 613A(c)(8)(B) and paragraph (h)(2) of §1.613A–3, if such persons are members of the same controlled group of corporations or if the relationship between such persons would result in a disallowance of losses under section 267 or 707(b), except that for this purpose the family of an individual includes only the individual's spouse and minor children.

(n) *Transfer*. The term *transfer* means any change in ownership for federal tax purposes after December 31, 1974, by sale, exchange, gift, lease, sublease, assignment, contract, or other disposition (including any contribution to or any distribution by a corporation, partnership, or trust), any change in the membership of a partnership or the beneficiaries of a trust, or any other change by which a taxpayer's proportionate share of the income subject to depletion of an oil or gas property is increased. For taxable years beginning after 1982, the term ''transfer'' includes an election by a C corporation to be an S corporation (properties deemed transferred by the C corporation on the day the election first becomes effective) and a termination of an S election (each shareholder's pro rata share of assets of S corporation deemed transferred to C corporation on the day that the termination first becomes effective). However, the term does not include—

(1) A transfer of property at death (including a distribution by an estate, whether or not a pro rata distribution),

(2) An exchange to which section 351 applies,

(3) A change of beneficiaries of a trust by reason of the death, birth, or adoption of any vested beneficiary if the transferee was a beneficiary of the trust or is a lineal descendant of the settlor or any other vested beneficiary of the trust, except in the case of any trust where any beneficiary of the trust is a member of the family (as defined in section 267(c)(4)) of a settlor who created inter vivos and testamentary trusts for members of the family and the settlor died within the last six days of the fifth month in 1970, and the law in the jurisdiction in which the trust was created requires all or a portion of the gross or net proceeds of any royalty or other interest in oil, gas, or other mineral representing any percentage depletion allowance to be allocated to the principal of the trust,

(4) A transfer of property between corporations which are members of the same controlled group of corporations (as defined in section 613A(c)(8)(D)(i)),

(5) A transfer of property between business entities which are under common control (within the meaning of section 613A(c)(8)(B)) or between related persons in the same family (within the meaning of section 613A(c)(8)(C)),

(6) A transfer of property between a trust and members of the same family (within the meaning of section 613A(c)(8)(C)) to the extent that both (i) the beneficiaries of the trust are and continue to be members of the family that transferred the property, and (ii) the tentative oil quantity is allocated among the members of such family,

(7) A reversion of all or part of an interest with respect to which the taxpayer was eligible for percentage depletion pursuant to section 613A(c), or

(8) A conversion of a retained interest which is eligible for such depletion into an interest which constituted all or part of an interest previously owned by the taxpayer also eligible for such depletion.

However, paragraph (n) (2), (4), and (5) of this section shall apply only so long as the tentative quantity determined under the table contained in section 613A(c)(3)(B) (as in effect prior to the Revenue Reconciliation Act of 1990) is required to be allocated under section 613A(c)(8) between the transferor and transferee, or among members of a controlled group of corporations. In the case of an individual transferor, the allocation test of the preceding sentence shall not be failed merely because of the death of the transferor. For purposes of paragraph (n) (3) and (6), an individual adopted by a beneficiary is a lineal descendant of that beneficiary. For purposes of paragraph (n) (7) and (8), a taxpayer previously ineligible for percentage depletion solely by reason of section 613A(d) (2) or (4) will be considered to have been eligible for such depletion. A transfer is deemed to occur on the day on which a contract or other commitment to transfer the property becomes binding upon both the transferor and transferee, or, if no such contract or commitment is made, on the day on which ownership of the interest in oil or gas property passes to the transferee.

(o) *Transferee*. The term ''transferee'', as used in section 613A(c)(9), paragraph (i)(1) of § 1.613A–3, and this section includes the original transferee of proven property and his or her successors in interest (excluding successors in interest of proven property transferred after October 11, 1990). A person shall not be treated as a transferee of an interest in a proven oil or gas property to the extent that such person was entitled to a percentage depletion allowance on mineral produced with respect to the property immediately before the transfer. However, a person shall be treated as a transferee of an interest in a proven property to the extent that the interest such person receives is greater than the interest in the property the person held immediately before the transfer. For example, where the owner of a proven oil property transfers his or her entire interest therein to a partnership of which he or she is a member and, as a consequence, becomes entitled to a depletion allowance based on only one-third of the oil produced with respect to that property, the owner (the transferor) is not denied percentage depletion with respect to the one-third interest in oil production which the owner still possesses. If the partnership agreement had made an effective allocation (under section 704 and § 1.704.1) of all the income in respect of such property to the transferor partner, that partner would be entitled to percentage depletion on the entire oil production from that property. For this purpose, a person who has transferred oil or gas property pursuant to a unitization or pooling agreement shall be treated as having been entitled to a depletion allowance immediately before the transfer to that person of the interest in the unit or pool with respect to all of the mineral in respect of which the person receives gross income from the property pursuant to the unitization or pooling agreement, except to the extent such income is attributable to consideration paid by that person for such interest in addition to that person's contribution of the oil or gas property and equipment affixed thereto.

(p) *Interest in proven oil or gas property*. The term *interest in an oil or gas property* means an economic interest in oil or gas property. An economic interest includes working or operating interests, royalties, overriding royalties, net profits interests, and, to the extent not treated as loans under section 636, production payments from oil or gas properties. The term also includes an interest in a partnership, S corporation, small business corporation, or trust holding an economic interest in oil or gas property but does not include shares of stock in a corporation (other than an S corporation and small business corporation) owning such an interest. An oil or gas property is ''proven'' if its principal value has been demonstrated by prospecting, exploration, or discovery work. The principal value of the property has been demonstrated by prospecting, exploration, or discovery work only if at the time of the transfer—

(1) Any oil or gas has been produced from a deposit, whether or not produced by the taxpayer or from the property transferred;

(2) Prospecting, exploration, or discovery work indicate that it is probable that the property will have gross income from oil or gas from the deposit sufficient to justify development of the property; and

(3) The fair market value of the property is 50 percent or more of the fair market value of the property, minus actual expenses of the transferee for equipment and intangible drilling and development costs, at the time of the first production from the property subsequent to the transfer and before the tansferee transfers his or her interest.

For purposes of this paragraph, the property is to be determined by applying section 614 and the regulations thereunder to the transferee at the time of the transfer. If the transfer is of an interest in a partnership, S corporation, small business corporation, or trust, the determination shall be made with respect to each property owned by the partnership, S corporation, small business corporation, or trust. The term *prospecting, exploration, or discovery work* includes activities which produce information relating to the existence, location, extent, or quality of any deposit of oil or gas, such as seismograph surveys and drilling activities (whether for exploration or for the production of oil or gas).

(q) *Amount disallowed.* The amount disallowed, within the meaning of section 613A(d)(1) and paragraph (a) of §1.613A–4, is the excess of the amount of the aggregate of the taxpayer's allowable depletion deductions (whether based upon cost or percentage depletion) computed without regard to section 613A(d)(1) over the amount of the aggregate of such deductions computed with regard to such section. The disallowed amount shall be carried over to the succeeding year and treated as an amount allowable as a deduction pursuant to section 613A(c) for the succeeding year, subject to the 65-percent limitation of section 613A(d)(1) and the rules contained in §1.613A–4(a).

(r) *Retailer.* (1) Except as otherwise provided in paragraph (r)(2) of this section, the term *retailer* means any taxpayer who directly, or through a related person (as defined in paragraph (m)(1) of this section), sells oil or natural gas, or any product derived from oil or natural gas—

(i) Through any retail outlet operated by the taxpayer or a related person, or

(ii) To any person—

(A) Obligated under an agreement or contract with the taxpayer or a related person to use a trademark, trade name, or service mark or name owned by such taxpayer or a related person, in marketing or distributing oil or natural gas or any product derived from oil or natural gas, or

(B) Given authority, pursuant to an agreement or contract with the taxpayer or a related person, to occupy any retail outlet owned, leased, or in any way controlled by the taxpayer or a related person.

For purposes of the preceding sentence, bulk sales (*i.e.*, sales in very large quantities) of oil or natural gas (but not bulk sales of any product derived from oil or natural gas) to commercial or industrial users shall be disregarded. Bulk sales made after September 18, 1982, of aviation fuels to the Department of Defense shall be also disregarded. In addition, sales of oil or natural gas (whether or not produced by the taxpayer), or of any product derived from oil or natural gas, which are made outside the United States shall be disregarded if no domestic production of oil, natural gas (or products derived therefrom) of the taxpayer or a related person is exported during the taxable year or the immediately preceding taxable year.

(2) Notwithstanding paragraph (r)(1) of this section, the taxpayer shall not be considered a retailer in any case where, during the taxable year of the taxpayer, the combined gross receipts from sales (excluding sales for resale) of oil or natural gas, or products derived therefrom, of all retail outlets taken into account under paragraph (r)(1) of this section (including sales through a retail outlet of oil, natural gas, or a product derived from oil or natural gas which had previously been the subject of a sale described in paragraph (r)(1)(ii) of this section) do not exceed $5 million. If the taxpayer's

combined gross receipts for the taxable year exceed $5 million, the taxpayer will be treated as a retailer as of the first day in which a retail sale was made. For purposes of paragraph (r)(1) of this section, a taxpayer shall be deemed to be selling oil or natural gas (or a product derived therefrom) through a related person in any case in which any sale of oil or natural gas (or a derivative product) by the related person produces gross income from which the taxpayer may benefit by reason of the taxpayer's direct or indirect ownership interest in the related person. In such cases (and in any other case in which the taxpayer is selling through a retail outlet referred to in section 613A(d)(2)(A) or is selling such items to a person described in section 613A(d)(2)(B)), it is immaterial whether the oil or natural gas which is sold, or from which is derived a product which is sold, was produced by the taxpayer. A taxpayer shall be deemed to be selling oil or natural gas (or a derivative product) through a retail outlet operated by a related person in any case in which a related person who operates a retail outlet acquires for resale oil or natural gas (or a derivative product) which the taxpayer produced or caused to be made available for acquisition by the related person pursuant to an arrangement whereby some or all of the taxpayer's production is marketed. An owner of a nonoperating mineral interest (such as a royalty) shall not be treated as an operator of a retail outlet merely because the owner's oil or gas is sold on the owner's behalf through a retail outlet operated by an unrelated person. In addition, the mere fact that a member of a partnership is a retailer shall not result in characterization of the remaining partners as retailers. However, any partner of a partnership who has a 5 percent or more interest in any entity actually engaging in retail activities (including the partnership or another entity to which the partnership is related) is treated as a retailer. See paragraph (m)(1) of this section for rules on the ownership interest by partners in an entity related to a partnership. Similarly, if a trust or estate is a retailer, only its beneficiaries having a 5 percent or more current income interest from the trust or estate are treated as retailers. A person who is a retailer during a portion of the taxable year shall be treated as a retailer with respect to a fraction of that person's gross and taxable income from oil or gas properties for the taxable year, the numerator of which is the number of days during the taxable year in which the taxpayer is a retailer and the denominator of which is the total number of days during the taxable year; except that a person who ceases to be a retailer during the taxable year before the first production of oil or gas during such year shall not be treated as a retailer for any portion of such year.

(3) For purposes of this paragraph (r), the term *any product derived from oil or natural gas* means gasoline, kerosene, Number 2 fuel oil, refined lubricating oils, diesel fuel, butane, propane, and similar products which are recovered from petroleum refineries or extracted from natural gas in field facilities or natural gas processing plants. The term *retail outlet* means any place where sales of oil or natural gas (excluding bulk sales of such items to commercial or industrial users), or a product of oil or natural gas (excluding bulk sales of aviation fuels to the Department of Defense), accounting for more than 5 percent of the gross receipts from all sales made at such place during the taxpayer's taxable year, are systematically made for any purpose other than for resale. For this purpose, sales of oil or natural gas, or any product derived from oil or natural gas, to a person for refining are considered as sales made for resale.

(s) *Refiner*. A person is a refiner if such person or a related person (as defined in paragraph (m)(1) of this section) engages in the refining of crude oil (whether or not owned by such person or related person) and if the total refinery runs of such person and any related persons exceed 50,000 barrels on any day during the taxable year. A refinery run is the volume of inputs of crude oil (excluding any product derived from oil) into the refining stream. For purposes of this paragraph, crude oil refined outside the United States shall be taken into account. Refining is any operation by which the physical or chemical characteristics of crude oil are changed, exclusive of such

operations as passing crude oil through separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and blending of crude oil products.

[T.D. 8348, 56 FR 21949, May 13, 1991; 57 FR 4913, Feb. 10, 1992, as amended by T.D. 8437, 57 FR 43903, Sept. 23, 1992; 58 FR 6678, Feb. 1, 1993]

§ 1.614–0 Introduction.

Section 614 relates to the definition of property and to the various special rules by means of which taxpayers are permitted to aggregate or combine separate properties or to treat such properties as separate. These rules are set forth in detail in §§ 1.614–1 through 1.614–8. Section 1.614–1 sets forth rules under section 614(a) relating to the definition of the term *property*. Section 1.614–2 contains the rules relating to the election under section 614(b), as it existed prior to its amendment by section 226(a) of the Revenue Act of 1964, to aggregate operating mineral interests. In the case of mines, the rules contained in § 1.614–2 are applicable only to taxable years beginning before January 1, 1958, to which the Internal Revenue Code of 1954 applies. In the case of oil and gas wells, the rules contained in § 1.614–2 are applicable only to taxable years beginning before January 1, 1964, to which the Internal Revenue Code of 1954 applies. In the case of oil and gas wells, the taxpayer may, however, for taxable years beginning before January 1, 1964, treat any operating mineral interests as if section 614 (a) and (b) (as it existed prior to its amendment by section 226(a) of the Revenue Act of 1964) had not been enacted. If any operating mineral interests are so treated, the rules contained in § 1.614–2 are not applicable to such interests and such interests are, in respect of taxable years beginning before January 1, 1964, subject to the rules set forth in § 1.614–4 relating to the Internal Revenue Code of 1939 treatment of separate operating mineral interests in the case of oil and gas wells. Section 1.614–3 prescribes the rules relating to the election under section 614(c)(1) permitting the aggregation of operating mineral interests in the cases of mines for taxable years beginning after December 31, 1957. Section 1.614–3 also sets forth rules relating to the election under section 614(c)(2) in the case of mines by means of which a taxpayer is permitted to treat a single operating mineral interest as more than one such interest for taxable years beginning after December 31, 1957. At the election of the taxpayer with respect to an operating unit, the rules contained in § 1.614–3 are also applicable to taxable years beginning before January 1, 1958, to which the Internal Revenue Code of 1954 applies. If the taxpayer makes such an election, the rules contained in § 1.614–2 are not applicable to any of the operating mineral interests which are part of the operating unit with respect to which the election described in § 1.614–3 is made. Section 1.614–5 sets forth the rules relating to the aggregation of nonoperating mineral interests. Section 1.614–6 contains the rules relating to basis, holding period, and abandonment and casualty losses where properties have been aggregated or combined. Section 1.614–7 relates to the extension of time for performing certain acts. Section 1.614–8 contains the rules relating to the elections under section 614(b) as amended by section 226(a) of the Revenue Act of 1964 to treat separate operating mineral interests in the case of oil and gas wells as separate properties or in combination for taxable years beginning after December 31, 1963.

[T.D. 6859, 30 FR 13699, Oct. 28, 1965]

§ 1.614–1 Definition of property.

(a) *General rule.* (1) For purposes of subtitle A of the Code, in the case of mines, wells, and other natural deposits, the term *property* means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

(2) The term *interest* means an economic interest in a mineral deposit. See paragraph (b) of § 1.611–1. The term includes working or operating interests, royalties, overriding royalties, net profits interests, and, to the extent not treated as loans under section 636, production payments.

(3) The term *tract or parcel of land* is merely descriptive of the physical scope of the land to which the taxpayer's interest relates. It is not descriptive of the nature of his rights or

interests in the land. All contiguous areas (even though separately described) included in a single conveyance or grant or in separate conveyances or grants at the same time from the same owner constitute a single separate tract or parcel of land. Areas included in separate conveyances or grants (whether or not at the same time) from separate owners are separate tracts or parcels of land even though the areas described may be contiguous. If the taxpayer's rights or interests within the same tract or parcel of land are dissimilar, then each such dissimilar interest constitutes a separate property. If the taxpayer's rights or interests (whether or not dissimilar) within the same tract or parcel of land relate to more than one separate mineral deposit, then his interest with respect to each such separate deposit is a separate property.

(4) Upon the transfer of a *property* in any transaction in which the basis of such property in the hands of the transferee is determined by reference to the basis of such property in the hands of the transferor, such property shall, notwithstanding the provisions of subparagraph (3) of this paragraph, retain the same status and identity in the hands of the transferee as it had in the hands of the transferor. See paragraph (c) of §1.614–6 if the transferor has made a binding election to treat a separate mineral interest as a separate property, to treat a separate mineral interest as more than one property under section 614(c), or to treat two or more separate mineral interests as an aggregated or combined property under section 614(b) (as it existed either before or after its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e).

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

Example 1. A taxpayer owns one tract of land under which lie three separate and distinct seams of coal. Therefore, the taxpayer owns three separate mineral interests each of which constitutes a separate property.

Example 2. A taxpayer conducts mining operations on eight tracts of land as a single unit. He acquired his interests in each of the eight tracts from separate owners. Even if each tract of land contains part of the same mineral deposit, the taxpayer owns eight separate mineral interests each of which constitutes a separate property.

Example 3. A taxpayer owns a tract of land under which lies one mineral deposit. The taxpayer operates a well on part of the tract and leases to another operator the mineral rights in the remainder retaining a royalty interest therein. The taxpayer thereafter owns two separate mineral interests each of which constitutes a separate property.

Example 4. In 1954, a taxpayer acquires from a single owner, in a single deed, three noncontiguous tracts of mineral land for a single consideration. Even if each tract contains part of the same mineral deposit, the taxpayer owns three separate mineral interests each of which constitutes a separate property.

Example 5. In 1954, taxpayer A simultaneously acquires in fee two contiguous tracts of mineral land from two separate owners. The same mineral deposit underlies both tracts. Thereafter, taxpayer A owns two separate mineral interests each of which constitutes a separate property.

Example 6. Assume that in 1955, taxpayer A, in example 5, leases the two contiguous tracts of mineral land that he acquired in 1954 to taxpayer B by means of a single lease. Thereafter, taxpayer B owns one mineral interest which constitutes a separate property for such time as the lease continues in existence.

Example 7. Assume that in 1955, taxpayer A, in example 5, sells at the same time all the mineral land he acquired in 1954 to taxpayer B. Thereafter, taxpayer B owns one mineral interest which constitutes a separate property. If taxpayer B acquires the mineral land in a transaction in which the basis of such mineral land in his hands is determined by reference to the basis of such mineral land in the hands of taxpayer A, then taxpayer B owns two separate mineral interests each of which constitutes a separate property.

Example 8. In 1954, taxpayer A simultaneously acquires two contiguous leasehold interests from two separate owners. The same mineral deposit underlies both tracts. Thereafter, taxpayer A owns two separate mineral interests each of which constitutes a separate property.

Example 9. In 1955, taxpayer A, in example 8, simultaneously assigns the two leases to taxpayer B. Thereafter, taxpayer B owns two separate mineral interests each of which constitutes a separate property.

(b) *Separation of interests treated as single property* under prior regulations. Each separate mineral interest which, in accordance with paragraph (a) of this section, is a separate property shall be so treated, notwithstanding the fact that the taxpayer under paragraph (i) of §39.23(m)–1 of this chapter

(Regulations 118) and corresponding provisions of prior regulations may have treated more than one of such interests as a *single property*. The basis of each such separate property must be established by a reasonable method. See, however, section 614 (b) and (d) (as they existed prior to amendment by section 226 of the Revenue Act of 1964), section 614 (c) and (e), and §§ 1.614–2, 1.614–3, 1.614–4, and 1.614–5 for special rules relating to the treatment of two or more separate mineral interests as a single property.

(c) *Treatment of a waste bank or residue.* A waste bank or residue of prior mining, the extraction of ores or minerals from which is treated as mining under section 613(c)(3), shall not be considered to be a separate mineral deposit but is a part of the mineral deposit from which it was extracted. However, if the owner of such waste bank or residue has disposed of the deposit from which the waste bank or residue was accumulated, or if the waste bank or residue cannot practicably be attributed to a particular deposit of the owner, the waste bank or residue will be regarded as a separate deposit.

[T.D. 6524, 26 FR 147, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13699, Oct. 28, 1965; T.D. 7261, 38 FR 5467, Mar. 1, 1973]

§ 1.614–2 Election to aggregate separate operating mineral interests under section 614(b) prior to its amendment by Revenue Act of 1964.

(a) *General rule.* (1) The provisions of this section relate to the election, under section 614(b) prior to its amendment by section 226(a) of the Revenue Act of 1964, to aggregate separate operating mineral interests, and, unless otherwise indicated, all references in this section to section 614(b) or any paragraph or subparagraph thereof are references to section 614(b) or a paragraph or subparagraph thereof as it existed prior to such amendment. Notwithstanding the preceding sentence, the definitions contained in paragraphs (b) and (c) of this section shall apply both before and after such amendment. All references in this section to section 614(d) are references to section 614(d) as it existed prior to its amendment by section 226(b)(3) of the Revenue Act of 1964.

(2) A taxpayer who owns two or more separate operating mineral interests, which constitute part or all of an operating unit, may elect under section 614(b) and this section to form one aggregation of any two or more of such operating mineral interests and to treat such aggregation as one property. Any operating mineral interest which the taxpayer does not elect to include within the aggregation within the time prescribed in paragraph (d) of this section shall be treated as a separate property. The aggregation of separate properties which results from exercising the election shall be considered as one property for all purposes of subtitle A of the Code. The preceding sentence does not preclude the use of more than one account under a single method of computing depreciation or the use of more than one method of computing depreciation under section 167, if otherwise proper. Any reasonable and consistently applied method or methods of computing depreciation of the improvements made with respect to the separate properties aggregated may be continued in accordance with section 167 and the regulations thereunder. Operating interests in different minerals which comprise part or all of the same operating unit may be included in the aggregation. It is not necessary for purposes of the aggregation that the separate operating mineral interests be included in a single tract or parcel of land or in contiguous tracts or parcels of land so long as such interests are a part of the same operating unit. Under section 614(b), a taxpayer cannot elect to form more than one aggregation of separate operating mineral interests within one operating unit. For definitions of *operating mineral interest* and *operating unit* see respectively paragraphs (b) and (c) of this section.

(b) *Operating mineral interest defined.* The term *operating mineral interest* means a separate mineral interest as described in section 614(a), in respect of which the costs of production are required to be taken into account by the taxpayer for purposes of computing the limitation of 50 percent of the taxable

income from the property in determining the deduction for percentage depletion computed under section 613, or such costs would be so required to be taken into account if the mine, well, or other natural deposit were in the production stage. The term does not include royalty interests or similar interests, such as production payments or net profits interests. For the purpose of determining whether a mineral interest is an operating mineral interest, *costs of production* do not include intangible drilling and development costs, exploration expenditures under section 615, or development expenditures under section 616. Taxes, such as production taxes, payable by holders of nonoperating interests are not considered costs of production for this purpose. A taxpayer may not aggregate operating mineral interests and nonoperating mineral interests such as royalty interests.

(c) *Operating unit defined.* (1) The term *operating unit* refers to the operating mineral interests which are operated together for the purpose of producing minerals. An *operating unit* of a particular taxpayer must be determined on the basis of his own operations. It is recognized that operating units may not be uniform in the various natural resources industries or in any one of the natural resources industries, such as coal, oil and gas, and the like. As to a particular taxpayer, business reasons may require the formation of operating units that vary in size and content. The term *operating unit* refers to a producing unit, and not to an administrative or sales organization. Among the factors which indicate that mineral interests are operated together as a unit are:

(i) Common field or operating personnel,

(ii) Common supply and maintenance facilities,

(iii) Common processing or treatment plants, and

(iv) Common storage facilities

However, operating mineral interests which are geographically widespread may not be treated as parts of the same operating unit merely because a single set of accounting records, a single executive organization, or a single sales force is maintained by the taxpayer with respect to such interests, or merely because the products of such interests are processed at the same treatment plant.

(2) If aggregated, an undeveloped operating mineral interest shall be aggregated only with those interests with which it will be operated as a unit when it reaches the production stage.

(3) While a taxpayer may operate an operating mineral interest through an agent, a coowner may aggregate only his operating mineral interests that are actually operated as a unit. For example, if A owned and actually operated the entire working interest in lease X and also owned an undivided fraction of lease Y in which B owned the remaining interest and which B actually operated as a unit with lease Z, A may not aggregate his interest in lease X with his undivided interest in lease Y, since they are not actually operated as a unit.

(4) The determination of the taxpayer as to what constitutes an operating unit is to be accepted unless there is a clear and convincing basis for a change in such determination.

(d) *Manner and scope of election*—(1) *Election; when made.* (i) Except as provided in subparagraph (2)(ii) of this paragraph, the election under section 614(b) and paragraph (a) of this section to treat a mineral interest as part of an aggregation shall be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof), for whichever of the following taxable years is the later:

(*a*) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, or

(*b*) The first taxable year in which any expenditure for exploration, development, or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest

See, however, paragraph (c) of § 1.614–6 as to the binding effect of an election where the basis of a separate operating mineral interest in the hands of the taxpayer is determined by reference to the basis in the hands of a transferor. The election under section 614(b) may not be made with respect to any taxable year beginning after December 31,

1957, except in the case of oil and gas wells. See paragraph (e) of this section for rules with respect to the termination of the election under section 614(b) except in the case of oil and gas wells. If an expenditure has been made in respect of a separate operating mineral interest, it is immaterial whether or not any proven deposit has been discovered with respect to such interest when such expenditure has been made. The provisions of this subdivision may be illustrated by the following example:

Example. Taxpayer A is producing from an oil and gas horizon and in 1958 he drills for the purpose of locating a deeper horizon which will be operated in the same operating unit as the upper producing horizon. At the end of the taxable year 1958 he has expended $50,000 drilling for the purpose of locating a deeper horizon although at such time there is no assurance that such a horizon will be found. If taxpayer A desires to aggregate the deeper horizon, if found, with the upper horizon under section 614(b), he must elect to do so in his return for 1958. If the election to aggregate the upper and lower horizons as one property is made, the drilling expenditures with respect to the prospective lower horizon must be taken into account along with the income and expenses with respect to the upper producing horizon in computing the depletion allowance on the aggregated property.

However, where expenditures for development of, or production from, a particular mineral deposit result in the discovery of another mineral deposit, the election with respect to such other deposit shall be made for the taxable year in which it is discovered and not for the taxable year in which the expenditures were first made which resulted in such discovery.

(ii) Except in the case of oil and gas wells, if a taxpayer fails to make an election under section 614(b) to aggregate a particular operating mineral interest on or before the time prescribed for the making of such election, such interest will be treated as if an election had been made under section 614(b) to treat it as a separate property and it cannot be included in any aggregation within the operating unit of which it is a part unless the taxpayer obtains the consent of the Commissioner. However, where the taxpayer owns more than one property within an operating unit, but has elected to treat such properties separately and one or more additional operating mineral interests are subsequently acquired, any one or more of the latter may be aggregated with one of the existing separate properties within the operating unit but not with more than one of them since they cannot be validly aggregated with each other.

(iii) In the case of oil and gas wells, if the taxpayer fails to make an election under section 614(b) with respect to a particular operating mineral interest on or before the time prescribed for the making of such election, the taxpayer shall be deemed to have treated such interest under the provisions of section 614(d). See section 614(d) and § 1.614–4.

(iv) For purposes of section 614(b), the acquisition of an option to acquire an economic interest in minerals in place does not constitute the acquisition of a mineral interest. Thus, a taxpayer who makes expenditures for the exploration of minerals on a particular tract under an option to acquire an economic interest in minerals in place is not required to make an election with respect to such interest at that time. Furthermore, the election need not be made in the taxable year in which payments are made for the acquisition of a lease, such as the payment of a bonus, unless exploratory, development, or operation expenditures are made thereafter with respect to the property in that year.

(2) *Election; how made*. (i) The election under section 614(b) must be made by a statement attached to the income tax return of the taxpayer for the first taxable year for which the election is made. This statement shall indicate that the taxpayer is making an aggregation of separate operating mineral interests within an operating unit under section 614(b) and shall contain a description of the aggregation and describe the operating mineral interests within the operating unit which are to be treated as separate properties apart from the aggregation. A general description, accompanied by maps appropriately marked, which accurately circumscribes the scope of the aggregation and identifies the properties which

are to be treated separately will be sufficient. The statement shall also contain a description of the operating unit in sufficient detail to show that the aggregated operating mineral interests are properly within a single operating unit. See paragraph (c) of this section. The taxpayer shall maintain adequate records and maps in support of the above information. In the event expenditures are first made on an operating mineral interest within an operating unit after an election with respect to the aggregation of interests in that operating unit has been made, the taxpayer shall furnish only information describing such operating mineral interest, its location in the operating unit, and whether it is to be included within the aggregation.

(ii) If the taxpayer made or did not make the election under section 614(b) with respect to a particular operating mineral interest and the last day prescribed by law for filing the return (including extensions of time therefor) on which the election was required to be made falls on or before May 1, 1961, consent is hereby given to the taxpayer to make or change the election not later than May 1, 1961. Any such election or change of such election shall be effective with respect to the earliest taxable year to which the election is applicable in respect of which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from such election or change is not prevented by any law or rule of law on the date such election or change is made. An election or change of election made pursuant to this subdivision shall be binding upon the taxpayer for the first taxable year for which it is effective and for all subsequent taxable years unless consent to a different treatment is obtained from the Commissioner. (See, however, paragraph (e) of this section for rules relating to the termination and nonapplicability of the election under section 614(b) except in the case of oil and gas wells.) Such election or change shall be made in the form of a statement setting forth the nature of the election or change, including information substantially the same as that required by subdivision (i) of this subparagraph, and shall be accompanied by an amended return or returns if necessary or, if appropriate, a claim for refund or credit. The appropriate documents must be filed on or before May 1, 1961 with the district director for the district in which the original return was filed.

(3) *Election; when effective.* If a taxpayer has elected to aggregate an operating mineral interest, the date on which the aggregation becomes effective is the earliest date within the taxable year affected, on which the taxpayer incurred any expenditure for exploration, development, or operation of such interest. The application of this rule may be illustrated by the following examples:

Example 1. In 1953, a taxpayer owned and operated mineral interests Nos. 1, 2, and 3. All three interests form one operating unit. The taxpayer, who files his return on a calendar year basis, continued to own and operate these interests during the year 1954, and in his return for that year, filed on April 15, 1955, elected to aggregate these three interests. As the result of this election, the aggregation was effective for all purposes of subtitle A of the Code as of January 1, 1954.

Example 2. Assume that, on March 1, 1955, the taxpayer described in example 1 acquired operating mineral interest No. 4 which was also a part of the operating unit composed of operating mineral interests Nos. 1, 2, and 3, that he made his first expenditure for exploration with respect to operating mineral interest No. 4 on September 1, 1955, and that, in his return filed on April 15, 1956, he elected to aggregate operating mineral interest No. 4 with the aggregation consisting of Nos. 1, 2, and 3. As the result of that election, operating mineral interest No. 4 became a part of the aggregation for all purposes of subtitle of the Code on September 1, 1955.

(4) *Election; binding effect.* A valid election made under section 614(b) and this section shall be binding upon the taxpayer for the taxable year for which made and all subsequent taxable years unless consent to make a change is obtained from the Commissioner. However, see paragraph (e) of this section for rules with respect to the termination of the election under section 614(b) except in the case of oil and gas wells. For rules relating to the binding effect of an election where the basis of a separate or an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of §1.614–6. A taxpayer can neither

include within the aggregation a separate operating mineral interest which he had previously elected to treat separately, nor exclude from the aggregation a separate operating mineral interest previously included therein unless consent to do so is obtained from the Commissioner. A change in tax consequences alone is not sufficient to obtain consent to change the treatment of an operating mineral interest. However, consent may be appropriate where, for example, there has been a substantial change in the taxpayer's operations so that a major part of an aggregation becomes a part of another operating unit. Applications for consent shall be made in writing to the Commissioner of Internal Revenue, Washington, DC 20224. The application must be accompanied by a statement indicating the reason or reasons for the change and furnishing the information required under subdivision (i) of subparagraph (2) of this paragraph, unless such information has been previously filed and is current.

(5) *Invalid aggregations*—(i) *In general.* In addition to aggregations which are invalid under section 614(b) because of the failure to make timely elections, aggregations may be invalid under such section in situations which may be divided into two general categories. The first category involves basic aggregations which were timely but otherwise initially invalid. The second category involves invalid additions of operating mineral interests to basic aggregations which additions became subject to the election in years subsequent to the year in which the initial basic aggregation or aggregations were formed.

(ii) *Invalid basic aggregations.* The term *invalid basic aggregations* refers to those aggregations which are initially invalid. Generally, such basic aggregations will be invalid because more than one aggregation has been formed within an operating unit or because operating mineral interests in two or more operating units have been improperly aggregated. For any year in which an invalid basic aggregation exists, each operating mineral interest included in such aggregation shall be treated for all purposes as a separate property unless consent is obtained from the Commissioner to treat any such interest in a different manner. Consent will be granted in appropriate cases as, for example, where the taxpayer demonstrates that he inadvertently formed an invalid basic aggregation. The provisions of this subdivision may be illustrated by the following examples:

Example 1. In 1953, taxpayer A owned six operating mineral interests, designated No. 1 through No. 6, and he continued to own and operate such interests during 1954. He acquired no other operating mineral interests during such year. All six of these operating mineral interests form one operating unit. Assume that A elected under section 614(b) to aggregate operating mineral interests Nos. 1 through 3 into one aggregation and Nos. 4 through 6 into another aggregation. Since A has formed two aggregations in one operating unit, they are invalid basic aggregations. Therefore, interests Nos. 1 through 6 must be treated as separate properties for 1954 and all subsequent taxable years unless consent is obtained from the Commissioner to treat any of such interests in a different manner.

Example 2. Assume the same facts as in example 1 and assume also that, in his return for 1954, A correctly elected to aggregate all six operating mineral interests into one aggregation under section 614(b). Assume further that all these operating mineral interests continued to be in one operating unit for the years 1954, 1955, and 1956 but that, because of changes in the facts and circumstances of A's operations, in 1957 operating mineral interests Nos. 1, 2, and 3 became a part of one operating unit and Nos. 4, 5, and 6 became a part of another operating unit. Notwithstanding the change in operations, the election made by A shall continue to be binding unless consent to change such election is obtained from the Commissioner.

(iii) *Invalid additions.* The term *additions* refers to the additions that a taxpayer makes by electing to aggregate an operating mineral interest with an aggregation formed in a previous year. Such additions will be invalid where the taxpayer either elected to aggregate an operating mineral interest with an invalid basic aggregation or elected to aggregate an operating mineral interest which is part of one operating unit with an aggregation of operating mineral interests which is a part of another operating unit. An operating mineral interest which is invalidly added to either a valid basic

aggregation or to an invalid basic aggregation shall be considered as a separate property unless consent is obtained from the Commissioner to treat such interest in a different manner. The following are examples of invalid additions:

Example 1. In 1953, taxpayer A owned six operating mineral interests designated No. 1 through No. 6 and he continued to own and operate such interests during 1954. He acquired no other operating mineral interests during that year. Nos. 1 through 3 formed one operating unit and Nos. 4 through 6 formed another operating unit. In his return for 1954, A incorrectly elected to aggregate all six operating mineral interests into one aggregation under section 614(b). In 1955, A acquired and commenced development of operating mineral interest No. 7 which is correctly a part of the operating unit of which operating mineral interests Nos. 1, 2, and 3 are a part. A elected under section 614(b), for the year 1955, to aggregate operating mineral interest No. 7 with the invalid basic aggregation composed of Nos. 1 through 6. Since operating mineral interest No. 7 was aggregated with an invalid basic aggregation, it is an invalid addition and must be treated as a separate property unless consent is obtained from the Commissioner to treat it in a different manner.

Example 2. In 1953, taxpayer A owned nine operating mineral interests designated No. 1 through No. 9. During 1954, he continued to own and operate such interests and acquired no other operating mineral interest. Interests No. 1 through No. 3 form one operating unit, Nos. 4 through 6 form another operating unit, and Nos. 7 through 9 form a third operating unit. For the year 1954, A elected under section 614(b) to aggregate operating mineral interests Nos. 1, 2, 3, and 4 into one aggregation, to treat Nos. 5 and 6 as separate properties, and to aggregate Nos. 7, 8, and 9 into another aggregation. Assume that in 1955 A acquired and commenced development of operating mineral interest No. 10 which was a part of the operating unit composed of Nos. 1, 2, and 3. Assume further that he elected under section 614(b) to aggregate No. 10 with the aggregation composed of Nos. 7, 8, and 9. This would be an invalid addition to a valid basic aggregation since operating mineral interest No. 10 was not properly a part of the operating unit formed by Nos. 7, 8, and 9. Therefore, interest No. 10 must be treated as a separate property for 1955 and all subsequent taxable years unless consent is obtained from the Commissioner to treat it in a different manner. However, the valid basic aggregation composed of interests Nos. 7 through 9 is not affected by the invalid addition of interest No. 10.

Example 3. Assume the same facts as in example 2 except that A elected under section 614(b) in 1955 to aggregate No. 10 with the aggregation of Nos. 1 through 4. This would also be an invalid addition because the aggregation composed of Nos. 1 through 4 is an invalid basic aggregation since operating mineral interest No. 4 is not a part of the operating unit consisting of Nos. 1, 2, and 3. Therefore, interest No. 10 must be treated as a separate property for 1955 and all subsequent taxable years unless consent is obtained from the Commissioner to treat such interest in a different manner.

(e) *Termination of election*—(1) *Taxable years beginning after December 31, 1963, in the case of oil and gas wells.* In the case of oil and gas wells, the election provided for under section 614(b) and paragraph (a) of this section to form an aggregation of separate operating mineral interests shall not apply with respect to any taxable year beginning after December 31, 1963. In addition, if a taxpayer treated certain separate operating mineral interests in a single tract or parcel of land as separate rather than as an aggregation and decides to continue such treatment for taxable years beginning after December 31, 1963, he must make an appropriate election under section 614(b) as amended by the Revenue Act of 1964. See § 1.614–8.

(2) *Taxable years beginning after December 31, 1957, in the case of mines.* Except in the case of oil and gas wells, the election provided for under section 614(b) and paragraph (a) of this section to form an aggregation of separate operating mineral interests shall not apply with respect to any taxable year beginning after December 31, 1957. Thus, if a taxpayer makes a binding election under section 614(b) to form an aggregation of separate operating mineral interests within an operating unit for taxable years beginning before January 1, 1958, he must make a new election for the first taxable year beginning after December 31, 1957, under section 614(c) within the time prescribed in § 1.614–3 if he wishes to aggregate any separate operating mineral interests within such operating unit. A new election must be made under section 614(c) notwithstanding the fact that the aggregation formed under section 614(b) would constitute a valid aggregation under section 614(c). Failure to

make such an election within the time prescribed shall constitute an election to treat each separate operating mineral interest within the operating unit as a separate property for taxable years beginning after December 31, 1957.

(3) *Taxable years beginning before January 1, 1958, in the case of mines.* An election made under section 614(b) and paragraph (a) of this section to form an aggregation of separate operating mineral interests within a particular operating unit shall not apply with respect to any taxable year beginning prior to January 1, 1958, for which the taxpayer makes an election under section 614(c)(3)(B) and paragraph (f)(2) of §1.614–3 which is applicable to any separate operating mineral interest within the same operating unit. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. In 1953, taxpayer A owned six separate operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Operating mineral interests Nos. 1 through 5 comprise a mine, and operating mineral interest No. 6 represents one mineral deposit in a single tract of land which is being extracted by means of two mines. Taxpayer A previously made a binding election under section 614(b) to aggregate operating mineral interests Nos. 1 through 5 and to treat operating mineral interest No. 6 as a separate property. Under section 614(c)(2) and (3)(B) taxpayer A makes an election which is applicable for the taxable year 1954 and all subsequent taxable years to treat operating mineral interest No. 6 as two separate operating mineral interests. Therefore, the previous election of taxpayer A to aggregate operating mineral interests Nos. 1 through 5 under section 614(b) does not apply. Unless taxpayer A also makes an election to aggregate operating mineral interests Nos. 1 through 5 as one property under section 614(c)(1) and (3)(B) within the time prescribed in paragraph (f)(2) of §1.614–3, he shall be deemed to have made an election to treat each of such interests as a separate property for 1954 and all subsequent taxable years.

Example 2. In 1953, taxpayer B owned six separate operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Operating mineral interests Nos. 1 through 3 comprise a mine and Nos. 4 through 6 comprise a second mine. Taxpayer B previously made a binding election under section 614(b) to aggregate operating mineral interests Nos. 1 through 8 and to treat Nos. 4 through 6 as separate properties. Under section 614(c) (1) and (3)(B) taxpayer B makes an election which is applicable for the taxable year 1954 and all subsequent taxable years to aggregate operating mineral interests Nos. 4 through 6 as one property. The previous election of the taxpayer under section 614(b) to aggregate operating mineral interests Nos. 1 through 3 does not apply even though such aggregation would constitute a valid aggregation if formed under section 614(c)(1). Therefore, if taxpayer B wishes to continue to treat operating mineral interests Nos. 1 through 3 as one property, he must also make an election to do so under section 614(c) (1) and (3)(B) within the time prescribed in paragraph (f)(2) of §1.614–3.

(4) *Bases of separate operating mineral interests.* If an aggregation formed under section 614(b) is terminated by reason of the provisions of section 614(b)(4)(A), is terminated under section 614(b)(4)(B) for any taxable year after the first taxable year to which the election under section 614(b) applies, or is terminated by reason of the provisions of section 614(b) as amended by the Revenue Act of 1964, the bases of the separate operating mineral interests (and combinations thereof) included in such aggregation shall be determined in accordance with the rules contained in paragraph (a)(2) of §1.614–6 as of the first day of the first taxable year for which the termination is effective. However, if by reason of the provisions of section 614(b)(4)(B), an election to aggregate under section 614(b) does not apply for any taxable year for which such election was made, the bases of the separate operating mineral interests included in the aggregation formed under section 614(b) shall be determined without regard to the election under section 614(b).

(f) *Alternative treatment of separate operating mineral interests in the case of oil and gas wells.* For rules relating to an alternative treatment of separate operating mineral interests in the case of oil and gas wells, see §1.614–4.

[T.D. 6524, 26 FR 147, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13700, Oct. 28, 1965]

§1.614–3 Rules relating to separate operating mineral interests in the case of mines.

(a) *Election to aggregate separate operating mineral interests*—(1) *General rule.* Except in the case of oil and gas wells,

a taxpayer who owns two or more separate operating mineral interests, which constitute part or all of the same operating unit, may elect under section 614(c)(1) and this paragraph to form an aggregation of all such operating mineral interests which comprise any one mine or any two or more mines and to treat such aggregation as one property. The aggregated property which results from the exercise of such election shall be considered as one property for all purposes of subtitle A of the Code. The preceding sentence does not preclude the use of more than one account under a single method of computing depreciation or the use of more than one method of computing depreciation under section 167, if otherwise proper. Any reasonable and consistently applied method or methods of computing depreciation of the improvements made with respect to the separate properties aggregated may be continued in accordance with section 167 and the regulations thereunder. It is not necessary for purposes of the aggregation that the separate operating mineral interests be included in a single tract or parcel of land or in contiguous tracts or parcels of land so long as such interests constitute part or all of the same operating unit. A taxpayer may elect to form more than one aggregation of separate operating mineral interests within one operating unit so long as each aggregation consists of all the separate operating mineral interests which comprise any one mine or any two or more mines. Thus, no aggregation may include any separate operating mineral interest which is a part of a mine without including all of the separate operating mineral interests which comprise such mine in the first taxable year for which the election to aggregate is effective. Any separate operating mineral interest which becomes a part of such mine in a subsequent taxable year must also be included in such aggregation as of the taxable year that such interest becomes a part of such mine. The taxable year in which such interest becomes a part of such mine shall be determined upon the basis of the facts and circumstances of the particular case. If a taxpayer fails to make an election under this paragraph to aggregate a particular operating mineral interest (other than an interest which becomes a part of a mine with respect to which the interests have been aggregated in a prior taxable year) on or before the last day prescribed for making such an election, such interest shall be treated as if an election had been made to treat it as a separate property. A taxpayer may not aggregate operating mineral interests and nonoperating mineral interests such as royalty interests. For definitions of the terms *operating mineral interest*, *operating unit*, and *mine*, see respectively paragraphs (c), (d), and (e) of this section.

(2) *Aggregation in subsequent taxable years*. If the taxpayer has made an election under section 614(c)(1) for a particular taxable year with respect to any operating mineral interest or interests within a particular operating unit, and if, for a subsequent taxable year, the taxpayer desires to make an election with respect to an additional operating mineral interest within the same operating unit, then whether or not the taxpayer may elect to include such additional interest in an aggregation or treat it as a separate property depends upon the nature of such additional interest and of the taxpayer's previous elections. If the additional interest is a part of a mine with respect to which the other interests have been aggregated, the additional interest must be included in such aggregation. If the additional interest is a part of a mine with respect to which the other interests have been treated as separate properties, the additional interest must be treated as a separate property. If the additional interest is part of a mine which previously consisted of only a single interest which has not been aggregated with any other mine, such additional interest may be aggregated or treated as a separate property. If the additional interest is an entire mine, it may, at the election of the taxpayer, (i) be added to any aggregation within the same operating unit, (ii) be aggregated with any other single interest which is an entire mine provided both interests are within the same operating unit even though such single interest has previously been treated as a separate property, or (iii) be treated as a separate property.

(b) *Election to treat a single operating mineral interest as more than one property*—(1) *General rule.* Except in the case of oil and gas wells, a taxpayer who owns a separate operating mineral interest in a mineral deposit in a single tract or parcel of land may elect under section 614(c)(2) and this paragraph to treat such interest as two or more separate operating mineral interests if such mineral deposit is being developed or extracted by means of two or more mines. In order for this election to be applicable, there must be at least two mines with respect to each of which an expenditure for development or operation has been made by the taxpayer. The election under section 614(c)(2) may also be made with respect to a separate operating mineral interest formed by a previous election under section 614(c)(2) at such time as the mineral deposit previously allocated to such interest is being developed or extracted by means of two or more mines. If there is more than one mineral deposit in a single tract or parcel of land, an election under section 614(c)(2) with respect to any one of such mineral deposits has no application to the other mineral deposits. The election under section 614(c)(2) may not be made with respect to an aggregated property or with respect to any operating mineral interest which is a part of any aggregation formed by the taxpayer unless the taxpayer obtains consent from the Commissioner. Such consent will not be granted where the principal purpose for the request to make the election is based on tax consequences. Application for such consent shall be made in writing to the Commissioner of Internal Revenue, Washington, DC 20224. The application must be accompanied by a statement setting forth in detail the reason or reasons for the request to exercise the election with respect to an aggregated property.

(2) *Allocation of mineral deposit.* If the taxpayer elects to treat a separate operating mineral interest in a mineral deposit in a single tract or parcel of land as more than one separate operating mineral interest, then all of such mineral deposit therein and all of the portion of the tract or parcel of land allocated thereto must be allocated to the newly formed separate operating mineral interests. A portion of such mineral deposit and such tract or parcel of land must be allocated to each such newly formed separate operating mineral interest. There must be at least one mine, with respect to which an expenditure for development or operation has been made by the taxpayer, with respect to each such portion. The extent of the portion to be allocated to each newly formed separate operating mineral interest is to be determined upon the basis of the facts and circumstances of the particular case.

(3) *Basis of newly formed separate operating mineral interests.* The adjusted basis of each of the separate operating mineral interests formed by the making of the election under section 614(c)(2) shall be determined by apportioning the adjusted basis of the separate operating mineral interest with respect to which such election was made between (or among) the newly formed separate operating mineral interests in the same proportion as the fair market value of each such newly formed interest (as of the date on which the election becomes effective) bears to the total fair market value of the interest with respect to which the election was made as of such date.

(4) *Aggregation of newly formed separate operating mineral interests.* Any separate operating mineral interest formed by the making of the election under section 614(c)(2) may be included as a part of an aggregation subject to the requirements of paragraph (a) of this section, provided that the time for making the election under section 614(c)(1) to include such separate operating mineral interest in such aggregation has not expired. See paragraph (f) of this section. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1958, taxpayer A acquired two separate operating mineral interests designated No. 1 and No. 2. Each is an interest in a single mineral deposit in a single tract of land. In the same year, taxpayer A made his first development expenditure with respect to a mine on operating mineral interest No. 1 and a mine on operating mineral interest No. 2. Operating mineral interests Nos. 1 and 2 are operated as a unit. Taxpayer A did not elect to aggregate operating mineral interests Nos. 1 and 2 under section

614(c)(1) within the time prescribed for making such an election. In 1960 taxpayer A made his first development expenditure with respect to a second mine on operating mineral interest No. 2. Taxpayer A elected under section 614(c)(2) to treat operating mineral interest No. 2 as two separate operating mineral interests, designated as Nos. 2(a) and 2(b), for the taxable year 1960 and all subsequent taxable years. No. 2(a) contained the mine for which the first development expenditure was made in 1958, and No. 2(b) contained the mine for which the first development expenditure was made in 1960. If taxpayer A wishes to do so, he may elect to aggregate mineral interests Nos. 1 and 2(b) under section 614(c)(1) for the taxable year 1960 and all subsequent taxable years since the first development expenditure with respect to the mine on operating mineral interest No. 2(b) was made during the taxable year 1960. Taxpayer A may not elect to aggregate mineral interests Nos. 1 and 2(a) under such section since the time for making such an election has expired.

(c) *Operating mineral interest defined.* For the definition of the term *operating mineral interest* as used in this section, see paragraph (b) of § 1.614–2.

(d) *Operating unit defined.* For the definition of the term *operating unit* as used in this section, see paragraph (c) of § 1.614–2.

(e) *Mine defined.* For purposes of this section, the term *mine* means any excavation or other workings or series of related excavations or related workings, as the case may be, for the purpose of extracting any known mineral deposit except oil and gas deposits. For the purpose of the preceding sentence, the term *excavations* or *workings* includes quarries, pits, shafts, and wells (except oil and gas wells). The number of excavations or workings that constitute a mine is to be determined upon the basis of the facts and circumstances of the particular case such as the nature and position of the mineral deposit or deposits, the method of mining the mineral, the location of the excavations or other workings in relation to the mineral deposit or deposits, and the topography of the area. The determination of the taxpayer as to the composition of a mine is to be accepted unless there is a clear and convincing basis for a change in such determination.

(f) *Manner and scope of election*—(1) *Election to apply section 614(c) (1) and (2) for taxable years beginning after December 31, 1957.* Except as provided in subparagraphs (2) and (3) of this paragraph, the election under section 614(c)(1) and paragraph (a) of this section to treat an operating mineral interest as part of an aggregation shall be made under section 614(c)(3)(A) not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for whichever of the following taxable years is the later:

(i) The first taxable year beginning after December 31, 1957, or

(ii) The first taxable year in which any expenditure for development or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest

Except as provided in subparagraphs (2) and (3) of this paragraph, the election under section 614(c)(2) and paragraph (b) of this section to treat a single operating mineral interest as more than one operating mineral interest shall be made under section 614(c)(3)(A) not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for whichever of the following taxable years is the later:

(iii) The first taxable year beginning after December 31, 1957, or

(iv) The first taxable year in which expenditures for development or operation of more than one mine in respect of the separate operating mineral interest are made by the taxpayer after the acquisition of such interest

However, if the latest time at which an election may be made under this subparagraph falls on or before May 1, 1961, such election may be made or modified at any time on or before May 1, 1961. See paragraph (c) of § 1.614–6 as to the binding effect of an election where the basis of a separate operating mineral interest in the hands of the taxpayer is determined by reference to the basis in the hands of a transferor.

(2) *Election to apply section 614(c) (1) and (2) for taxable years beginning before January 1, 1958.* In accordance with section 614(c)(3)(B), the election under section 614(c) (1) and paragraph (a) of this section to treat an operating mineral interest as part of an aggregation may,

at the election of the taxpayer, be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for whichever of the following taxable years is the later:

(i) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, for which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from an election under section 614(c)(1), is not prevented on September 2, 1958, by the operation of any law or rule of law, or

(ii) The first taxable year in which any expenditure for development or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest

In accordance with section 614(c) (3)(B), the election under section 614(c)(2) and paragraph (b) of this section to treat an operating mineral interest as more than one operating mineral interest may, at the election of the taxpayer, be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for whichever of the following taxable years is the later:

(iii) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, for which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from an election under section 614(c)(2), is not prevented on September 2, 1958, by the operation of any law or rule of law, or

(iv) The first taxable year in which expenditures for development or operation of more than one mine in respect of the separate operating mineral interest are made by the taxpayer after the acquisition of such interest

However, if the latest time at which an election may be made under this subparagraph falls on or before May 1, 1961, such election may be made or modified at any time on or before May 1, 1961. See paragraph (c) of §1.614–6 as to the binding effect of an election where the basis of a separate operating mineral interest in the hands of the taxpayer is determined by reference to the basis in the hands of a transferor.

(3) *Limitation*. If the taxpayer makes an election under section 614(c) (1) or (2) in accordance with section 614(c)(3)(B) and subparagraph (2) of this paragraph with respect to any operating mineral interest which constitutes part or all of an operating unit, such taxpayer may not make any election under section 614(c) (1) or (2) in accordance with section 614(c)(3)(A) and subparagraph (1) of this paragraph with respect to any operating mineral interest which constitutes part or all of such operating unit. The provisions of this subparagraph may be illustrated by the following example:

Example: In 1953, taxpayer A owned six separate operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Operating mineral interests Nos. 1 through 5 comprise a mine, and operating mineral interest No. 6 represents one mineral deposit in a single tract of land which is being extracted by means of two mines. In accordance with section 614(c)(3)(B) and subparagraph (2) of this paragraph, taxpayer A elects under section 614(c)(2) to treat operating mineral interest No. 6 as two separate operating mineral interests for the taxable year 1954 and all subsequent taxable years. Unless taxpayer A also makes an election under section 614(c)(1) to aggregate operating mineral interests Nos. 1 through 5 for the taxable year 1954 and all subsequent taxable years in accordance with section 614(c)(3)(B) and subparagraph (2) of this paragraph, he shall be deemed to have made an election to treat each of such interests as a separate property. Taxpayer A may not elect, under section 614(c) (1) and (3)(A), to aggregate operating mineral interests Nos. 1 through 5 for the taxable year 1958 or any subsequent taxable year.

(4) *Statute of limitations*. If the taxpayer makes any election in accordance with section 614(c)(3)(B) and subparagraph (2) of this paragraph and if assessment of any deficiency for any taxable year resulting from such election is prevented on May 1, 1961, or at any time within one year after such first day, by the operation of any law or rule of law, such assessment may, nevertheless, be made within one year after May 1, 1961. Any election by a taxpayer in accordance with section 614(c)(3)(B) shall constitute consent to the assessment of any deficiency resulting from any such election. If refund or credit of any overpayment of

income tax resulting from any election made in accordance with section 614(c)(3)(B) is prevented on May 1, 1961, or at any time within one year after May 1, 1961, by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed but only if claim therefor is filed within one year after May 1, 1961. This subparagraph shall not apply with respect to any taxable year of a taxpayer for which an assessment of a deficiency resulting from an election made in accordance with section 614(c)(3)(B) or a refund or credit of an overpayment resulting from any such election, as the case may be, is prevented by the operation of any law or rule of law on September 2, 1958.

(5) *Elections—how made*—(i) *General rule*. Except as provided in subdivision (ii) of this subparagraph, an election under section 614(c) (1) or (2) and paragraph (a) or (b) of this section must be made by a statement attached to the income tax return of the taxpayer for the first taxable year for which the election is made. The statement shall contain the following information:

(*a*) Whether the taxpayer is making an election or elections with respect to the operating unit in accordance with section 614(c)(3) (A) or (B);

(*b*) A description of the operating unit of the taxpayer in sufficient detail to identify the operating mineral interests which are included within such operating unit;

(*c*) A description of each aggregation to be formed within the operating unit in sufficient detail to show that each aggregation consists of all the separate operating mineral interests which comprise any one mine or any two or more mines;

(*d*) A description of each separate operating mineral interest within the operating unit which is to be treated as a separate property in sufficient detail to show that such interest is not a part of any mine for which an election to aggregate has been made;

(*e*) The taxable year in which the first expenditure for development or operation was made by the taxpayer with respect to each separate operating mineral interest within the operating unit, but if the first expenditure for development or operation has not been made with respect to a separate operating mineral interest before the close of the taxable year for which the election under this section is made, such information should also be included;

(*f*) A description of each separate operating mineral interest within the operating unit which the taxpayer elects to treat as more than one such interest under section 614(c)(2) in sufficient detail to show that the separate operating mineral interest was not a part of an aggregation formed by the taxpayer under section 614(c)(1) for any taxable year prior to the taxable year for which the election under section 614(c)(2) is made, and to show that the mineral deposit representing the separate operating mineral interest is being developed or extracted by means of two or more mines;

(*g*) The taxable year in which the first expenditure for development or operation was made by the taxpayer with respect to each mine on the separate operating mineral interest that the taxpayer is electing to treat as more than one such interest; and

(*h*) The allocation of the mineral deposit representing the separate operating mineral interest between (or among) the newly formed interests and the method by which such allocation was made

For the purpose of applying subdivisions (*e*) and (*g*) of this subdivision, if the first expenditure for development or operation with respect to a separate operating mineral interest or a mine was made prior to the first taxable year for which the election with respect to such interest or mine is applicable, the taxpayer may state that such is the case in lieu of identifying the exact taxable year in which such first expenditure was made. In any case where part of the information required under this subdivision can be adequately supplied by means of appropriately marked maps, the statement may be accompanied by such maps and may omit the required descriptive material to the extent replaced by the maps. The taxpayer shall maintain adequate records and maps in support of the above information. In the event that the first expenditure for development or operation with respect to a separate operating mineral interest is

made by the taxpayer in a taxable year subsequent to the taxable year for which an election under this section has been made with respect to the operating unit of which such interest is a part, the taxpayer shall furnish information describing such interest in sufficient detail to identify it as a part of such operating unit, to show whether it is a part of a mine with respect to which the interests have previously been aggregated or have previously been treated as separate properties, and to indicate whether it is to be included within an aggregation.

(ii) *Special rule.* If the last day prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for the first taxable year for which an election under section 614(c) (1) or (2) is made falls before May 1, 1961, the statement of election or modification thereof for such taxable year must be filed on or before May 1, 1961, with the district director for the district in which such return was filed. The statement must contain the information as required in subdivision (i) of this subparagraph, must indicate the first taxable year for which the election contained therein is made, and shall be accompanied by an amended return or returns if necessary or, if appropriate, a claim for refund or credit.

(6) *Elections; when effective.* If the taxpayer has elected to form an aggregation under section 614(c)(1) and this section, the date on which the aggregation becomes effective is the first day of the first taxable year for which the election is made; except that if any separate operating mineral interest included in such aggregation was acquired after such first day, the date on which the inclusion of such interest in such aggregation becomes effective is the date of its acquisition. If the taxpayer elects to add another operating mineral interest to such aggregation for a subsequent taxable year, the date on which aggregation of the additional interest becomes effective is the first day of such subsequent taxable year or the date of acquisition of such interest, whichever is later. If an operating mineral interest is required to be included in the aggregation for a subsequent taxable year because such interest becomes a part of a mine which the taxpayer has previously elected to aggregate, the date on which the inclusion of such interest in the aggregation becomes effective is the first day of the subsequent taxable year or the date of acquisition of such interest, whichever is later. If the taxpayer has elected to treat a separate operating mineral interest as more than one such interest, the date on which the election becomes effective is the first day of the first taxable year for which the election is made or the earliest date on which the first expenditure for development or operation has been made by the taxpayer with respect to a mine on each newly formed separate operating mineral interest, whichever is later.

(7) *Elections; binding effect.* A valid election under section 614(c) (1) or (2) whether made in accordance with section 614(c)(3) (A) or (B) shall be binding upon the taxpayer for the taxable year for which made and for all subsequent taxable years unless consent to change the treatment of an operating mineral interest with respect to which an election has been made is obtained from the Commissioner. For rules relating to the binding effect of an election where the basis of a separate or an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of §1.614–6. A taxpayer can neither include within an aggregation a separate operating mineral interest which he has previously elected to treat as a separate property, nor exclude from an aggregation a separate operating mineral interest which he has properly elected to include within such aggregation unless consent to do so is obtained from the Commissioner. A change in tax consequences alone is not sufficient to obtain consent to change the treatment of an operating mineral interest. However, consent may be appropriate where, for example, there has been a substantial change in the taxpayer's operations so that a major part of an aggregation becomes a part of another operating unit. Applications for consent shall be made in writing to the Commissioner of Internal Revenue, Washington, DC 20224. The application must be accompanied by a statement indicating the reason

or reasons for the change and furnishing the information required in subparagraph (5)(i) of this paragraph, unless such information has been previously filed and is current.

(8) *Invalid aggregations*—(i) *General rule*. In addition to aggregations which are invalid under this section because of the failure to make timely elections, aggregations may be invalid under this section in situations which may be divided into two general categories. The first category involves invalid basic aggregations. The second category involves invalid additions to basic aggregations.

(ii) *Invalid basic aggregations*. The term *invalid basic aggregations* refers to aggregations which are initially invalid. Generally, a basic aggregation is initially invalid because it does not include all the separate operating mineral interests which comprise a complete mine or mines or because it includes separate operating mineral interests which are not part of the same operating unit. If the taxpayer makes an invalid basic aggregation, each of the separate operating mineral interests included in such aggregation shall be treated as a separate property for the first taxable year for which the election is made and for all subsequent taxable years unless consent is obtained from the Commissioner to treat any such interest in a different manner. Consent will be granted in appropriate cases. For example, assume that the taxpayer elects to form an aggregation of the operating mineral interests which comprise one or more complete mines. If the taxpayer demonstrates that he inadvertently failed to include a minor part of one of the aggregated mines or inadvertently included a minor part of another mine that is not a part of the aggregation, consent will ordinarily be granted to maintain the aggregation by including the part omitted or by excluding the part included. The provisions of this subdivision may be illustrated by the following examples:

Example 1. In 1958, taxpayer A owned ten operating mineral interests, designated No. 1 through No. 10, which he operated as a unit. Interests Nos. 1 through 5 comprised mine X, and interests Nos. 6 through 10 comprised mine Y. Taxpayer A had made his first development expenditure with respect to each of the ten interests before January 1, 1958. Taxpayer A elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 through 8 for 1958 and all subsequent taxable years. The aggregation formed by taxpayer A is an invalid basic aggregation because it does not include all the operating mineral interests which comprise a complete mine or mines. Therefore, interests Nos. 1 through 8 must be treated as separate properties for 1958 and all subsequent taxable years unless consent is obtained from the Commissioner to treat any of such interests in a different manner.

Example 2. In 1958, taxpayer B owned ten operating mineral interests designated No. 1 through No. 10. Interests Nos. 1 through 5 comprised mine X, and interests Nos. 6 through 10 comprised mine Y. Taxpayer B had made his first development expenditure with respect to each of the ten interests before January 1, 1958. Taxpayer B elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 through 10 for 1958 and all subsequent taxable years. Upon audit, it was determined that mines X and Y were in two separate operating units. Therefore, the aggregation formed by taxpayer B is invalid, and interests Nos. 1 through 10 must be treated as separate properties for 1958 and all subsequent taxable years unless consent is obtained from the Commissioner to treat any of such interests in a different manner.

(iii) *Invalid additions*. The term *invalid addition* refers to an operating mineral interest which is invalidly aggregated with an existing aggregation. Generally, an addition is invalid because it is a part of a mine and is aggregated with an aggregation which does not include other interests which are parts of the same mine, or because it is in one operating unit and is included as part of an aggregation which is in another operating unit. If an invalid addition is properly a part of a mine with respect to which other interests have been validly aggregated for a taxable year prior to the first taxable year for which the election to aggregate the invalid addition is made, then the invalid addition shall be included in the aggregation of which it is properly a part for such first taxable year and all subsequent taxable years. Any other invalid addition shall be treated as a separate property for the first taxable year for which the election to aggregate such addition is made and for all subsequent taxable years unless consent is obtained from the Commissioner to treat any such interest in a

different manner. The provisions of this subdivision may be illustrated by the following examples:

Example 1. In 1958, taxpayer A owned six operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Interests Nos. 1 through 3 comprised mine X, and interests Nos. 4 through 6 comprised mine Y. Taxpayer A had made his first development expenditure with respect to each of the six interests before January 1, 1958. Taxpayer A elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 through 3 for 1958 and all subsequent taxable years. He elected to treat interests Nos. 4 through 6 as separate properties for 1958 and all subsequent taxable years. In 1959, taxpayer A acquired and made his first development expenditure with respect to interest No. 7. Interest No. 7 was a part of the mine composed of interests Nos. 4 through 6. Taxpayer A elected under section 614(c) (1) and (3)(A) to aggregate interest No. 7 with the aggregation of interests Nos. 1 through 3 for 1959 and all subsequent taxable years. Interest No. 7 is an invalid addition and must be treated as a separate property for 1959 and all subsequent taxable years. It cannot be aggregated with interests Nos. 4 through 6 since taxpayer A has previously elected to treat such interests as separate properties. However, the valid basic aggregation composed of interests Nos. 1 through 3 is not affected by the invalid addition of interest No. 7.

Example 2. Assume the same facts as in example 1 except that taxpayer A elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 through 3 as one aggregation and interests Nos. 4 through 6 as another aggregation for 1958 and all subsequent taxable years. The aggregation of interest No. 7 with the aggregation consisting of interests Nos. 1 through 3 constitutes an invalid addition. Interest No. 7 must be included in the aggregation consisting of interests Nos. 4 through 6 for 1959 and all subsequent taxable years.

Example 3. In 1958, taxpayer B owned three operating mineral interests, designated No. 1 through No. 3, which comprised mine X. Taxpayer B had made his first development expenditure with respect to each of the three interests before January 1, 1958. Taxpayer B elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 through 3 for 1958 and all subsequent taxable years. In 1959, taxpayer B acquired interests Nos. 4 through 7 which comprised mine Y. Taxpayer B made his first development expenditure with respect to each of the four interests during 1959. Taxpayer B elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 4 through 6 and to aggregate interest No. 7 with the aggregation consisting of interests Nos. 1 through 3 for 1959 and all subsequent taxable years. The aggregation consisting of interests Nos. 4 through 6 is an invalid basic aggregation, and the aggregation of interest No. 7 is an invalid addition. Interests Nos. 4 through 7 must be treated as separate properties for 1959 and all subsequent taxable years unless consent is obtained from the Commissioner to treat such interests in a different manner.

(g) *Special rule as to deductions under section 615(a) prior to aggregation*—(1) *General rule.* If an aggregation of operating mineral interests under section 614(c)(1) and paragraph (a) of this section includes any interest or interests in respect of which exploration expenditures, paid or incurred after the acquisition of such interest or interests, were deducted by the taxpayer under section 615(a) for any taxable year which precedes the date on which such aggregation becomes effective, then the tax imposed by chapter 1 of the Code for the taxable year or years in which such exploration expenditures were so deducted shall be recomputed in accordance with the rules contained in this paragraph. If an operating mineral interest is added to such aggregation for a subsequent taxable year and exploration expenditures made with respect to such interest after its acquisition were deducted by the taxpayer under section 615(a) for any taxable year which precedes the date on which the aggregation of such additional interest becomes effective, then the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year or years in which such exploration expenditures were so deducted shall be recomputed. For purposes of this paragraph, such taxable year or years shall be referred to as the taxable year or years for which a recomputation is required to be made. See paragraph (f)(6) of this section for rules relating to the date on which an aggregation becomes effective or the date on which the aggregation of an additional interest to an aggregation becomes effective. See subparagraph (3) of this paragraph for rules relating to the method of recomputation of tax. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. In 1954, taxpayer A owned two operating mineral interests designated Nos. 1 and 2. Interest No. 1 was in the production stage prior to 1954. The first exploration expenditures with respect to interest No. 2 were made by taxpayer A in 1954 and were

deducted under section 615(a) on his return for that year. In 1955, taxpayer A made his first development expenditure with respect to interest No. 2, and thereafter it was operated with interest No. 1 as a unit. Taxpayer A elected under section 614(c) (1) and (3)(B) to form an aggregation of interests Nos. 1 and 2 for 1955 and all subsequent taxable years. Taxpayer A must recompute his tax for 1954 in accordance with this paragraph.

Example 2. Assume the same facts as in example 1 except that, in 1957, taxpayer A acquired another operating mineral interest, designated No. 3, made his first exploration expenditures with respect to such interest in that year, and deducted such expenditures under section 615(a) on his return for that year. In 1958, taxpayer A made his first development expenditure with respect to interest No. 3. Interest No. 3 was part of the same operating unit as interests Nos. 1 and 2. Taxpayer A elected under section 614(c) (1) and (3)(B) to add interest No. 3 to his aggregation of interests Nos. 1 and 2 for 1958 and all subsequent taxable years. Taxpayer A must recompute his tax for 1957 in accordance with this paragraph.

(2) *Exceptions*—(i) *Taxable years beginning before January 1, 1958.* In the case of exploration expenditures deducted by the taxpayer with respect to an operating mineral interest for any taxable year beginning before January 1, 1958, subparagraph (1) of this paragraph shall apply only if the taxpayer has made an election under section 614(c) (1) or (2) with respect to the operating unit of which such interest is a part and such election applies to the taxable year for which such exploration expenditures were deducted. Thus, if the taxpayer does not make an election with respect to the operating unit under section 614(c) (1) or (2) and (3)(B), subparagraph (1) of this paragraph does not apply in the case of exploration expenditures deducted with respect to any operating mineral interest which is a part of such operating unit for any taxable year beginning before January 1, 1958. The provisions of this subdivision may be illustrated by the following examples:

Example 1. In 1956, taxpayer A acquired two operating mineral interests designated Nos. 1 and 2. Interest No. 1 was in the production stage at that time. Taxpayer A made his first exploration expenditures with respect to interest No. 2 in 1956, 1957, and 1958 and deducted such expenditures under section 615(a) on his returns for such years. In 1959, taxpayer A made his first development expenditure with respect to interest No. 2. Interests Nos. 1 and 2 were operated as a unit. Taxpayer A elected under section 614(c) (1) and (3)(A) to aggregate interests Nos. 1 and 2 for 1959 and all subsequent taxable years. Only the exploration expenditures deducted by the taxpayer for 1958 must be taken into account for purposes of applying subparagraph (1) of this paragraph.

Example 2. In 1954, taxpayer B owned two operating mineral interests, designated Nos. 1 and 2, which he operated as a unit. Interest No. 1 was in the production stage at that time, and interest No. 2 represented one mineral deposit in a single tract of land which was being extracted by means of two mines. Under section 614(c) (2) and (3)(B), taxpayer B elects to treat interest No. 2 as two separate operating mineral interests, designated as Nos. 2(a) and 2(b), for 1954 and all subsequent taxable years. In 1955, taxpayer B acquired operating mineral interest No. 3. He made his first exploration expenditures with respect to interest No. 3 in 1955, 1956, and 1957 and deducted such expenditures under section 615(a) on his returns for such years. In 1958, taxpayer B made his first development expenditure with respect to interest No. 3, and thereafter it was operated with interests Nos. 1, 2(a), and 2(b) as a unit. Taxpayer B elects under section 614(c) (1) and (3)(B) to aggregate interests Nos. 1 and 3 for 1958 and all subsequent taxable years. The exploration expenditures deducted by the taxpayer for 1955, 1956, and 1957 must be taken into account for purposes of applying subparagraph (1) of this paragraph since the taxpayer has made an election under section 614(c)(2) with respect to the operating unit of which interest No. 3 is a part and such election applies to the taxable years 1955, 1956, and 1957.

(ii) *Interests formed pursuant to an election under section 614(c)(2).* In the case of exploration expenditures deducted with respect to an operating mineral interest which the taxpayer elects to treat as more than one such interest under section 614(c)(2) and paragraph (b) of this section, subparagraph (1) of this paragraph shall not apply. Thus, if the taxpayer deducts exploration expenditures with respect to an operating mineral interest, subsequently elects to treat such interest as more than one interest under section 614(c)(2), and includes one of the newly formed interests in an aggregation under section 614(c)(1), subparagraph (1) of this paragraph does not apply in the case of the exploration expenditures deducted with respect to the interest which the taxpayer elected to

treat as more than one interest. The provisions of this subdivision may be illustrated by the following examples:

Example 1. In 1958, taxpayer A acquired two operating mineral interests, designated Nos. 1 and 2, which he operated as a unit. Each interest was an interest in a single mineral deposit in a single tract or parcel of land. There was a mine in the production stage of each of two interests at that time. Taxpayer A elected under section 614(c)(1)(B) to treat interests Nos. 1 and 2 as separate properties. In 1959 and 1960, taxpayer A made exploration expenditures with respect to interest No. 2 for the purpose of extracting the mineral by means of a second mine, and he deducted such expenditures on his returns for such years. In 1961, taxpayer A made his first development expenditure with respect to a second mine on interest No. 2. Taxpayer A elected under section 614(c)(2) to treat interest No. 2 as two separate operating mineral interests, designated as Nos. 2(a) and 2(b), for 1961 and all subsequent taxable years. Interest No. 2(a) contained the producing mine and interest No. 2(b) contained the subsequently developed mine. In his return for 1961, taxpayer A also elected under section 614(c)(1)(A) to aggregate interests Nos. 1 and 2(b) for 1961 and all subsequent taxable years. The exploration expenditures deducted with respect to interest No. 2 prior to the effective date of the formation of interests Nos. 2(a) and 2(b) need not be taken into account for purposes of applying subparagraph (1) of this paragraph.

Example 2. In 1954, taxpayer B owned two operating mineral interests designated Nos. 1 and 2. Interest No. 1 was an interest in a single mineral deposit in a single tract of land which was being extracted by means of two mines. Taxpayer B elected under section 614(c) (2) and (3)(B) to treat interest No. 1 as two separate operating mineral interests, designated as Nos. 1(a) and 1(b), for 1954 and all subsequent taxable years. In 1955, 1956, and 1957, taxpayer B made exploration expenditures with respect to interest No. 2 and deducted such expenditures on his returns for such years. In 1958, taxpayer B made his first development expenditure with respect to interest No. 2, and, on his return for that year, taxpayer B elected to aggregate interests Nos. 1(a) and 2 under section 614(c)(1) for 1958 and all subsequent taxable years. The exploration expenditures deducted with respect to interest No. 2 for 1955, 1956, and 1957 shall be taken into account for purposes of applying subparagraph (1) of this paragraph since such exploration expenditures were deducted with respect to an interest to which this subdivision does not apply.

(3) *Recomputation of tax*—(i) *General rule.* In the case of an aggregation formed under section 614(c)(1) and paragraph (a) of this section in respect of which a recomputation of tax is required to be made under the provisions of subparagraphs (1) and (2) of this paragraph for any taxable year or years, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 shall be recomputed for each such taxable year as if:

(*a*) The taxpayer had elected to form an aggregation for the taxable year for which the recomputation is required to be made, and

(*b*) Such aggregation had included all the interests included in the aggregation formed under section 614(c)(1) except those interests which the taxpayer did not own during the taxable year for which the recomputation is required to be made and those interests in respect of which the taxpayer had made no expenditures for exploration, development, or operation before or during the taxable year for which the recomputation is required to be made

If a recomputation of tax is required to be made for any taxable year in the case of the aggregation of an additional interest to an existing aggregation under section 614(c)(1), such recomputation shall be made as if:

(*c*) The taxpayer had elected to form an aggregation for the taxable year for which the recomputation is required to be made, and

(*d*) Such aggregation had included all the interests included in the aggregation formed under section 614(c)(1) (including any interest which the taxpayer had disposed of prior to the date on which the aggregation of the additional interest becomes effective) except those interests which the taxpayer did not own during the taxable year for which the recomputation is required to be made and those interests in respect of which the taxpayer had made no expenditures for exploration, development, or operation before or during the taxable year for which the recomputation is required to be made

For purposes of this paragraph, any aggregation which is treated as having been formed under subdivisions (*a*) and (*b*) or under subdivisions (*c*) and (*d*) shall be referred to as the *constructed aggregated property*.

(ii) *Recomputation of depletion allowance.* The taxpayer shall compute the depletion allowance with respect to the constructed aggregated property for the taxable year for which the recomputation is required to be made. In making this computation, cost depletion for such taxable year shall be computed with reference to the depletion unit for the constructed aggregated property. See paragraph (a) of § 1.611–2. Percentage depletion for such taxable year shall not exceed 50 percent of the taxable income from the constructed aggregated property computed in accordance with § 1.613–5. If a recomputation is required to be made for the same taxable year with respect to any other aggregation or aggregations formed by the taxpayer under section 614(c)(1), the depletion allowance with respect to the other constructed aggregated property or properties shall be similarly computed. If, for a taxable year in respect of which a recomputation is required, the sum of the depletion allowance or allowances as computed under this subdivision is less than the sum of the depletion allowance or allowances actually deducted for such taxable year with respect to all the properties required to be taken into account in making the computation under this subdivision, then the total depletion allowance deducted by the taxpayer for such taxable year shall be reduced by the difference. The taxable income or net operating loss of the taxpayer for such taxable year shall be adjusted to reflect such reduction for purposes of the recomputation of tax. However, if for a taxable year in respect of which a recomputation is required, the sum of the depletion allowance or allowances as computed under this subdivision exceeds the sum of the depletion allowance or allowances actually deducted for such taxable year with respect to all the properties required to be taken into account in making the computation under this subdivision, the recomputation of tax for such taxable year is disregarded for purposes of applying section 614(c)(4)(B), (C), and (D).

(iii) *Effect of recomputation with respect to items based on amount of income.* In making the recomputation of tax under this subparagraph for any taxable year, any deduction, credit, or other allowance which is based upon the adjusted gross income or taxable income of the taxpayer for such year shall be recomputed taking into account the adjustment required under subdivision (ii) of this subparagraph. For example, if a corporate taxpayer's taxable income is increased under the provisions of such subdivision, then the amount of charitable contributions which may be deducted under the limitation contained in section 170(b)(2) shall be correspondingly increased for purposes of the recomputation. Moreover, the effect that the recomputation of any deduction, credit, or other allowance for a taxable year has on the tax imposed for any other taxable year shall also be taken into account for purposes of the recomputation of tax under this subparagraph. Any change in items of tax preferences (as defined in section 57 and the regulations thereunder) must also be taken into account for purposes of the recomputation under this subparagraph.

(iv) *Effect of recomputation with respect to a net operating loss and a net operating loss deduction.* If the recomputation of tax under this subparagraph for the taxable year for which the recomputation is required to be made results in a reduction of a net operating loss for such year, then the taxpayer shall take into account the effect of such reduction on the tax imposed by chapter I of the Internal Revenue Code of 1954 (or by corresponding provisions of the Internal Revenue Code of 1939) for any taxable year affected by such reduction. If the recomputation of tax for the taxable year for which the recomputation is required to be made results in an increase in taxable income as defined in section 172(b)(2) for such year, then the taxpayer shall take into account the effect of such increase on the tax imposed by chapter I of the Internal Revenue Code of 1954 (or by corresponding provisions of the Internal Revenue Code of 1939) for any taxable year affected by such increase. Furthermore, in making the recomputation of tax for any taxable year for which the recomputation is required to be made, the taxpayer shall take into

account any change in the net operating loss deduction for such year resulting from the recomputation of tax for any other taxable year for which a recomputation is required to be made. For provisions relating to the net operating loss deduction, see section 172 and the regulations thereunder. For rules relating to the effect of the net operating loss deduction on the minimum tax for tax preferences see section 56 and the regulations thereunder and § 1.58–7.

(v) *Determination of increase in tax*. If the taxpayer elects to form an aggregation or aggregations for a taxable year under section 614(c)(1) and if a recomputation of tax is required to be made under this paragraph for any prior taxable year or years, then the taxpayer shall compute the difference between the tax, including the tax imposed by section 56 (relating to the minimum tax for tax preferences), as recomputed under this subparagraph for such prior taxable year or years (and other taxable years affected by the recomputation) and the tax liability previously determined (computed without regard to section 614(c)(4)) with respect to such prior taxable year or years (and other taxable years affected by the recomputation). If the taxpayer is subsequently required to make a recomputation with respect to any taxable year or years for which he has previously made a recomputation, then the taxpayer shall compute the difference between the tax as subsequently recomputed for such taxable year or years (and other taxable years affected by the subsequent recomputation) and the tax as previously recomputed for such taxable year or years (and other taxable years affected by the subsequent recomputation). For treatment of the increase in tax resulting from the recomputation of tax under this subparagraph, see subparagraph (4) of this paragraph.

(4) *Treatment of increase in tax*—(i) *General rule*. If the taxpayer elects to form an aggregation or aggregations for a taxable year under section 614(c)(1) and if a recomputation of tax is required to be made for any prior taxable year or years, then the total increase in tax resulting from such recomputation determined under subparagraph (3)(v) of this paragraph shall be taken into account in the first taxable year to which the election to form such aggregation or aggregations is applicable and in each succeeding taxable year until the full amount of such total increase in tax has been taken into account. The number of taxable years over which such total increase shall be taken into account shall be equal to the number of taxable years for which a recomputation of tax is required to be made under subparagraph (1) of this paragraph as limited by subparagraph (2) of this paragraph and for which such recomputation results in a reduction of the taxpayer's depletion allowance under subparagraph (3)(ii) of this paragraph. The amount of the increase in tax which is to be taken into account in a taxable year is determined by dividing the total increase in tax by the number of taxable years over which such total increase is to be taken into account. The tax imposed by chapter I of the Code for each of the taxable years over which the total increase in tax is to be taken into account shall be increased by the amount determined in accordance with the preceding sentence. However, such increase in tax for each of such taxable years shall have no effect upon the determination of the amount of any credit against the tax for any of such taxable years. For example, the amount of such increase shall not affect the computation of the limitation on the foreign tax credit under section 904. The amount of the increase in tax which is required to be taken into account by the taxpayer in a particular taxable year under section 614(c)(4)(C) shall be treated as a tax imposed with respect to such taxable years even though, without regard to section 614(c)(4) and this paragraph, such taxpayer would otherwise have no tax liability for such taxable year.

(ii) *Increase in tax not determinable as of first taxable year of aggregation*. If the recomputation of tax under subparagraph (3) of this paragraph, for any taxable year or years prior to the first taxable year to which the election to form an aggregation or aggregations under section 614(c)(1) applies, results in a reduction of any net operating loss carryover to a taxable year subsequent to such first taxable year, then the

total increase in tax resulting from the recomputation is not determinable as of such first taxable year. In such case, the total increase in tax shall be taken into account in equal installments in the first taxable year for which such total increase is determinable and in each succeeding taxable year for which a portion of the increase in tax would have been taken into account under subdivision (i) of this subparagraph if the total increase had been determinable as of the first taxable year to which the election to form the aggregation or aggregations under section 614(c)(1) applies. The provisions of this subdivision may be illustrated by the following example:

Example. Assume that taxpayer A elects under section 614(c)(1) to form an aggregation for 1960 and all subsequent taxable years. Assume further that taxpayer A is required to recompute his tax for four prior taxable years under subparagraphs (1) and (2) of this paragraph and that the recomputation for each of such taxable years results in a reduction of taxpayer A's depletion allowance. Under subdivision (i) of this subparagraph, the total increase in tax resulting from the recomputation is to be taken into account in equal installments in 1960, 1961, 1962, and 1963. However, if the total increase in tax is not determinable until 1961 because the recomputation for the prior taxable years results in the reduction of a net operating loss carryover to 1961, then the total increase shall be taken into account in equal installments in 1961, 1962, and 1963. In like manner, if the total increase in tax is not determinable until 1962, it shall be taken into account in equal installments in 1962 and 1963.

(iii) *Death or cessation of existence of taxpayer*. If the taxpayer dies or ceases to exist, the portion of the increase in tax determined under subparagraph (3)(v) of this paragraph which has not been taken into account under subdivision (i) or (ii) of this subparagraph for taxable years prior to the taxable year of the occurrence of such death or such cessation of existence, as the case may be, shall be taken into account for the taxable year in which such death or such cessation of existence, as the case may be, occurs.

(5) *Adjustments to basis of aggregated property*. If the taxpayer elects to form an aggregated property or properties under section 614(c)(1) for a taxable year and if a recomputation of tax is required to be made for any taxable year which results in reduction of the depletion allowance previously deducted by the taxpayer for such year, then proper adjustments shall be made with respect to the adjusted basis of such aggregated property or properties. In such a case:

(i) If the sum of the depletion allowances actually deducted with respect to the interests included in a constructed aggregated property exceeds the depletion allowance computed under subparagraph (3)(ii) of this paragraph with respect to such constructed aggregated property, the adjusted basis of the aggregated property formed under section 614(c)(1) shall be increased by such excess, and

(ii) If the depletion allowance computed under subparagraph (3)(ii) of this paragraph with respect to a constructed aggregated property exceeds the sum of the depletion allowances actually deducted with respect to the interests included in such constructed aggregated property, the adjusted basis of the aggregated property formed under section 614(c)(1) shall be reduced (but not below zero) by such excess.

However, the adjusted basis of an aggregated property formed under section 614(c)(1) may be increased only to the extent such excess would have resulted in an increase in such adjusted basis if taken into account under paragraph (a) of §1.614–6. Thus, if depletion previously allowed with respect to the separate operating mineral interests included in the aggregation formed under section 614(c)(1) exceeds the total of the unadjusted bases of such interests by $5,000, and if the recomputation of tax required to be made under this paragraph results in a depletion allowance which is $7,000 less than the depletion actually deducted with respect to such interests, then the adjusted basis of such aggregation may be increased by only $2,000. If, with respect to the same aggregated property formed under section 614(c)(1), adjustments to adjusted basis are required under this subparagraph as a result of recomputation of tax for two or more taxable years, the total or net amount of such adjustments shall be taken into account. Any adjustment to the adjusted basis of an aggregation required by this

subparagraph shall be taken into account as of the effective date of the election to form such aggregation under section 614(c)(1) and shall be effective for all purposes of subtitle A of the Code. For other rules relating to the determination of the adjusted basis of an aggregated property, see paragraph (a) of § 1.614–6.

[T.D. 6524, 26 FR 150, Jan. 10, 1961, as amended by T.D. 7170, 37 FR 5382, Mar. 15, 1972; T.D. 7564, 43 FR 40494, Sept. 12, 1978]

§ 1.614–4 Treatment under the Internal Revenue Code of 1939 with respect to separate operating mineral interests for taxable years beginning before January 1, 1964, in the case of oil and gas wells.

(a) *General rule.* (1) All references in this section to section 614(b) or any paragraph or subparagraph thereof are references to section 614(b) or a paragraph or subparagraph thereof as it existed prior to its amendment by section 226(a) of the Revenue Act of 1964. All references in this section to section 614(d) are references to section 614(d) as it existed prior to its amendment by section 226(b)(3) of the Revenue Act of 1964.

(2) For taxable years beginning before January 1, 1964, in the case of oil and gas wells, a taxpayer may treat under section 614(d) and this section any property as if section 614 (a) and (b) had not been enacted. For purposes of this section, the term *property* means each separate operating mineral interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. Separate tracts or parcels of land exist not only when areas of land are separated geographically, but also when areas of land are separated by means of the execution of conveyances or leases. If the taxpayer treats any property or properties under this section, the taxpayer must treat each such property as a separate property except that the taxpayer may treat any two or more properties that are included within the same tract or parcel of land as a single property provided such treatment is consistently followed. If the taxpayer treats two or more properties as a single property under this section, such properties shall be considered as a single property for all purposes of subtitle A of the Internal Revenue Code of 1954. The taxpayer may not make more than one combination of properties within the same tract or parcel of land. Thus, if the taxpayer treats two or more properties that are included within the same tract or parcel of land as a single property, each of the remaining properties included within such tract or parcel of land shall be treated as a separate property. If the taxpayer has treated two or more properties that are included within the same tract or parcel of land as a single property and subsequently discovers or acquires an additional mineral deposit within the same tract or parcel of land, he may include his interest in such deposit with the two or more properties which are being treated as a single property or he may treat his interest in such deposit as a separate property. If the taxpayer has treated each property included within a tract or parcel of land as a separate property and subsequently discovers or acquires an additional mineral deposit within the same tract or parcel of land, he may combine his interest in such deposit with any one of the separate properties included within the tract or parcel of land, but not with more than one of them since they cannot be validly combined with each other. The taxpayer may not combine properties which are included within different tracts or parcels of land under this section irrespective of whether such tracts or parcels of land are contiguous. The treatment of a property as a separate property or the treatment of two or more properties included within a single tract or parcel of land as a single property under this section shall be binding upon the taxpayer for the first taxable year for which such treatment is effective and for all subsequent taxable years beginning before January 1, 1964. For the continuation of such treatment under § 1.614–8 for taxable years beginning after December 31, 1963, see paragraph (d) of § 1.614–8. For provisions relating to the first taxable year for which treatment under this section becomes effective, see paragraph (d) of this section.

(b) *Treatment consistent with treatment for taxable years prior to 1954.* If the taxpayer has treated properties in a manner consistent with the rules contained in paragraph (a) of this section for taxable years to which the Internal Revenue Code of 1939 applies and if the taxpayer desires to treat such properties under section 614(d), then such properties must continue to be treated in the same manner. The provisions of this paragraph may be illustrated by the following examples:

Example 1. In 1950, taxpayer A owned two separate tracts of land designated No. 1 and No. 2. Each tract contained three mineral deposits. In the case of tract No. 1, taxpayer A treated the three mineral deposits as a single property. In the case of tract No. 2, taxpayer A treated the first mineral deposit as a separate property and treated the second and third mineral deposits as a single property. This treatment was consistently followed for the taxable years 1950, 1951, 1952, and 1953. Taxpayer A desires, for 1954 and subsequent taxable years, to treat the properties in tracts Nos. 1 and 2 as if section 614 (a) and (b) had not been enacted. For 1954 and subsequent taxable years, the three deposits in tract No. 1 must be treated as a single property; the first deposit in tract No. 2 must be treated as a separate property; and the second and third deposits in tract No. 2 must be treated as a single property.

Example 2. Assume the same facts as in example 1 except that, at the time the treatment under this section is adopted, assessment of any deficiency or credit or refund of any overpayment for the taxable years 1954 and 1955 resulting from the treatment of properties under this section is prevented by the operation of the statute of limitations. For 1956 and subsequent taxable years, the three deposits in tract No. 1 must be treated as a single property; the first deposit in tract No. 2 must be treated as a separate property; and the second and third deposits in tract No. 2 must be treated as a single property.

(c) *Bases of separate properties previously included in an aggregation under section 614(b).* If the taxpayer has made an election under section 614(b) to form an aggregation of operating mineral interests and if such taxpayer subsequently revokes such election for all taxable years for which it was made and treats the properties that are included within such aggregation under section 614(d) and this section by filing the statement required by paragraph (e) of this section, then the adjusted basis of each separate property (as defined in paragraph (a) of this section) that is a part of such aggregation shall be determined as if the taxpayer had made no election under section 614(b). However, if, at the time of the filing of the statement revoking the election under section 614(b), assessment of any deficiency or credit or refund of any overpayment, as the case may be, resulting from such revocation is prevented by the operation of any law or rule of law for any taxable year or years for which the election under section 614(b) was made, then the adjusted basis of each separate property that is a part of the aggregation shall be determined in accordance with the provisions contained in paragraph (a)(2) of §1.614.6 as of the first day of the first taxable year for which the revocation is effective. After determining the adjusted basis of each separate property included within the aggregation, the taxpayer may treat such properties in any manner which is in accordance with paragraph (a) of this section. See, however, paragraph (b) of this section. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Taxpayer A owns two separate tracts of land, designated No. 1 and No. 2, each of which contains three mineral deposits. The interests in the two tracts of land constitute an operating unit as defined in paragraph (c) of §1.614–2. Taxpayer A elects under section 614(b) to form an aggregation of all the interests in the operating unit for 1954 and all subsequent taxable years. Subsequently, taxpayer A revokes such election by filing a statement in accordance with paragraph (e) of this section. Such revocation is effective for 1956 and subsequent taxable years because, at the time of the filing of the statement of revocation, assessment of any deficiency or credit or refund of any overpayment for the taxable years 1954 and 1955 resulting from such revocation is prevented by the operation of the statute of limitations. The adjusted bases of the six properties that are included within the aggregation shall be determined in accordance with paragraph (a)(2) of §1.614–6 as of the beginning of the taxable year 1956.

Example 2. Assume the same facts as in example 1 and, in addition, assume that for taxable years to which the Internal Revenue Code of 1939 is applicable, taxpayer A treated the three deposits in tract No. 1 as a single property and the three deposits in tract No. 2 as a single property. After determining the adjusted basis of each of the six properties as

illustrated in example 1, the adjusted basis of the three properties in tract No. 1 must be combined and the adjusted bases of the three properties in tract No. 2 must be combined since the manner in which such properties were treated for taxable years to which the Internal Revenue Code of 1939 is applicable is consistent with the rules contained in paragraph (a) of this section.

(d) *Treatment; when effective.* If a taxpayer treats any property in accordance with this section, then such treatment shall be effective for whichever of the following taxable years is the later:

(1) The latest taxable year for which an election could have been made with respect to such property under section 614(b); or

(2) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in respect of which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from the treatment of such property under this section, is not prevented by the operation of any law or rule of law on the date such treatment is adopted.

(e) *Manner of adopting the treatment of properties under this section.* If the taxpayer does not make an election under section 614(b) with respect to a property within the time prescribed for making such an election, then the taxpayer shall be deemed to have treated such property under this section. In such case, the manner in which such property is treated in filing the taxpayer's income tax return for the first taxable year for which the treatment of such property is effective under paragraph (d) of this section shall establish the treatment which must be consistently followed with respect to such property for subsequent taxable years. However, if the income tax return for such first taxable year is filed prior to May 1, 1961, then the taxpayer may adopt the treatment provided for under this section with respect to the property by filing a statement at any time on or before May 1, 1961, with the district director for the district in which the taxpayer's income tax return was filed for the first taxable year for which the treatment of such property is effective under paragraph (d) of this section. Such statement shall set forth the first taxable year for which the treatment of the property under this section is effective, shall revoke any previous elections made with respect to such property under section 614(b), shall state the manner in which such property was treated for taxable years subject to the Internal Revenue Code of 1939, shall state the manner in which such property is to be treated under this section, and shall be accompanied by an amended return or returns if necessary.

(f) *Certain treatment under this section precludes election to aggregate under section 614(b) with respect to the same operating unit.* If the taxpayer's treatment of any properties that are included within an operating unit (as defined in paragraph (c) of § 1.614–2) under section 614(d) and this section would constitute an aggregation under section 614(b) and if such taxpayer elects, or has elected, to form an aggregation within the same operating unit under section 614(b) for any taxable year for which the treatment under section 614(d) is effective, then the election made under section 614(b) shall not apply for any such taxable year.

[T.D. 6524, 26 FR 157, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13700, Oct. 28, 1965]

§ 1.614–5 Special rules as to aggregating nonoperating mineral interests.

(a) *Aggregating nonoperating mineral interests for taxable years beginning before January 1, 1958.* Upon proper showing to the Commissioner, a taxpayer who owns two or more separate nonoperating mineral interests in a single tract or parcel of land, or in two or more contiguous tracts or parcels of land, shall be permitted to aggregate all such interests in each separate kind of mineral deposit and treat them as one property. Permission will be granted by the Commissioner only if the taxpayer establishes that he will sustain an undue hardship if such nonoperating mineral interests are not treated as one property. Such hardship may exist, for example, if it is impossible for the taxpayer to determine the boundaries, source, or costs of the separate interests, or if a taxpayer who owns a single royalty interest, production payment, or net profits interest cannot determine the separate deposits from which his payments will be derived. In no

event shall undue hardship be deemed to exist solely by reason of tax disadvantage. The treatment of such interests as one property shall be applicable for all purposes of subtitle A of the Internal Revenue Code of 1954. In no event may nonoperating mineral interests in tracts or parcels of land which are not contiguous be treated as one property. The term *two or more contiguous tracts or parcels of land* means tracts or parcels of land which have common boundaries. Common boundaries include survey lines, public roads, or similar easements for the use of land without the existence of an intervening mineral right between the tracts or parcels of land. Tracts or parcels of land which touch only at a common corner are not contiguous. For the definition of *nonoperating mineral interests*, see paragraph (g) of this section.

(b) *Manner and scope of election*—(1) *Time for filing application for permission to aggregate separate nonoperating mineral interests under paragraph (a) of this section*. The application for permission to aggregate separate nonoperating mineral interests under paragraph (a) of this section shall be filed at any time on or before May 1, 1961. Such application shall indicate the first taxable year for which the aggregation is to be formed. If, prior to January 10, 1961, an application has been filed, the taxpayer need file only a supplemental application containing such additional information as is necessary to comply with the requirements of subparagraph (2) of this paragraph.

(2) *Contents of application and returns under permission*. The application for permission to aggregate nonoperating mineral interests under paragraph (a) of this section shall include a complete statement of the facts upon which the taxpayer relies to show the undue hardship which would result if such an aggregation was not permitted. Such application shall also include a description of the nonoperating mineral interests owned by the taxpayer within the tract or tracts of land involved. A general description, accompanied by maps appropriately marked, which accurately circumscribes the scope of the aggregation and shows that the taxpayer is aggregating all the nonoperating mineral interests in a particular kind of mineral deposit within the tract or tracts of land involved will be sufficient. If the Commissioner grants permission, a copy of the letter granting such permission shall be filed with the district director for the district in which the taxpayer's income tax return was filed for the first taxable year for which such permission applies, and shall be accompanied by an amended return or returns if necessary.

(3) *Election; binding effect*. The election to aggregate separate nonoperating mineral interests under paragraph (a) of this section shall be binding upon the taxpayer for the first taxable year for which made and all subsequent taxable years beginning before January 1, 1958, unless consent to make a change is obtained from the Commissioner. The application for consent to make a change must set forth in detail the reason or reasons for such change. Consent to a different treatment shall not be granted where the principal purpose for such change is due to tax consequences. For rules relating to the binding effect of an election where the basis of an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of § 1.614–6.

(4) *Aggregations under the Internal Revenue Code of 1939*. An application for permission to aggregate nonoperating mineral interests under paragraph (a) of this section shall be submitted in accordance with the requirements of this paragraph notwithstanding the fact that the taxpayer may have aggregated such interests for taxable years to which the Internal Revenue Code of 1939 is applicable. If such interests were aggregated for taxable years to which the Internal Revenue Code of 1939 applies and the aggregation was approved by the Internal Revenue Service for such years after full consideration thereof on its merits, such approval will generally be accepted as evidence that undue hardship would result if the aggregation were not permitted.

(c) *Termination of aggregation of nonoperating mineral interests*—(1) *General rule*. Any aggregation of nonoperating mineral interests formed under paragraphs (a) and (b) of this section shall not apply with respect to any taxable

year beginning after December 31, 1957. Thus, if a taxpayer makes a binding election to form such an aggregation for taxable years beginning before January 1, 1958, then in order to form an aggregation with respect to any taxable year beginning after December 31, 1957, he must obtain permission in accordance with the rules prescribed in paragraphs (d) and (e) of this section.

(2) *Bases of separate nonoperating mineral interests*. If a taxpayer forms an aggregation of nonoperating mineral interests under paragraphs (a) and (b) of this section which is terminated under subparagraph (1) of this paragraph, the adjusted bases of the separate nonoperating mineral interests included in such aggregation shall be determined in accordance with paragraph (a)(2) of § 1.614–6.

(d) *Aggregating nonoperating mineral interests for taxable years beginning after December 31, 1957, or for earlier taxable years*. Upon proper showing to the Commissioner, a taxpayer who owns two or more separate nonoperating mineral interests in a single tract or parcel of land, or in two or more adjacent tracts or parcels of land, shall be permitted, under section 614(e), to form an aggregation of all of such interests in each separate kind of mineral deposit and treat such aggregation as one property. Permission shall be granted by the Commissioner only if the taxpayer establishes that a principal purpose in forming the aggregation is not the avoidance of tax. The fact that the aggregation of nonoperating mineral interests will result in a substantial reduction in tax is evidence that avoidance of tax is a principal purpose of the taxpayer. An aggregation formed under the provisions of this paragraph shall be considered as one property for all purposes of the Code. In no event may nonoperating mineral interests in tracts or parcels of land which are not adjacent be aggregated and treated as one property. The term *two or more adjacent tracts or parcels of land* means tracts or parcels of land that are in reasonably close proximity to each other depending on the facts and circumstances of each case. Adjacent tracts or parcels of land do not necessarily have any common boundaries, and may be separated by intervening mineral rights. For the definition of *nonoperating mineral interests*, see paragraph (g) of this section.

(e) *Manner and scope of election*—(1) *Time for filing application for permission to aggregate separate nonoperating mineral interests under section 614(e)*. The application for permission to aggregate separate nonoperating mineral interests under section 614(e) and paragraph (d) of this section shall be made in writing to the Commissioner of Internal Revenue, Washington, DC 20224. Such application shall be filed within 90 days after the beginning of the first taxable year beginning after December 31, 1957, for which aggregation is desired or within 90 days after the acquisition of one of the nonoperating mineral interests which is to be included in the aggregation, whichever is later. However, if the last day on which the application may be filed under this paragraph falls before May 1, 1961, such application may be filed at any time on or before May 1, 1961. If, prior to January 10, 1961, an application has been filed, the taxpayer need file only a supplemental application containing such additional information as is necessary to comply with subparagraph (4) of this paragraph.

(2) *Election to apply section 614(e) retroactively*. The application for permission to aggregate separate nonoperating mineral interests under section 614 (e) and paragraph (d) of this section may be filed, at the election of the taxpayer, for any taxable year beginning before January 1, 1958, to which the Internal Revenue Code of 1954 is applicable. In such case, the application may be filed at any time on or before May 1, 1961. Such application shall designate the first taxable year for which the aggregation is to be formed. If, prior to January 10, 1961, an application has been filed, the taxpayer need file only a supplemental application containing such additional information as is necessary to comply with the requirements of subparagraph (4) of this paragraph.

(3) *Limitation*. If the taxpayer forms any aggregation of nonoperating mineral interests under subparagraph (2) of this paragraph, then any aggregation of nonoperating mineral interests formed under paragraphs (a) and (b) of

this section shall not apply for any taxable year. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1954, taxpayer A owns six separate nonoperating mineral interests designated No. 1 through No. 6. Interests Nos. 1 through 3 are royalty interests in contiguous tracts of land. Interests Nos. 4 through 6, which are located in an entirely different area from interests Nos. 1 through 3, are royalty interests in tracts of land which are not contiguous but which are adjacent to each other. In 1959 taxpayer A obtains permission and elects under section 614(e) and subparagraph (2) of this paragraph to form an aggregation of interests Nos. 4 through 6 for 1956 and all subsequent taxable years. Taxpayer A may not elect to form an aggregation of interests Nos. 1 through 3 under paragraphs (a) and (b) of this section for 1954 or any subsequent taxable year. If taxpayer A wishes to form an aggregation of interests Nos. 1 through 3, he must obtain permission under paragraph (d) of this section and this paragraph.

(4) *Contents of application and returns under permission*. The application for permission to aggregate nonoperating mineral interests under section 614(e) and paragraph (d) of this section shall include a complete statement of the facts upon which the taxpayer relies to show that avoidance of tax is not a principal purpose of forming the aggregation. Such application shall also include a description of the nonoperating mineral interests within the tract or tracts of land involved. A general description, accompanied by maps appropriately marked, which accurately circumscribes the scope of the aggregation and shows that the taxpayer is aggregating all the nonoperating mineral interests in a particular kind of mineral deposit within the tract or tracts of land involved will be sufficient. If the Commissioner grants permission, a copy of the letter granting such permission shall be attached to the taxpayer's income tax return for the first taxable year for which such permission applies. If the taxpayer has already filed such return, a copy of the letter of permission shall be filed with the district director for the district in which such return was filed and shall be accompanied by an amended return or returns if necessary or, if appropriate, a claim for credit or refund.

(5) *Election; binding effect*. The election to aggregate separate nonoperating mineral interests under section 614 (e) and paragraph (d) of this section shall be binding upon the taxpayer for the first taxable year for which made and for all subsequent taxable years unless consent to make a change is obtained from the Commissioner. The application for consent to make a change must set forth in detail the reason or reasons for such change. Consent to a different treatment shall not be granted where the principal purpose for such change is due to tax consequences. For rules relating to the binding effect of an election where the basis of an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of § 1.614–6.

(6) *Aggregations under the Internal Revenue Code of 1939*. An application for permission to aggregate nonoperating mineral interests under section 614 (e) and paragraph (d) of this section shall be submitted in accordance with the requirements of this paragraph notwithstanding the fact that the taxpayer may have aggregated such interests for taxable years to which the Internal Revenue Code of 1939 is applicable. If such interests were aggregated for taxable years to which the Internal Revenue Code of 1939 applies and the aggregation was approved by the Internal Revenue Service for such years after full consideration thereof on its merits, such approval will generally be accepted as evidence that avoidance of tax is not a principal purpose of forming the aggregation.

(f) *Elections; when effective*. If the taxpayer has elected to form an aggregation under either paragraph (a) or paragraph (d) of this section, the date on which the aggregation becomes effective is the first day of the first taxable year for which the election is made; except that if any separate nonoperating mineral interest included in such aggregation was acquired after such first day, the date on which the inclusion of such interest in such aggregation becomes effective is the date of its acquisition.

(g) *Definition of nonoperating mineral interests*. For purposes of this section, *nonoperating mineral interests* includes

only those interests described in section 614(a) which are not operating mineral interests within the meaning of paragraph (b) of §1.614–2. The taxpayer who holds the operating or working rights in a mineral deposit, but is not actually conducting operations with respect to such deposit, does not have a nonoperating mineral interest in such deposit notwithstanding the fact that he intends to transfer such operating rights at a later time.

[T.D. 6524, 26 FR 158, Jan. 10, 1961]

§ 1.614–6 Rules applicable to basis, holding period, and abandonment losses where mineral interests have been aggregated or combined.

(a) *Basis of property resulting from aggregation or combination*—(1) *General rule.* (i) When a taxpayer has aggregated as one property two or more interests under section 614(b) (prior to its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e), the unadjusted basis of such aggregated property shall be the sum of the unadjusted bases of the various mineral interests aggregated. The adjusted basis of the aggregated property on the effective date of the aggregation shall be the unadjusted basis of the aggregated property, adjusted by the total of all adjustments to the bases of the several mineral interests aggregated as required by section 1016 to the effective date of aggregation. Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the aggregated property for all purposes of subtitle A of the Code.

(ii) When a taxpayer has combined as one property two or more interests under section 614(b) (as amended by section 226(a) of the Revenue Act of 1964), the adjusted basis of such combined property shall be the sum of:

(*a*) The unadjusted bases of all such interests which have never been included in an aggregation; and

(*b*) The adjusted bases of all such interests which at some time have been included in an aggregation, as of the date on which they ceased to participate in an aggregation

adjusted by the total of all adjustments to the bases of the several mineral interests combined, as required by section 1016,

(*c*) In the case of interests described in (*a*), for the entire period of the taxpayer's ownership of such interest; and

(*d*) In the case of interests described in (*b*), for the period, if any, between the time of deaggregation and the time of combination.

Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the combined property for all purposes of subtitle A of the Code.

(2) *Bases upon disposition of part of, or termination of, or change in, an aggregated or combined property*—(i) *In general.* (*a*) When a taxpayer has aggregated or combined two or more separate mineral interests as one property under section 614(b) (either before or after its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e) and thereafter sells, exchanges, or otherwise disposes of part of such property, the total adjusted basis of the property as of the date of sale, exchange, or other disposition shall be apportioned to determine the adjusted basis of the part disposed of and the part retained for purposes of computing gain or loss, depletion and for all other purposes of subtitle A of the Code. Such adjusted basis shall be determined by apportioning the total adjusted basis of the property between the part of the property disposed of and the part retained in the same proportion as the fair market value of each part (as of the date of sale, exchange, or other disposition) bears to the total fair market value of the property as of such date. For determining gain or loss on the sale or exchange of any part of the aggregated or combined property, the adjusted basis of the aggregated or combined property (from which the adjusted basis of the part is determined) shall not be reduced below zero.

(*b*) If, for any taxable year after the first taxable year for which an aggregation under section 614(b) (prior to its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e) is effective:

(*1*) Any such aggregation is terminated for any reason other than the expiration of an aggregation by reason of section 614(b) as amended by section 226(a) of the Revenue Act of 1964 (see

subdivision (ii) of this subparagraph), or

(*2*) The treatment of any mineral interests in any such aggregation is changed after obtaining the consent of the Commissioner

then the adjusted basis of the aggregated property as of the first day of the first taxable year for which such termination or change is effective shall be apportioned to determine the adjusted bases of the resultant separate mineral interests, as of such first day, for purposes of computing gain or loss, depletion, and for all other purposes of subtitle A of the Code. The adjusted bases of such separate mineral interests shall be determined by apportioning the adjusted basis of the aggregated property (as of the first day of the first taxable year for which such termination or change is effective) between or among such interests in the same proportion as the fair market value of each such interest (as of such first day) bears to the total fair market value of the aggregated property as of such first day. For the purpose of determining the adjusted bases of the separate mineral interests, the adjusted basis of the aggregated property (from which the adjusted basis of each separate mineral interest is determined) shall not be reduced below zero.

(ii) *Allocation of basis of aggregation of operating mineral interests in oil and gas wells as of the first day of the first taxable year beginning after December 31, 1963—(a) Fair market value method.* Unless the taxpayer elects to use the allocation of adjustments method of determining basis provided in (b) of this subdivision (ii), the adjusted basis as of the first day of the first taxable year beginning after December 31, 1963, of each interest which was participating in an aggregation of operating mineral interests on the day preceding such first day shall be determined by multiplying the adjusted basis of the aggregation by a fraction the numerator of which is the fair market value of such interest and the denominator of which is the fair market value of such aggregation. For purposes of this subdivision (*a*), the adjusted basis and the fair market value of the aggregation, and the fair market value of such interest, shall be determined as of the day preceding the first day of the first taxable year which begins after December 31, 1963. Unless the taxpayer elects to use the allocation of adjustments method, he shall obtain accurate and reliable information, and keep records with respect thereto, establishing all facts necessary for making the computation prescribed in this subdivision (*a*). See example 5 of subparagraph (3) of this paragraph.

(*b*) *Allocation of adjustments method.* (*i*) The taxpayer may elect to determine basis by an allocation of adjustments in lieu of the fair market value method prescribed in (*a*) of this subdivision (ii). In such a case, the adjusted basis (as of the first day of the first taxable year beginning after December 31, 1963) of each interest which was participating in an aggregation of operating mineral interests on the day preceding such first day is the unadjusted basis of such interest immediately after its acquisition by the taxpayer, adjusted by the total of all adjustments to its basis as required by section 1016 to the effective date of aggregation, and by that portion of those section 1016 adjustments to the basis of the aggregation which is reasonably attributable to such interest. For this purpose, two or more interests which are being combined upon deaggregation shall be treated as one interest. An adjustment to the basis of the aggregation is reasonably attributable to such interest to the extent that the adjustment thereto resulted from inclusion of the interest in the aggregation, even though such interest would not have been entitled to the adjustment to the same extent if such interest had been treated separately because of the 50 percent of taxable income limitation or for any other reason. In a case in which the amount of a percentage depletion deduction which was allowed with respect to an aggregation was limited by the 50 percent of taxable income limitation of section 613(a), the portion of such amount which is attributable to each of the interests in the aggregation shall be determined by multiplying such amount by a fraction, the numerator of which is the gross income from such interest and the denominator of which is the gross income from the aggregation.

The determination as to which property a particular adjustment is attributable may be based upon records of production or any other facts which establish the reasonableness of the determination. See example 6 of subparagraph (3) of this paragraph.

(*ii*) If, under the adjustment described in (*i*) of this subdivision (*b*), the total of the adjusted bases of the interests which were included in the aggregation exceeds the adjusted basis of the aggregation, the adjusted bases of the interests shall be further adjusted so that the total of the adjusted bases of the interests equals the adjusted basis of the aggregation. This further adjustment shall be made by reducing the basis of each interest (other than an interest having a basis of zero) by an amount which is determined by multiplying such excess by a fraction, the numerator of which is the adjusted basis of such interest after making the adjustment described in (*i*) of this subdivision (*b*) and the denominator of which is the total of the adjusted bases of all such interests after making the adjustment described in (*i*) of this subdivision (*b*). See example 6 of subparagraph (3) of this paragraph.

(*iii*) The election provided for in this subdivision (*b*) shall be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for the first taxable year beginning after December 31, 1963, and shall be made in a statement attached to such return.

(3) The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. A taxpayer owning three operating mineral interests, designated Nos. 1, 2, and 3, within a single operating unit, properly elects to aggregate such properties under section 614(b) for the calendar year 1954 in his income tax return filed on April 15, 1955. The unadjusted bases and adjustments under section 1016 for depletion through December 31, 1953, in respect of such properties are as follows:

	Unadjusted basis	Adjustments under Section 1016
No. 1	$25,000	$27,000
No. 2	18,000	10,000
No. 3	15,000	4,000
Total	58,000	41,000

The adjusted basis of the aggregated property as of January 1, 1954, is $17,000 ($58,000–$41,000).

Example 2. Assume the same facts as in example 1, except that a portion of the aggregated property is sold on June 1, 1956, for $15,000 which is also the fair market value of such portion on the date of sale. In order to determine the gain or loss from this sale as well as the adjusted basis of the retained property, an apportionment must be made. The aggregated property had a fair market value of $25,000 on the date of sale. From January 1, 1954, through May 31, 1956, $10,000 of depletion has been allowed with respect to the aggregated property. The adjusted basis of the portion sold is determined as follows:

$$\$7{,}000\ \text{(adjusted basis of aggregated property)} \times \frac{\$15{,}000}{\$25{,}000} = \$4{,}200\ \text{(adjusted basis of portion sold)}$$

Therefore, the gain on this sale of the portion sold is $10,800 ($15,000–$4,200). The adjusted basis of the property retained is $2,800 ($7,000–$4,200).

Example 3. Assume the same facts as in example 2, except that instead of selling, the taxpayer subleases one of the leases making up the aggregated property, retaining a one-eighth royalty interest therein. The fair market value of such lease is $15,000 on the date of the sublease. The adjusted basis of such royalty interest is $4,200 which is computed as follows:

$$\$7{,}000\ \text{(adjusted basis of aggregated property)} \times \frac{\$15{,}000\ \text{(FMV of portion transferred)}}{\$25{,}000\ \text{(FMV of aggregated property)}}$$

Example 4. In 1953, a taxpayer owned mineral interests Nos. 1, 2, and 3 which he operated as a unit. He owned no other operating interests during that year. The unadjusted bases of these properties were $10,000, $15,000, and $20,000, respectively, and depletion allowed through December 31, 1953, was $5,000 with respect to each property. The taxpayer operated these properties during the year 1954 and, in addition, operated as part of the unit mineral interest No. 4 which he acquired on July 1, 1954, on which date he made the first exploration expenditure with respect thereto. He paid $20,000 for No. 4. In his return for the calendar year 1954, the taxpayer elected under section 614(b) to aggregate all of these mineral interests. The taxpayer must compute cost depletion for the calendar year 1954 on the basis of an aggregated property with an adjusted basis of $30,000 ($45,000–$15,000) for the period from January 1 to June 30, and with an adjusted basis of $50,000 (less depletion for the first six months) for the period from July 1 to December 31. If applicable, the taxpayer must compute percentage depletion on the basis of gross income and taxable income from the aggregated property for the entire year, including the gross income and deductions with respect to operating mineral interest No. 4 for the period from July 1 to December 31. If a portion of the aggregated property is sold during the first six months, its adjusted basis must be determined at the time of sale with an adjustment for depletion to the date of sale. If percentage depletion is applicable, it must be allocated on an equitable basis to the periods prior and subsequent to the date of sale in order to determine the adjustment for depletion to the date of sale.

Example 5. A taxpayer owns two operating mineral interests in oil wells, designated Nos. 1 and 2, in tract A, and another such interest, designated No. 3, in tract B. All three interests are in the same operating unit (as defined in paragraph (c) of §1.614–2). The taxpayer, who is on a calendar year basis, has properly elected under §1.614–2 to aggregate such interests for the calendar years 1954 through 1963. The unadjusted bases and adjustments under section 1016 for depletion through December 31, 1953, in respect of such interests are as follows:

	Unadjusted basis	Adjustments under section 1016
No. 1	$42,000	$11,000
No. 2	37,000	4,000
No. 3	19,000	23,000
Total	98,000	38,000

The adjusted basis of the aggregated property as of January 1, 1954, is therefore $60,000 ($98,000 minus $38,000). The taxpayer properly elects under section 614(b) and §1.614–8 to treat Nos. 1 and 2 as separate properties for the calendar year 1964 and thereafter and does not elect to use the allocation of adjustments method of determining basis provided in subparagraph (2) (ii) (*b*) of this paragraph. No. 3 will be treated as a separate property, also, because it is in a different tract than the taxpayer's other interests. From January 1, 1954, through December 31, 1963, $50,000 of depletion has been allowed with respect to the aggregated property, leaving an adjusted basis of $10,000 ($60,000 minus $50,000) on January 1, 1964. On December 31, 1963, the aggregated property has a fair market value of $40,000. Nos. 1, 2, and 3 have fair market values of $16,000, $22,000, and $2,000, respectively. Accordingly, the adjusted bases of Nos. 1, 2, and 3 on January 1, 1964, are $4,000,

$$\left(\begin{array}{l}\$10{,}000\,(\text{adjusted basis}\\ \text{of aggregated property})\end{array}\times\frac{16{,}000}{40{,}000}\right),$$

$5,500 [$10,000 × (22,000/40,000)], and

$500 [$10,000 × (2,000/40,000)] respectively.

Example 6. A taxpayer owns four operating mineral interests in oil wells, designated Nos. 1, 2, 3, and 4. All four interests are in the same operating unit and the same tract or parcel of land. The taxpayer, who is on a calendar year basis, has properly elected under §1.614–2 to aggregate such interests for the calendar years 1954 through 1963. The taxpayer properly elects under section 614(b) and paragraph (a) of §1.614–8 to treat Nos. 1 and 2 as separate properties for the calendar year 1964 and thereafter. The taxpayer also properly elects to use the allocation of adjustments method of determining basis as provided in subparagraph (2) (ii) (*b*) of this paragraph. The unadjusted bases of Nos. 1, 2, and combined 3 and 4, the adjustments attributable to each, and the deaggregated basis of each (prior to further adjustment as provided in subparagraph (2) (ii) (*b*)(*ii*) of this paragraph) are as follows:

	Basis upon acquisition	Adjustments to time of aggregation	Attributable adjustments during aggregation	Basis upon deaggregation after first adjustment
No. 1	$35,000	$1,000	$16,000	$18,000
No. 2	30,000	11,000	23,000	0
No. 3	25,000	3,000	5,000	.....
No. 4	10,000	12,000	9,000	6,000
Total	100,000	27,000	53,000	24,000

The total of the adjusted bases (prior to further adjustment) of the interests which were included in the aggregation is $24,000 while the adjusted basis of the aggregation is $20,000 ($100,000 minus the sum of $27,000 and $53,000). Therefore, the adjusted bases of the

interests are further reduced by $4,000 ($24,000 minus $20,000). The adjusted basis of No. 1 of $18,000 is further reduced by $3,000 [$4,000 × (18,000 ÷ 24,000)] to $15,000. Similarly, the adjusted basis of combined Nos. 3 and 4 of $6,000 is further reduced by $1,000 [$4,000 × (6,000 ÷ 24,000)] to $5,000. Assume further that the taxpayer also owns interest No. 5 in the same tract or parcel of land, that such interest was not a part of any aggregation, that such interest had a basis of $15,000 upon acquisition and had subsequent adjustments in reduction of basis totalling $17,000, and that the taxpayer does not elect to treat such interest as a separate property. In such case, Nos. 3, 4, and 5 will be combined. The combination will have an adjusted basis of $3,000, determined by adding the unadjusted basis of No. 5 ($15,000) and the adjusted bases of combined Nos. 3 and 4 upon deaggregation ($5,000), and subtracting from the total thereof ($20,000) the adjustments to No. 5 ($17,000).

(4) *Basis for gain and loss where mineral interests acquired before March 1, 1913, are included in an aggregation.* Where mineral interests acquired before March 1, 1913, are included in an aggregation under section 614 (b), (c), or (e), the aggregated property has two bases, one for the determination of gain and another for the determination of loss upon the disposition of the whole or a part of the aggregated property. For the purpose of determining gain, the adjusted basis of the aggregated property on the effective date of aggregation shall be the sum of:

(i) The unadjusted bases of those mineral interests acquired on or after March 1, 1913, plus

(ii) The cost of any interest acquired before March 1, 1913 (adjusted for the period before March 1, 1913), or the fair market value of such interest as of March 1, 1913, whichever is greater and such sum shall be adjusted by the total of all adjustments to the bases of the several mineral interests aggregated as required by section 1016 to the effective date of aggregation. For the purpose of determining loss, the adjusted basis of the aggregated property on the effective date of aggregation shall be the sum of:

(iii) The unadjusted bases of those mineral interests acquired on or after March 1, 1913, plus

(iv) The cost of those interests acquired before March 1, 1913, adjusted for the period before March 1, 1913 and such sum shall be adjusted by the total of all adjustments to the bases of the several mineral interests aggregated as required by section 1016 to the effective date of aggregation. Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the aggregated property for all purposes of the Code. Upon disposition of a part of the aggregated property, or upon termination of the aggregation for any reason, or upon change in the treatment of any mineral interests in the aggregation with consent of the Commissioner, the adjusted basis for determining gain and the adjusted basis for determining loss with respect to each resultant part of the aggregated property shall be determined in accordance with subparagraph (2) of this paragraph. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. At the close of 1953 a taxpayer owned two operating mineral interests designated as Nos. 1 and 2 in the same operating unit. Operating mineral interest No. 1 was acquired by the taxpayer before March 1, 1913, and on such date its basis with reference to its fair market value was $50,000 and its adjusted basis with reference to its cost was $44,000. The unadjusted basis of operating mineral interest No. 2, acquired after March 1, 1913, was $30,000. Adjustments under section 1016 for depletion from March 1, 1913, through December 31, 1953, were $37,000 for operating mineral interest No. 1 and $20,000 for operating mineral interest No. 2. Assume that the taxpayer elected for the taxable year 1954 to aggregate operating mineral interests Nos. 1 and 2. The adjusted basis of the aggregated property as of January 1, 1954, for the purpose of determining gain would be $23,000 ($50,000 plus $30,000) minus ($37,000 plus $20,000). For the purpose of determining loss, the adjusted basis would be $17,000 ($44,000 plus $30,000) minus ($37,000 plus $20,000).

Example 2. Assume the same facts as in example 1 and further assume that for the taxable years 1954 and 1955, the taxpayer was allowed $5,000 of depletion on the aggregated property, that on January 1, 1956, he sold a portion of the aggregated property for $20,000, and that, as of January 1, 1956, the aggregated property had a fair market value of $24,000. At the time of sale, the adjusted basis of the aggregated property for the purpose of determining gain was $18,000 ($23,000–$5,000); and the adjusted basis for the purpose of determining loss was $12,000 ($17,000–$5,000). The adjusted basis of the portion sold would be computed as follows:

$$\frac{\$20{,}000\ (\text{FMV of portion sold})}{\$24{,}000\ (\text{FMV of aggregated property})} \times \begin{matrix}\$18{,}000\ (\text{adjusted}\\ \text{basis for gain})\end{matrix} = \begin{matrix}\$15{,}000\ (\text{adjusted}\\ \text{basis of portion sold})\end{matrix}$$

Taxpayer's gain would then be computed as follows:

	$20,000	(amount received for portion sold)
Less:	$15,000	(adjusted basis of portion sold)
	$5,000	(gain on portion sold)

The adjusted basis of the portion retained as of January 1, 1956, for the purpose of determining gain is $3,000 ($18,000–$15,000). For the purpose of determining loss, the adjusted basis is $2,000 ($12,000–$10,000).

Example 3. Assume the same facts as in example 2, except that a portion of the aggregated property was sold for $5,000 and that the fair market value of the aggregated property at the time of sale was $10,000. The adjusted basis of the portion sold would be computed as follows:

$$\frac{\$5{,}000\ (\text{FMV of portion sold})}{\$10{,}000\ (\text{FMV of aggregated property})} \times \begin{matrix}\$12{,}000\ (\text{adjusted}\\ \text{basis for loss})\end{matrix} = \begin{matrix}\$6{,}000\ (\text{adjusted basis}\\ \text{of portion sold})\end{matrix}$$

Taxpayers loss would then be computed as follows:

	$5,000	(amount received for portion sold)
Less:	$6,000	(adjusted basis of portion sold)
	($1,000)	(loss on portion sold)

(5) *Basis for gain and loss where mineral interests acquired before March 1, 1913, are included in a combination and one or more of such interests have not previously been included in an aggregation.* Where mineral interests acquired before March 1, 1913, are included in a combination under section 614(b) and §1.614–8 and one or more of such interests have not previously been included in an aggregation, the combined property has two bases, one for the determination of gain and another for the determination of loss upon the disposition of the whole or a part of the combined property. For the purpose of determining gain, the adjusted basis of the combined property on the effective date of combination shall be the sum of:

(i) The adjusted bases at the time of deaggregation, as determined under subparagraph (2) of this paragraph, of all interests which have previously been included in an aggregation,

(ii) The unadjusted bases of other mineral interests acquired on or after March 1, 1913, and

(iii) The cost of each other interest acquired before March 1, 1913 (adjusted

for the period before March 1, 1913), or the fair market value of such interest as of March 1, 1913, whichever is greater

and such sum shall be adjusted by the total of all adjustments to the bases of the mineral interests as required by section 1016 to the effective date of combination. For the purpose of determining loss, the adjusted basis of the combined property on the effective date of combination shall be the sum of:

(iv) The adjusted bases at the time of deaggregation, as determined under subparagraph (2) of this paragraph, of all interests which have previously been included in an aggregation.

(v) The unadjusted bases of other mineral interests acquired on or after March 1, 1913, and

(vi) The cost of other mineral interests acquired before March 1, 1913, adjusted for the period before March 1, 1913

and such sum shall be adjusted by the total of all adjustments to the bases of the mineral interests as required by section 1016 to the effective date of combination. Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the combined property for all purposes of the Code. Upon disposition of a part of the combined property, the adjusted basis for determining gain and the adjusted basis for determining loss with respect to each resultant part of the combined property shall be determined in accordance with subparagraph (2) of this paragraph.

(b) *Holding period of aggregated or combined properties.* Where a taxpayer sells or exchanges either a part or all of an aggregated or combined property which includes part or all of a mineral interest which the taxpayer has held for (1 year 6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less, the sales price and adjusted basis attributable to the interest sold must be apportioned in proportion to the relative fair market values as of the date of sale to determine the amount of income represented by the sale of property held for (1 year 6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less. The application of this rule may be illustrated by the following example:

Example. Taxpayer A owns operating mineral interests Nos. 1, 2, and 3. He acquired interests Nos. 1 and 2 in 1953 but purchased and made development expenditures on interest No. 3 on December 1, 1954. In his return for the taxable year 1954, taxpayer A elects to aggregate interests Nos. 1, 2, and 3 which are operated as a unit. On May 1, 1955, taxpayer A sells the north half of the aggregated property which includes portions of interests Nos. 1, 2, and 3. The sales price of the north half was $80,000; the adjusted basis of the aggregated property as of the date of sale was $20,000; and the fair market value of the aggregated property as of the date of sale was $100,000. The adjusted basis applicable to the north half is computed as follows:

$$\frac{\$80{,}000\ \text{(FMV of portion sold)}}{\$100{,}000\ \text{(FMV of aggregated property)}} \times \$20{,}000\ \text{(adjusted basis of aggregated property)} = \$16{,}000\ \text{(adjusted basis of portion sold)}$$

The total gain on the sale is $64,000 ($80,000 − $16,000).

The gain attributable to the sale of the portion held for six months or less is computed as follows (assuming that the fair market value of the portion of No. 3 included in the sale as of the date of sale was $30,000):

$$\frac{\$30{,}000\ \text{(FMV of portion of No. 3 sold)}}{\$80{,}000\ \text{(FMV of north half)}} \times \$16{,}000\ \text{(adjusted basis of north half)} = \$6{,}000\ \text{(adjusted basis of portion of No. 3 sold)}$$

The gain on the portion of No. 3 sold is $24,000 ($30,000–$6,000).

(c) *Acquisition of property with transferor's basis.* If a separate property or an aggregated or combined property is acquired in a transaction in which the basis of such property in the hands of the taxpayer is determined by reference to the basis of such property in the hands of a transferor, then the election of such transferor as to the treatment of such separate, aggregated, or combined property shall be binding upon the taxpayer for all taxable years ending after the transfer unless, in the case of an aggregation, the aggregation terminates or consent to make a change is obtained under paragraph (d) (4) of § 1.614–2, paragraph (f) (7) of § 1.614–3, or paragraph (b) (3) or (e) (5) of § 1.614–5, whichever is applicable.

(d) *Abandonment and casualty losses.* In the case of mineral interests which are aggregated or combined as one property, no losses resulting from worthlessness or abandonment are allowable until all the mineral rights in the entire aggregated or combined property are proven to be worthless or until the entire aggregated or combined property is disposed of or abandoned. Casualty losses are allowable in accordance with the rules applicable to casualty losses in general. For rules applicable to losses in general, see section 165 and the regulations thereunder.

[T.D. 6524, 26 FR 159, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13701, Oct. 28, 1965; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.614–7 Extension of time for performing certain acts.

Sections 1.614–2 to 1.614–5, inclusive, require certain acts to be performed on or before May 1, 1961 (the first day of the first month which begins more than 90 days after the regulations under section 614 were published in the FEDERAL REGISTER as a Treasury decision). The district director may, upon good cause shown, extend for a period not exceeding 6 months the period within which such acts are to be performed, and shall, if the interests of the Government would otherwise be jeopardized thereby, grant such an extension only if the taxpayer and the district director agree in writing to a corresponding or greater extension of the period prescribed for the assessment of the tax, or in the case of taxable years described in section 614(c)(3)(E), the assessment of the tax resulting from the exercise or change in an election.

[T.D. 6561, 26 FR 3523, Apr. 25, 1961]

§ 1.614–8 Elections with respect to separate operating mineral interests for taxable years beginning after December 31, 1963, in the case of oil and gas wells.

(a) *Election to treat separate operating mineral interests as separate properties*—(1) *General rule.* If a taxpayer has more than one operating mineral interest in oil and gas wells in one tract or parcel of land, he may elect to treat one or more of such interests as separate properties for taxable years beginning after December 31, 1963. Any such interests with respect to which the taxpayer does not so elect shall be combined and treated as one property. Nonoperating mineral interests may not be included in such combination. There may be only one such combination in one tract or parcel. Any such combination of interests shall be considered as one property for all purposes of subtitle A of the Code for the period to which the election applies. The preceding sentence does not preclude the use of more than one account under a single method of computing depreciation or the use of more than one method of computing depreciation under section 167, if otherwise proper. Any reasonable and consistently applied method or methods of computing depreciation of the improvements made

with respect to the separate interests which are combined may be continued in accordance with section 167 and the regulations thereunder. Except as provided in paragraph (b) of this section, such an interest in one tract or parcel may not be combined with such an interest in another tract or parcel. For rules with respect to the allocation of the basis of an aggregation of separate operating mineral interests under this section among such interests as of the first day of the first taxable year beginning after December 31, 1963, see paragraph (a) (2) (ii) of § 1.614–6. For the definition of *operating mineral interest* see paragraph (b) of § 1.614–2.

(2) *Election in respect of newly discovered or acquired interest or interest ceasing to participate in cooperative or unit plan of operation.* (i) If the taxpayer makes an election under this paragraph in respect of an operating mineral interest in a tract or parcel of land and, after the taxable year for which such election is made, an additional operating mineral interest in the same tract or parcel is discovered or acquired by the taxpayer or is the subject of an election under this paragraph because it ceases to participate in a cooperative or unit plan of operation to which paragraph (b) of this section applies, the additional operating mineral interest shall be treated:

(*a*) If there is no combination of interests in such tract or parcel, as a separate property unless the taxpayer elects to combine it with another interest, or

(*b*) If there is a combination of interests in such tract or parcel, as part of such combination unless the taxpayer elects to treat it as a separate property.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. Prior to 1964 a taxpayer acquired, and incurred development expenditures with respect to, three operating mineral interests in oil, designated Nos. 1, 2, and 3. All three interests are in the same tract or parcel of land. For the taxable year 1964, the taxpayer elects to treat such interests as three separate properties. During the taxable year 1965, the taxpayer discovers and incurs development costs with respect to a fourth operating mineral interest, No. 4, in the same tract of land. During the taxable year 1966, the taxpayer discovers and incurs development costs with respect to a fifth operating mineral interest, No. 5, in the same tract of land. If the taxpayer makes no election relative to No. 4 for 1965, such interest will thereafter be treated as a separate property. Alternatively, the taxpayer may make an election for 1965 to combine No. 4 with any one (and only one) of the three other interests and to treat such combination as one property. If, for example, he elects to combine No. 4 with No. 3, then in 1966, No. 5 will automatically become part of the combination of Nos. 3 and 4 if no election is made to treat it as a separate property. After the combination of Nos. 3 and 4 is formed, Nos. 1 and 2, which were acquired or discovered prior to the formation of the combination and which were not included in such combination within the time prescribed, may not be included in that or any other combination. However, see subparagraph (3) (iv) of this paragraph.

(3) *Manner and scope of election*—(i) *Election; when made.* Except as provided hereafter in this subdivision (i), any election under subparagraph (1) or (2) of this paragraph shall be made for each operating mineral interest not later than the time prescribed by law for filing the income tax return (including extensions thereof) for whichever of the following taxable years is later:

(*a*) The first taxable year beginning after December 31, 1963; or

(*b*) The first taxable year in which any expenditure for development or operation in respect of such operating mineral interest is made by the taxpayer after his acquisition of such interest

Notwithstanding the provisions of (*a*) and (*b*), if it is determined that the operating mineral interest in respect of which the election is to be made was, during what would otherwise be the entire effective period of the election insofar as it would apply to the appropriate taxable year determined under (*a*) and (*b*), participating in a cooperative or unit plan of operation to which section 614(b)(3) applies, the election shall be made not later than the time prescribed by law for filing the income tax return (including extensions thereof) for the taxable year in which the interest ceases to participate in the cooperative or unit plan. See subdivision (iii) of this subparagraph for provisions relating to the effective date of an

election and paragraph (b) of this section for provisions relating to certain unitization or pooling arrangements. For purposes of this subparagraph, expenditures for development include any intangible drilling or development costs within the purview of section 263(c). Delay rentals are not considered as expenditures for development. For purposes of this subparagraph, the acquisition of an option to acquire an economic interest in minerals in place does not constitute the acquisition of a mineral interest.

(ii) *Election; how made.* Any election under this paragraph shall be made by a statement attached to the income tax return of the taxpayer for the first taxable year for which the election is made. This statement shall identify by name, code number, or other means the operating mineral interests within the same tract or parcel of land which the taxpayer is electing to treat as separate properties or in combination, as the case may be. The statement shall also identify by name, code number, or other means the tract or parcel and shall set forth the facts upon which its treatment as a single and entire tract or parcel is based. See paragraph (a) (3) of §1.614–1. However, if the taxpayer is electing to treat all of his operating mineral interests in a tract or parcel as separate properties, a blanket election with respect to all of such interests in that tract or parcel which are owned by the taxpayer at the time the election is made will suffice and only the tract or parcel itself need be so identified. The taxpayer shall maintain and have available records and maps sufficient to clearly define the tract or parcel and all of the taxpayer's operating mineral interests therein.

(iii) *Election; when combination effective.* (*a*) If, by reason of the exercise or nonexercise of an election under this paragraph, a combination is formed of two or more operating mineral interests, all of which are owned and operated by a taxpayer on the first day of the first taxable year beginning after December 31, 1963, and are not participating in a cooperative or unit plan of operation to which paragraph (b) of this section applies on such first day, the combination is effective on such first day.

(*b*) If, by reason of the exercise or nonexercise of an election under this paragraph, a combination of operating mineral interests not described in (*a*) of this subdivision (including a combination described in (*a*) to which another operating mineral interest is added) is formed, the date on which each operating mineral interest which is being combined by the taxpayer for the first time enters into the combination is the later of (*1*) the earliest date within the taxable year affected on which the taxpayer incurred any expenditure for development or operation of such interest at a time when such interest was not participating in a cooperative or unit plan of operation to which paragraph (b) of this section applies, or (*2*) the earliest date on which the taxpayer incurred any expenditure for development or operation of any other interest with which such interest is to be combined at a time when such other interest was not participating in a cooperative or unit plan of operation to which paragraph (b) of this section applies.

(*c*) The application of these provisions may be illustrated by the following examples:

Example 1. In 1963, a taxpayer owned and operated mineral interests Nos. 1 and 2, both of which are in the same tract or parcel of land. Neither No. 1 nor No. 2 participates in a cooperative or unit plan of operation. The taxpayer, who is on a calendar year basis, continued to own and operate these interests during the year 1964, and made no election with respect to such interests in his income tax return for that year. As a result, Nos. 1 and 2 are combined as of January 1, 1964.

Example 2. Assume that the taxpayer described in example 1 discovered operating mineral interests Nos. 3 and 4 in the same tract or parcel of land as Nos. 1 and 2, that he made his first expenditures for the development of No. 3 on June 1, 1964, and of No. 4 on September 1, 1964, and that, in a timely return for 1964, he elected to treat No. 3 as a separate property and made no election with respect to No. 4. As a result, No. 3 is treated as a separate property and No. 4 joins the combination of Nos. 1 and 2 as of September 1, 1964.

Example 3. On March 1, 1964, a taxpayer acquired a tract or parcel of land containing operating mineral interests Nos. 1 and 2. The taxpayer made his first operating expenditures on No. 1 on April 1, 1964. On October 1, 1964, the taxpayer made his first development expenditures with respect to operating mineral interest No. 2. The taxpayer made

no election with respect to these interests. As a result, Nos. 1 and 2 enter into a combination as of October 1, 1964.

(iv) *Election; binding effect.* A valid election made under section 614(b) and this subparagraph shall be binding upon the taxpayer for the first taxable year for which made and for all subsequent taxable years. However, notwithstanding the preceding sentence, an election to treat one or more operating mineral interests as separate properties shall not prevent the making of a later election to combine a newly discovered or acquired operating mineral interest with one of such interests, if no other combination exists in the tract or parcel of land on the date when the later election would become effective under subdivision (iii) of this subparagraph. Nor will an election to treat an operating mineral interest as a separate property prevent its treatment with another interest as a single property under paragraph (b) of this section if such interest later participates in a cooperative or unit plan of operation to which paragraph (b) applies. For rules relating to the binding effect of an election in certain cases in which the basis of a separate or combined property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of § 1.614–6.

(b) *Certain unitization or pooling arrangements.* (1) Except as provided in this paragraph, if one or more of the taxpayer's operating mineral interests, or a part or parts thereof, participate, under a voluntary or compulsory unitization or pooling agreement as defined in subparagraph (6) of this paragraph, in a single cooperative or unit plan of operation, then for the period of such participation in taxable years beginning after December 31, 1963, such interest or interests, and part or parts thereof, included in such unit, shall be treated for purposes of subtitle A of the Code as one property, separate from the interest or interests, or part or parts thereof, not included in such unit.

(2) Subparagraph (1) of this paragraph shall apply to a voluntary agreement only if all the operating mineral interests covered by the agreement are in the same deposit or are in two or more deposits, the joint development or production of which is logical, without taking tax benefits into account, from the standpoint of geology, convenience, economy, or conservation, and which are in tracts or parcels of land which are contiguous or in close proximity. Operating mineral interests under a voluntary agreement to which subparagraph (1) does not apply are subject to the rules contained in paragraph (a) of this section. For purposes of this paragraph an agreement is voluntary unless required by the laws or rulings of any State or any agency of any State.

(3) Notwithstanding the provisions of subparagraph (1) of this paragraph, if the taxpayer, for the last taxable year beginning before January 1, 1964, treated as separate properties two or more operating mineral interests which participate, under a voluntary or compulsory unitization or pooling agreement entered into in any taxable year beginning before January 1, 1964, in a single cooperative or unit plan of operation, and if it is determined that such treatment was proper under the law applicable to such taxable year, the taxpayer may continue to treat all such interests in a consistent manner for the period of such participation. If it is determined that such treatment was not proper under the law applicable to such taxable year, or if the taxpayer does not continue to treat all such interests in a manner consistent with the treatment of them for the last taxable year beginning before January 1, 1964, the treatment of the interests shall be in accordance with the provisions of subparagraph (1).

(4) If only a part of an operating mineral interest, which interest is not being treated under paragraph (a) of this section as part of a combination of interests, participates in a unit or pool, such part shall, for the period of its participation in the unit or pool, be treated for purposes of this section as being separate from the nonparticipating portion of the operating mineral interest of which it is a part. A portion of the adjusted basis and of the units of mineral of such operating mineral interest remaining at the beginning of the period described in the preceding

sentence shall be allocated to the participating part in accordance with the principles contained in paragraph (a)(2)(i)(*a*) of § 1.614–6 as if such participating part had been sold. If participation in the unit or pool ends, the separate status of the participating part shall immediately terminate. At such time the adjusted basis of such part and the units of mineral with respect to such part remaining at the time of termination shall be added to the adjusted basis and to the remaining units of mineral of the nonparticipating portion of the operating mineral interest. During the period of participation in the unit or pool such participating part shall not be treated separately from the nonparticipating portion of the operating mineral interest in applying section 165.

(5) Where an operating mineral interest which is being treated under paragraph (a) of this section as part of a combination of interests begins participation in a unit or pool, the combination shall remain in force but the treatment of such participating interest as a part of the combination shall be suspended for the period of its participation in the unit or pool. If, for example, a taxpayer owns operating mineral interests Nos. 1, 2, and 3 in a single tract or parcel of land, elects to treat No. 1 as a separate property (with mineral interests Nos. 2 and 3 thus being combined), is later required by an agency of a State to place No. 2 in a unit, and subsequently discovers operating mineral interest No. 4 in the same tract or parcel of land, then under paragraph (a)(2)(i)(*b*) of this section No. 4 will automatically be combined with No. 3 unless the taxpayer elects to treat it as a separate property. Under this subparagraph, an interest may be treated as part of a combination for a portion of a taxable year and as part of a unit or pool for a portion of a taxable year. At the commencement of participation in the unit or pool, a portion of the adjusted basis of the combination and a portion of the units of mineral with respect to the combination remaining at that time shall be allocated to such participating interest in accordance with the principles contained in paragraph (a)(2)(i)(*a*) of § 1.614–6 as if such interest had been sold. During the period of participation in the unit or pool such participating interest is nevertheless treated as a part of the combination for purposes of paragraph (d) of § 1.614–6. If participation in the unit or pool ends, the treatment of such interest as participating in the unit or pool shall immediately terminate. At such time, the adjusted basis of the participating interest and the units of mineral with respect to such interest remaining at the time of termination shall be added to the adjusted basis and to the remaining units of mineral of the nonparticipating portion of the combination. In determining the adjusted basis of the participating interest at the time of termination there shall be taken into account any section 1016 adjustments attributable to such interest for the period of its participation in the unit or pool. If two or more operating mineral interests of the taxpayer participate in a unit or pool and are treated as one property under subparagraph (1) of this paragraph, and if participation by such interests in the unit or pool terminates, the adjusted basis of each such interest at the time of termination shall be separately determined. If the total of the adjusted bases of such interests upon termination of their participation in the unit or pool exceeds the adjusted basis of such one property, then the adjusted bases of such interests shall be further adjusted by applying the principles contained in paragraph (a)(2)(ii)(*b)(ii*) of § 1.614–6 so that the total of the adjusted bases of such interests equals the adjusted basis of such one property. In addition, the units of oil and gas estimated to be attributable to a participating interest at the time of termination of participation shall be restored to the units of oil and gas of the combination of which it is a part. The rules stated in this subparagraph with respect to an operating mineral interest which is being treated under paragraph (a) of this section as part of a combination and which begins participation in a unit or pool shall also apply to a portion of an operating mineral interest which is being treated under paragraph (a) as part of a combination if such portion begins participation in a unit or pool.

(6) As used in this paragraph, the term *unitization or pooling agreement* means an agreement under which two or more persons owning operating mineral interests agree to have the interests operated on a unified basis and further agree to share in production on a stipulated percentage or fractional basis regardless of from which interest or interests the oil or gas is produced. In addition, in a situation in which one person owns operating mineral interests in several leases, an agreement of such person with his several royalty owners to determine the royalties payable to each on a stipulated percentage basis regardless of from which lease or leases oil or gas is obtained is also considered to be a unitization or pooling agreement. No formal cross-conveyance of properties is necessary. An agreement between co-owners of a tract or parcel of land or a part thereof for the development of the property by one of such co-owners for the account of all is not a unitization or pooling agreement, provided that the agreement does not affect ownership of minerals or entitle any such co-owner to share in production from any operating mineral interests other than his own.

(c) *Operating mineral interest defined.* For the definition of the term *operating mineral interest* as used in this section, see paragraph (b) of § 1.614–2.

(d) *Alternative treatment under Internal Revenue Code of 1939.* If, on the day preceding the first day of the first taxable year beginning after December 31, 1963, the taxpayer has any operating mineral interests which he treats under section 614(d) (as in effect before the amendments made by the Revenue Act of 1964) and § 1.614–4, such treatment shall be continued and shall be deemed to have been adopted pursuant to the provisions of section 614(b) and paragraph (a) of this section. Accordingly, a taxpayer, who has four operating mineral interests in a single tract or parcel of land, and who has treated two of such interests as one property and two of such interests as separate properties under section 614(d) prior to the first day of the first taxable year beginning after December 31, 1963, is deemed to have adopted such treatment pursuant to the provisions of section 614(b) and paragraph (a) of this section. Hence, in the absence of an election to the contrary, a fifth operating mineral interest in the same tract or parcel acquired by the taxpayer in a taxable year beginning after December 31, 1963, will, after an expenditure for development or operation, be combined with the combination of two interests made under section 614(d). Furthermore, an election which was made for a taxable year beginning before January 1, 1964, under section 614(d) as then in effect will be binding for all taxable years beginning after December 31, 1963, even though the time for making an election under section 614(b) and paragraph (a) of this section has not elapsed.

[T.D. 6859, 30 FR 13703, Oct. 28, 1965]

§ 1.615–1 Pre-1970 exploration expenditures.

(a) *General rule.* Section 615 prescribes rules for the treatment of expenditures (paid or incurred before January 1, 1970) for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (other than oil or gas) paid or incurred by the taxpayer before the beginning of the development stage of the mine or other natural deposit. Such expenditures hereinafter in the regulations under section 615 will be referred to as exploration expenditures. The development stage of the mine or other natural deposit will be deemed to begin at the time when, in consideration of all the facts and circumstances (including the actions of the taxpayer), deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. A taxpayer who elects under section (e) may treat exploration expenditures under either section 615(a) or section 615(b). See § 1.615–6 for the method of making the election to treat exploration expenditures under section 615. Under section 615(a), a taxpayer may, at his option, deduct exploration expenditures paid or incurred in an amount not to exceed $100,000 for any taxable year. Under section 615(b) and § 1.615–2, he may elect to defer any part of such amount and deduct such part on a ratable basis as the units of produced minerals benefited by such expenditures are sold. If the taxpayer does not treat exploration

expenditures under either section 615 (a) or (b) in any year for which his election under section 615(e) is effective, the expenditures for such year will be charged to depletable capital account. The option to deduct under section 615(a) and the election to defer under section 615(b), however, are subject to the limitation provided in section 615(c) and § 1.615–4. In the case of certain corporations which are members of an affiliated group which has elected the 100 percent dividends received deduction under section 243(b), see section 243(b) (3) and § 1.243–5 for limitations on the option to deduct under section 615(a) and the election to defer under section 615(b).

(b) *Expenditures to which section 615 is not applicable.* (1) Section 615 is not applicable to expenditures which would be allowed as a deduction for the taxable year without regard to such section.

(2) Section 615 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowances for depreciation of such improvements which are used in the exploration of ores or minerals are considered exploration expenditures under section 615. If such improvements are used only in part for exploration during a taxable year, an allocable portion of the allowance for depreciation shall be treated as an exploration expenditure.

(3) Section 615 is applicable to exploration expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired by the taxpayer. The expenditures attributable to the remaining fractional share shall be considered as the cost of his acquired interest and shall be recovered through depletion allowances. For example, taxpayer A owns mineral leases on unexplored mineral lands and agrees to convey an undivided three-fourths (¾) interest in such leases to taxpayer B provided B will pay all of the exploration expenditures for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral which will be incurred before the beginning of the development stage. B shall treat three-fourths of such amount under section 615, and shall treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) The provisions of section 615 do not apply to costs of exploration which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Such provisions apply only to costs paid or incurred by the taxpayer for exploration undertaken directly or through a contract by the taxpayer. See, however, sections 381(a) and 381(c) (10) for special rules with respect to deferred exploration expenditures in certain corporate acquisitions.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7192, 37 FR 12938, June 30, 1972]

§ 1.615–2 Deduction of pre-1970 exploration expenditures in the year paid or incurred.

(a) *In general.* (1) If the election to treat exploration expenditures under section 615 has been made or is deemed made under § 1.615–6(b) subject to the total limitation of $100,000, a taxpayer who has made exploration expenditures prior to January 1, 1970, with respect to more than one mine or other natural deposit may deduct for a taxable year for which such election is effective any portion of such expenditures attributable to each mine or deposit. With respect to a particular mine or other natural deposit, a taxpayer who has made the election described in the preceding sentence may deduct under section 615(a) a portion of the exploration expenditures and may defer and deduct under section 615(b) the balance of such expenditures. For any taxable year for which the election to treat exploration expenditures under section 615 is effective, the taxpayer must charge any amount of exploration expenditures in excess of $100,000 to capital account and must charge to capital account whatever amount has not been deducted currently or deferred. For example, taxpayer A who has elected under section 615(e) has three mines, X, Y, and Z. In the taxable year 1967, A makes exploration expenditures of $75,000 with respect to each mine. The

total allowable deduction for exploration expenditures is $100,000. A deducts $50,000 and defers $25,000 with respect to X. He deducts $25,000, and charges to capital account $50,000 with respect to Y, and charges to capital account the entire $75,000 paid with respect to Z. Thus, A has deducted or deferred $100,000 and capitalized the excess.

(2) Except as provided in section 615(e) and § 1.615–6, a taxpayer cannot change his treatment of exploration expenditures for a taxable year after the due date (including extensions of time) for filing the return for the taxable year except where it is subsequently determined that any part of such exploration expenditures deducted under section 615(a) or deferred under section 615(b) are not exploration expenditures for the taxable year. Where the taxpayer has made the election to treat exploration expenditures under section 615 and it is subsequently determined that part of the expenditures deducted under section 615(a) or deferred under section 615(b), for a taxable year, were not exploration expenditures for such taxable year, the exploration expenditures required to be charged to capital account for such taxable year by reason of the limitation may be deducted or deferred (to the extent of the subsequent determination) and proper adjustment made to capital account. A taxpayer claiming a deduction under section 615(a) shall indicate clearly on his income tax return the amount of the deduction claimed under such section with respect to each mine or other natural deposit. Such mine or deposit shall be identified by an adequate description.

[T.D. 7192, 37 FR 12938, June 30, 1972]

§ 1.615–3 Election to defer pre-1970 exploration expenditures.

(a) *General rule.* A taxpayer who makes the election provided in section 615(e) may defer any portion of the exploration expenditures made before January 1, 1970, with respect to each mine or other natural deposit, subject to the limitations described in section 615(c) and § 1.615–4. The amounts so deferred shall be deducted ratably as the units of produced ores or minerals discovered or explored by reason of such expenditures are sold.

(b) *Effect and manner of making election.* (1) The election to defer exploration expenditures shall apply only to expenditures for the taxable year for which made. However, once made, the election shall be binding with respect to the expenditures for that taxable year. Thus, a taxpayer cannot revoke his election for any reason whatsoever.

(2) The election shall be made for each mine or other natural deposit by a clear indication on the return or by a statement filed with the district director with whom the return was filed, not later than the time prescribed by law for filing such return (including extensions thereof) for the taxable year to which such election is applicable.

(c) *Expenditures made by the owner who retains a non-operating mineral interest.* (1) A taxpayer who elects to defer exploration expenditures and thereafter transfers his interest in the mine or other natural deposit, retaining an economic interest therein, shall deduct an amount attributable to such interest on a pro rata basis as the interest pays out. For example, a taxpayer who defers exploration expenditures and then leases his deposit, retaining a royalty interest therein, shall deduct the deferred expenditures ratably as he receives royalties. If the taxpayer receives a bonus or advanced royalties in connection with the transfer of his interest, he shall deduct deferred expenditures allocable to such bonus or advanced royalties in an amount which is in the same proportion to the total of such costs as the bonus or advanced royalties bears to the bonus and total royalties expected to be received. Also, in the case of a transfer of a mine or other natural deposit by a taxpayer who retains a production payment therein, he shall deduct the exploration expenditures ratably over the payments expected to be received.

(2) Where a taxpayer receives an amount, in addition to retaining an economic interest, which amount is treated as from the sale or exchange of a capital asset or property treated under section 1231 (except coal or iron ore to which section 631(c) applies), the deferred exploration expenditures shall

be allocated between the interest sold and the interest retained in proportion to the fair market values of each interest as of the date of sale. The amount allocated to the interest sold may not be deducted, but shall be a part of the basis of such interest.

(d) *Losses from abandonment.* Section 165 and the regulations thereunder contain general rules relating to the treatment of losses resulting from abandonment.

(e) *Computation of amount of deduction.* The amount of the deduction allowable during the taxable year is an amount A, which bears the same ratio to B (the total deferred exploration expenditures for a particular mine or other natural deposit reduced by the amount of such expenditures deducted in prior taxable years) as C (the number of units of the ore or mineral benefited by such expenditures sold during the taxable year) bears to D (the number of units of ore or mineral benefited by such expenditures remaining as of the taxable year). For the purposes of this proportion, the *number of units of ore or mineral benefited by such expenditures remaining as of the taxable year* is the number of units of ore or mineral benefited by the deferred exploration expenditures remaining at the end of the year to be recovered from the mine or other natural deposit (including units benefited by such expenditures recovered but not sold) plus the number of units benefited by such expenditures sold within the taxable year. The principles outlined in § 1.611–2 are applicable in estimating the number of units remaining as of the taxable year and the number of units sold during the taxable year. The estimate is subject to revision in accordance with that section in the event it is ascertained from any source, such as operations or development work, that the remaining units are materially greater or less than the number of units remaining from a prior estimate.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6685, 28 FR 11405, Oct. 24, 1963; T.D. 6841, 30 FR 9306, July 27, 1965; T.D. 7192, 37 FR 12939, June 30, 1972]

§ 1.615–4 Limitation of amount deductible.

(a) *Taxable years beginning before July 7, 1960.* For any taxable year beginning before July 7, 1960 (including taxable years of less than 12 months), a taxpayer may deduct or defer exploration expenditures paid or incurred in the taxable year in an amount not in excess of $100,000. However, for such taxable years, the taxpayer may not avail himself of the provisions of section 615 for more than four taxable years (including taxable years of less than 12 months and taxable years subject to the Internal Revenue Code of 1939). Such four taxable years need not be consecutive. In determining the number of years in which a taxpayer has availed himself of section 615, a year for which he makes an election to defer exploration expenditures shall count as one year. Any subsequent taxable year in which such deferred expenditures are deducted shall not be taken into account as one of the four years. For purposes of the 4-year limitation, a year in which both a deduction and an election to defer are availed of by the taxpayer shall be taken into account as only one year.

(b) *Taxable years beginning after July 6, 1960.* For any taxable year beginning after July 6, 1960 (including taxable years of less than 12 months), a taxpayer who is otherwise eligible may deduct or defer exploration expenditures paid or incurred before January 1, 1970, in the lesser of the following amounts:

(1) The amount paid or incurred in the taxable year,

(2) $100,000, or

(3) $400,000 minus all amounts deducted or deferred for taxable years ending after December 31, 1950

For purposes of this paragraph, the number of taxable years for which the taxpayer availed himself of the provisions of section 615 or the corresponding provisions of prior law is immaterial.

(c) *Special rules for previously deferred expenditures.* In determining whether an election to defer was availed of in applying the limitations of paragraphs (a) and (b) of this section, there shall be taken into account any year with

respect to which amounts were deferred but not fully deducted because of a sale or other disposition of the mineral property, even though the balance of the deferred amounts was treated as part of the basis of the mineral property in determining gain or loss from the sale.

(d) *Example of application of provisions.* The application of the provisions of subparagraphs (a) and (b) of this section may be illustrated by the following example:

Example. A taxpayer on the calendar year basis, who has never claimed the benefits of section 615, or section 23(ff) of the 1939 Code, expended $200,000 for exploration expenditures during the year 1956. For each of the years 1957, 1958, 1959, and 1960 the taxpayer had exploration costs of $80,000. The taxpayer deducted or deferred the maximum amounts allowed for each of the years 1956, 1957, 1958, and 1959. None of the $80,000 expenditures for 1960 could be deducted or deferred by the taxpayer because he had already deducted or deferred exploration expenditures for 4 prior years. In 1961 the taxpayer expended $200,000 for exploration expenditures. The maximum amount the taxpayer may deduct or defer for the taxable year 1961 is $60,000 computed as follows:

(1) Add all yearly amounts deducted or deferred for exploration expenditures by the taxpayer for prior years.

Year	Expenditures	Deducted or deferred
1956	$200,000	$100,000
1957	80,000	80,000
1958	80,000	80,000
1959	80,000	80,000
1960	80,000	0
Total		340,000

(2) Subtract the sum of the amounts obtained in (1), $340,000, from $400,000, the maximum amount allowable to the taxpayer for deductions or deferrals of exploration expenditures.

Maximum amount allowable to taxpayer	$400,000
Sum of amounts obtained in (1)	340,000
	60,000

(e) *Transferee of mineral property.* (1) Where an individual or corporation transfers any property to the taxpayer and the transfer is one to which any of the subdivisions of this subparagraph apply, the taxpayer shall take into account for purposes of the 4-year limitation described in paragraph (a) of this section, all years that the transferor deducted or deferred exploration expenditures, and for purposes of the $400,000 limitation described in paragraph (b) of this section, all amounts that the transferor deducted or deferred.

(i) The taxpayer acquired any mineral property in a transaction described in section 23(ff)(3) of the Internal Revenue Code of 1939, excluding the reference therein to section 113(a)(13).

(ii) The taxpayer would be entitled under section 381(c)(10) to deduct exploration expenditures if the transferor (or distributor) corporation had elected to defer such expenditures. For example, if the taxpayer acquired any mineral property in a transaction described in section 381(a) (relating to the acquisition of assets through certain corporate liquidations and reorganizations), there shall be taken into account in applying the limitations of paragraph (a) of this section the years in which the transferor exercised the election to defer or deduct exploration expenditures, and there shall be taken into account in applying the limitations of paragraph (b) of this section any amount so deducted or deferred. See also section 381(c)(10) and the regulations thereunder.

(iii) The taxpayer acquired any mineral property under circumstances which make applicable the following sections of the Internal Revenue Code:

(*a*) Section 334(b)(1), relating to the liquidation of a subsidiary where the basis of the property in the hands of the distributee is the same as it would be in the hands of the transferor.

(*b*) Section 362 (a) and (b), relating to property acquired by a corporation as paid-in surplus or as a contribution to capital, or in connection with a transaction to which section 351 applies.

(*c*) Section 372(a), relating to reorganization in certain receiverships and bankruptcy proceedings.

(*d*) Section 373(b)(1), relating to property of a railroad corporation acquired in certain bankruptcy or reciversship proceedings.

(*e*) Section 1051, relating to property acquired by a corporation that is a member of an affiliated group.

(*f*) Section 1082, relating to property acquired pursuant to a Securities Exchange Commission order.

(2) For purposes of subparagraph (1) of this paragraph, it is immaterial whether a deduction has been allowed or an election has been made by the transferor with respect to the specific mineral property transferred.

(3) Where a mineral property is acquired under any circumstance except those described in subparagraph (1) of this paragraph, the taxpayer is not required to take into account the election exercised by or deduction allowed to his transferor.

(4) For purposes of applying the limitations imposed by section 615(c): (i) the partner, and not the partnership, shall be considered as the taxpayer (see paragraph (a)(8)(iii) of § 1.702–1), and (ii) an electing small business corporation, as defined in section 1371(b), and not its shareholders, shall be considered as the taxpayer.

(5) For purposes of subparagraph (1)(iii)(*b*) of this paragraph: (i) if mineral property is acquired from a partnership, the transfer shall be considered as having been made by the individual partners, so that the number of years for which section 615 has been availed of by each partner and the amounts which each partner has deducted or deferred under section 615 shall be taken into account, or (ii) if on interest in a partnership having mineral property is transferred, the transfer shall be considered as a transfer of mineral property by the partner or partners relinquishing an interest, so that the number of years for which section 615 has been availed of by each such partner and the amounts which each such partner has deducted or deferred under section 615 shall be taken into account.

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

Example 1. A calendar year taxpayer who has never claimed the benefits of section 615 received in 1956 a mineral deposit from X Corporation upon a distribution in complete liquidation of the latter under conditions which would make the provisions of section 334(b)(1) applicable in determining the basis of the property in the hands of the taxpayer. During the year 1955 X Corporation expended $60,000 for exploration expenditures which it elected to treat as deferred expenses. Assume further that the taxpayer made similar expenditures of $150,000, $125,000, $100,000, $60,000, and $180,000 for the years 1956, 1957, 1958, 1959, and 1961, respectively, which the taxpayer elected to deduct for each of those years to the extent allowable. No such expenditures were made for 1960. On the basis of these facts, the taxpayer may deduct or defer $100,000 for each of the years 1956, 1957, and 1958. No deduction or deferral is allowable for 1959 since the 4-year limitation of paragraph (a) of this section applies. The taxpayer may deduct or defer a maximum of $40,000 for 1961 since the $400,000 limitation of paragraph (b) of this section applies, but the 4-year limitation of paragraph (a) does not apply.

Example 2. Assume the same facts stated in example 1 except that, prior to acquisition by the taxpayer of the deposit from X Corporation in 1956, X Corporation had acquired the deposit in 1954 in a similar distribution from Y Corporation which, in the years 1952 and 1953, deducted exploration costs paid in respect of an entirely different deposit in the amounts of $30,000 and $50,000, respectively. Under these circumstances, the taxpayer may deduct or defer exploration expenditures paid or incurred in the amount of $100,000 for 1956. No deduction or deferral is allowable to the taxpayer for expenditures made in 1957, 1958, and 1959 since the 4-year limitation of paragraph (a) applies. The taxpayer may deduct or defer a maximum of $100,000 for 1961 since the 4-year limitation of paragraph (a) of this section no longer applies. If the taxpayer deducted or deferred $100,000 for each of the years 1956 and 1961 and also made exploration expenditures in 1962, the taxpayer may deduct or defer a maximum of $60,000 for that year under the $400,000 limitation of paragraph (b) of this section.

Example 3. In 1957, A and B transfer assets to a corporation under circumstances making section 351 applicable to such a transfer. Among the assets transferred by A is a mineral lease with respect to certain coal lands. A has deducted exploration expenditures under section 615 for the years 1954 and 1956 in the amounts of $50,000 and $100,000, respectively, made with respect to other deposits not included in the transfer to the corporation. The corporation shall be required to take into account the deductions previously made by A for purposes of applying the limitations of paragraphs (a) and (b) of this section.

Example 4. In 1956, A, B, and C form a partnership for the purpose of exploring for, developing, and producing uranium. A contributes a uranium lease to the partnership. A had individually made exploration expenses in the amount of $50,000 and $100,000 with respect to other mineral properties not contributed to the partnership and which he has deducted under section 615(a) for the years 1954 and 1955, respectively. B contributes a uranium lease to the partnership on which

he made exploration expenditures in the amount of $100,000 in 1955 which he elected to defer under section 615(b). This is the only year in which B has used section 615. C contributes only cash to the partnership and has not previously used section 615. Subject to the limitations of section 615, for taxable years beginning before July 7, 1960, A may deduct or defer exploration expenses for two more taxable years (either as to expenditures incurred by him individually or with respect to his distributive share of partnership exploration expenses). B may deduct or defer exploration expenditures for three more years, and C may deduct or defer exploration expenditures for four years. For taxable years beginning after July 6, 1960, subject in each case to the $100,000 limitation per year, A may deduct or defer exploration expenditures in an amount not in excess of $250,000 ($400,000–$150,000), either as to expenditures incurred by him individually or with respect to his distributive share of partnership exploration expenditures. B may similarly deduct or defer exploration expenditures in an amount not in excess of $300,000 ($400,000–$100,000), and C may deduct or defer exploration expenditures in an amount not in excess of $400,000.

[T.D. 6685, 28 FR 11405, Oct. 24, 1963, as amended by T.D. 7192, 37 FR 12939, June 30, 1972]

§ 1.615–5 Time for making election with respect to returns due on or before May 2, 1960.

In the case of any taxable year beginning after December 31, 1953, and ending after August 16, 1954, the income tax return for which is due not later than May 2, 1960, the time for exercising any option or making any election under section 615 shall expire on May 2, 1960.

§ 1.615–6 Election to deduct under section 615.

(a) *General rule*. The election to deduct or defer exploration expenditures under section 615 shall be made in a statement filed with the director of the Internal Revenue service center with whom the taxpayer's income tax return is required to be filed. If the election is made within the time period prescribed for filing an income tax return (including extensions thereof) for the first taxable year ending after September 12, 1966, during which the taxpayer pays or incurs expenditures which are within the scope of section 615 and which are paid or incurred by him after September 12, 1966, this statement shall be attached to the taxpayer's income tax return for such taxable year. If the election is made after the time prescribed for filing such return but before the expiration of the period (described in paragraph (e) of this section) for making the election under section 615(e), the statement must be signed by the taxpayer or his authorized representative. The statement shall be filed even though the taxpayer charges to capital account all such expenditures paid or incurred by him during such taxable year after such date. The statement shall clearly indicate that the taxpayer elects to have section 615 apply to all amounts deducted or deferred by him with respect to exploration expenditures paid or incurred after September 12, 1966, and before January 1, 1970. If the taxpayer desires, he may file this statement by attaching it to his return for a taxable year prior to the first taxable year ending after September 12, 1966, in which he pays or incurs exploration expenditures. Except as provided in paragraph (b) of this section, if the taxpayer does not file such a statement within the period prescribed by section 615(e) and paragraph (e) of this section, any amounts deducted by him with respect to exploration expenditures paid or incurred after September 12, 1966, will be deemed to have been deducted pursuant to an election under section 617(a).

(b) *Exception*. The last sentence of paragraph (a) of this section shall not apply if all exploration expenditures paid or incurred by the taxpayer after September 12, 1966, and before January 1, 1970, and deducted by him on his income tax return for the first taxable year ending after September 12, 1966, during which he pays or incurs such expenditures are outside the scope of section 617(a) (as it existed before its amendment by section 504(b) of the Tax Reform Act of 1969). For example, assume that, in his return for his taxable year ending December 31, 1966, a calendar-year taxpayer deducts exploration expenditures paid or incurred after September 12, 1966, and does not attach to his return the statement described in paragraph (a) of this section. However, all of the exploration expenditures paid or incurred by the taxpayer

after September 12, 1966, and before the end of the taxable year were paid or incurred with respect to minerals located neither in the United States nor on the Outer Continental Shelf. The taxpayer will be deemed to have made an election under section 615(e) by deducting all or part of those expenditures as expenses in his income tax return.

(c) *Information to be furnished.* A taxpayer who makes or has made an election under section 615(e) with respect to expenditures paid or incurred after September 12, 1966, and before January 1, 1970, shall indicate clearly on his income tax return for each taxable year for which he deducts any such expenditures the amount of the deduction claimed under section 615 (a) or (b) with respect to each property or mine. The property or mine shall be identified by a description adequate to permit application of the rules of section 615(g) (relating to effect of transfer of mineral property).

(d) *Effect of election*—(1) *In general.* A taxpayer who has made or is deemed to have made an election under section 615(e) may not make an election under section 617(a) with respect to expenditures made before January 1, 1970, unless, within the period set forth in section 615(e), he revokes his election under section 615(e). Except as provided in paragraph (a)(2) of §1.615–2, a taxpayer who makes an election under section 615(e) may not change his treatment of exploration expenditures deducted, deferred, or capitalized pursuant to such election unless he revokes the election made under section 615(e).

(2) *Transfer of mineral property.* The binding effect of a taxpayer's election under section 615(e) shall not be affected by his receiving property with respect to which deductions have been allowed under section 617(a). However, see section 615(g)(2) and §1.615–7 for rules under which amounts deducted under section 615 by a transferor may be subject to recapture in the hands of a transferee who has made an election under section 617(a). See §1.617–3(d)(2)(ii) for rules under which amounts deducted under section 617(a) by a transferor may be subject to recapture in the hands of a transferee who has made an election under section 615(e).

(e) *Time for making election under section 615(e).* A taxpayer may not make an election under section 615(e) after the expiration of the 3-year period beginning with the date prescribed by section 6072 or other provision of law for filing the taxpayer's income tax return for the first taxable year ending after September 12, 1966, in which the taxpayer pays or incurs expenditures to which section 615(a) would apply if an election were made under section 615(e). This 3-year period shall be determined without regard to any extension of time for filing the taxpayer's income tax return for such year. An election under section 615(e) may not be made after the expiration of the 3-year period even though the taxpayer charged to capital account, or erroneously deducted as development expenditures under section 616, all exploration expenditures paid or incurred by him after September 12, 1966, and before the end of his first taxable year ending after September 12, 1966, in which he paid or incurred such expenditures.

(f) *Revocation of section 615(e) election*—(1) *Manner of revoking election.* A taxpayer may revoke an election made by him under section 615(e) by filing with the director of the Internal Revenue service center with whom the taxpayer's income tax return is required to be filed, within the period set forth in subparagraph (2) of this paragraph, a statement, signed by the taxpayer or his authorized representative, which sets forth that the taxpayer is revoking the election previously made by him with respect to exploration expenditures paid or incurred after September 12, 1966, and states with whom and where the document making the election was filed. Such revocation shall be a revocation for all taxable years for which the taxpayer's election was in effect and the taxpayer revoking such an election shall file amended income tax returns, reflecting any increase or decrease in tax attributable to the revocation of election. In applying the revocation of election to the years affected there shall be taken into account the effect that any adjustments resulting from the revocation of

election shall have on other items affected thereby (such as the deduction for charitable contributions, the foreign tax credit, net operating loss, and other deductions or credits the amount of which is limited by the taxpayer's income) and the effect that adjustments of any such items have on items in other taxable years.

(2) *Time for revoking election under section 615(e).* An election under section 615(e) may be revoked at any time before the expiration of the 3-year period described in paragraph (e) of this section. Such an election may not be revoked after the expiration of the 3-year period.

(3) *Additional information to be furnished by a transferor of mineral property.* If, before revoking his election, the taxpayer has transferred any mineral property with respect to which he deducted exploration expenditures paid or incurred after September 12, 1966, and before January 1, 1970, to another person in a transaction as a result of which the basis of such property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, the statement submitted pursuant to subparagraph (1) of this paragraph shall state that such property has been so transferred and shall identify the transferee, the property transferred, and the date of the transfer. The preceding sentence shall not apply in the case of any mineral property transferred after December 31, 1969.

(g) *Taxable years beginning before September 13, 1966, and ending after September 12, 1966*—(1) *In general.* An election made under section 615(e) applies only to expenditures paid or incurred after September 12, 1966. The income tax treatment of exploration expenditures paid or incurred before September 13, 1966, will be determined in accordance with the provisions of section 615 prior to its amendment by the Act of September 12, 1966 (Public Law 89–570, 80 Stat. 759). If a taxpayer makes an election under section 615(e) in his income tax return for a taxable year which begins before September 13, 1966, and which ends after September 12, 1966, amounts deducted and amounts deferred under section 615 with respect to expenditures paid or incurred during such taxable year but before September 13, 1966, will be taken into account in determining whether the $100,000 limitation set forth in section 615(a) is reached during the taxable year. Similarly, a taxpayer who makes an election under section 615(e) shall take into account expenditures deducted or deferred under section 615 for the period prior to September 13, 1966, in determining when the $400,000 overall limitation set forth in section 615(c) is reached. The fact that a taxpayer deducts or defers under section 615 exploration expenditures paid or incurred prior to September 13, 1966, shall not affect his right to make an election under section 617(a) to deduct under section 617 expenditures paid or incurred after September 12, 1966.

(2) *Allocation in case of inadequate records.* If a taxpayer pays or incurs exploration expenditures during a taxable year beginning before September 13, 1966, and ending after September 12, 1966, but his records as to any mine or property are inadequate to permit a determination of the amount paid or incurred during the portion of the year ending after September 12, 1966, and the amount paid or incurred on or before such date, the exploration expenditures, as to which the records are inadequate, paid or incurred with respect to the mine or property during the taxable year shall be allocated to each part year (that is, the part occurring before September 13, 1966, and the part occurring after September 12, 1966) in the same ratio which the number of days in each such part year bears to the number of days in the entire taxable year. For example, if the records of a calendar year taxpayer for 1966 are inadequate to permit a determination of the amount of exploration expenditures paid or incurred with respect to a certain mine or property after September 12, 1966, and the amount paid or incurred before September 13, 1966, 255/365 of the total exploration expenditures paid or incurred by the taxpayer with respect to the mine or property during 1966 shall be allocated to the period beginning January 1, 1966, and ending September 12, 1966, and 110/365 of the total exploration expenditures paid or incurred with respect to the mine or property during 1966 shall be allocated

to the period beginning September 13, 1966, and ending December 31, 1966.

(3) *Partnership elections*. With respect to exploration expenditures paid or incurred by a partnership before September 13, 1966, the option to deduct under section 615(a) and the election to defer under section 615(b) shall be made by the partnership, rather than by the individual partners. With respect to exploration expenditures paid or incurred by a partnership after September 12, 1966, all elections under sections 615 and 617 as to the tax treatment of a partner's distributive share of exploration expenditures paid or incurred by a partnership of which he is a member shall be made by the individual partner, rather than by the partnership. See section 703(b) and the regulations thereunder.

[T.D. 7192, 37 FR 12939, June 30, 1972]

§ 1.615–7 Effect of transfer of mineral property.

(a) *Transfer before election by transferor*. (1) If mineral property is transferred in a transaction as a result of which the basis of the property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor and the transferor had not made an election under either section 615(e) or 617(a) at the time of the transfer, no election made by the transferor after the transfer shall apply with respect to expenditures properly chargeable to the transferred property which were paid or incurred before the date of the transfer.

(2) For purposes of subparagraph (1) of this paragraph, a transferor of mineral property who made an election under section 617(a) or section 615(e) before the transfer but who revokes such election after such transfer and does not make an election under either section before the expiration of the 3-year period prescribed by section 6072 or other provision of law for filing his income tax return for the taxable year in which such transfer occurred shall be treated with respect to such property as not having made an election under either section.

(b) *Transfer after election by transferor*. If a transferee who at the time of the transfer of a mineral property has not made an election under section 617(a) receives property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to its basis in the hands of the transferor and with respect to such property the transferor has deducted expenditures under section 617(a), the adjusted exploration expenditures properly chargeable to the property immediately after the transfer shall be treated as expenditures allowed as deductions under section 617(a) to the transferee. See section 617 and the regulations thereunder.

(c) *Transfer after election by transferee*. (1) If a transferee who makes an election under section 617(a) receives before January 1, 1970, mineral property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to the basis of the property in the hands of the transferor and the transferor had in effect at the time of the transfer an election under section 615(e), an amount equal to the total of the amounts allowed as deductions to the transferor under section 615 with respect to the transferred mineral property shall be treated as expenditures allowed as deductions under section 617(a) to the transferee. The preceding sentence shall not apply to expenditures which would not have been reflected in the basis of the property in the hands of the transferor had the transferor not made the section 615(e) election.

(2) Any expenditures with respect to the transferred property deferred by the transferor under section 615(b) which are not allowed as deductions to him prior to transfer of the property may not be deducted by the transferee and in his hands shall be charged to capital account.

[T.D. 7192, 37 FR 12940, June 30, 1972]

§ 1.615–8 Termination of section 615.

(a) *In general*. The provisions of section 615 shall not apply to exploration expenditures paid or incurred after December 31, 1969. Expenditures paid or incurred before January 1, 1970, which were deferred under section 615(b) will be deductible under such section after such date as the units of ore or mineral discovered or explored by reason of

such expenditures are sold. An election under section 615(e) with respect to expenditures paid or incurred prior to January 1, 1970, shall remain in effect with respect to such expenditures unless it is revoked under section 615(e) and § 1.615–6. See § 1.615–9 for treatment of a section 615(e) election with respect to expenditures paid or incurred after December 31, 1969.

(b) *Taxable years beginning before January 1, 1970, and ending after December 31, 1969*—(1) *In general*. The termination of section 615 applies to expenditures paid or incurred after December 31, 1969. The income tax treatment of exploration expenditures paid or incurred before January 1, 1970, will be determined in accordance with the provisions of sections 615 and 617 prior to their amendment by the Tax Reform Act of 1969 (83 Stat. 487). The fact that on his income tax return for a taxable year beginning before January 1, 1970, and ending after December 31, 1969, a taxpayer deducts under section 615 expenditures paid or incurred before January 1, 1970, shall not affect his right to deduct under section 617(a) expenditures paid or incurred during such taxable year after December 31, 1969.

(2) *Allocation in case of inadequate records*. If a taxpayer pays or incurs exploration expenditures during a taxable year beginning before January 1, 1970, and ending after December 31, 1969, but his records are inadequate to permit a determination of the amount paid or incurred during the portion of the year ending after December 31, 1969, and the amount paid or incurred on or before such date, the exploration expenditures as to which the records are inadequate paid or incurred with respect to the mine or property during the taxable year shall be allocated to each part of the year (that is, the part before January 1, 1970, and the part occurring after December 31, 1969) in the same ratio which the number of days in each such part year bears to the number of days in the entire taxable year.

[T.D. 7192, 37 FR 12941, June 30, 1972]

§ 1.615–9 Notification under Tax Reform Act of 1969.

(a) *In general*. An election under section 615(e) with respect to exploration expenditures paid or incurred prior to January 1, 1970, shall be treated as an election under section 617(a) with respect to exploration expenditures paid or incurred after December 31, 1969.

(b) *Exception*. Paragraph (a) of this section shall not apply to an election under section 615(e) if the taxpayer files the notice described in paragraph (c) of this section or the taxpayer revokes his election under section 615(e) before the date prescribed for the filing of notice under paragraph (c)(2) of this section.

(c) *Filing of notice*—(1) *In general*. The notice not to have a section 615(e) election treated as a section 617(a) election shall be made in a statement filed with the Director of the Internal Revenue service center with whom the taxpayer's income tax return is required to be filed. If the election is made within the time period prescribed for filing an income tax return (including extensions thereof) for the first taxable year during which the taxpayer pays or incurs, after December 31, 1969, expenditures which would be deductible by the taxpayer under section 617(a) if he made a valid election to deduct exploration expenditures under such section, the statement shall be attached to the taxpayer's income tax return for such year. If the statement is filed after the time prescribed for filing such return but before the expiration of the period (described in paragraph (e) of this section) for filing the notice, the statement must be signed by the taxpayer or his authorized representative. The statement shall be filed even though the taxpayer charges to capital account all such expenditures paid or incurred by him after December 31, 1969. If the taxpayer desires, he may file this statement by attaching it to his return for a taxable year prior to the first taxable year in which he pays or incurs after December 31, 1969, expenditures which would be deductible by him under section 617(a) if at such time he had in effect a valid election under such section.

(2) *Information to be furnished*. The notice shall clearly state that the taxpayer elects not to have his section 615(e) election treated as an election under section 617(a). The notice shall state the first taxable year for which the section 615(e) election was effective

and with whom and where the election was filed.

(d) *Effect of notification.* A taxpayer who has filed notice pursuant to this section may make an election under section 617(a) with respect to exploration expenditures paid or incurred after December 31, 1969, without revoking either his section 615(e) election or his notice under this section.

(e) *Time for filing notice.* A taxpayer may not file the notice described in paragraph (c)(1) of this section after the expiration of the 3-year period beginning with the date prescribed by section 6072 or other provision of law for filing the taxpayer's income tax return for the first taxable year in which the taxpayer pays or incurs after December 31, 1969, expenditures which would be deductible by him if he made the election under section 617(a). This 3-year period shall be determined without regard to any extension of time for filing the taxpayer's income tax return.

[T.D. 7192, 37 FR 12941, June 30, 1972]

§ 1.616–1 Development expenditures.

(a) *General rule.* Section 616 prescribes rules for treating expenditures paid or incurred during the taxable year by the taxpayer for the development of a mine or other natural deposit (other than an oil or gas well). Development expenditures under section 616 are those which are made after such time when, in consideration of all the facts and circumstances (including actions of the taxpayer), deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. Under section 616(a), a taxpayer is allowed a deduction for development expenditures whether or not such expenditures are made in the development or production state of the mine or other natural deposit. Under section 616(b), the taxpayer may elect to defer development expenditures made in the development or producing stage and to deduct such expenditures ratably as the minerals or ores benefited are sold. While the mine or other natural deposit is in the development stage, the election applies only to that portion of the development expenditures which is in excess of net receipts from the mine or other natural deposit. See § 1.616–2 for rules with respect to the election to defer. It is not necessary that the taxpayer incur the development costs directly. He may engage a contractor to make the expenditures on his behalf.

(b) *Expenditures to which section 616 is not applicable.* (1) Section 616 is not applicable to development expenditures which are deductible for the taxable year under any other provision of the internal revenue laws.

(2) Section 616 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowance for depreciation of such improvements which are used in the development of ores or minerals are considered development expenditures under section 616. If such improvements are used only in part for development during a taxable year, an allocable portion of the allowance for depreciation shall be treated as a development expenditure.

(3) Section 616 is applicable to development expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired. The expenditure attributable to the remaining fractional share shall be considered as part of the cost of his acquired interest and shall be capitalized and recovered through depletion allowances. For example, taxpayer A owns mineral leases on undeveloped mineral lands. A agrees to convey an undivided three-fourths (¾) interest in such leases to B, provided B will pay all of the expenditures incurred during the development stage of the deposits on these leases. B may deduct three-fourths (¾) of such amount under section 616, but shall treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) The provisions of section 616 do not apply to costs of development paid or incurred by a prior owner which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Such provisions apply only to costs paid or incurred by the taxpayer for development undertaken directly or

through contract by the taxpayer. See, however, section 381(a) and 381(c)(10) for special rules with respect to deferred development expenditures in certain corporate acquisitions.

(c) *Mine or other natural deposit.* Section 616 has reference to expenditures made for the development of a mine or other natural deposit. Within an aggregated property, as that term is defined in section 614 (b) and (c), or within a single tract or parcel of land, there may be more than one mine or other natural deposit. Where a property, as determined under section 614, contains more than one mine or other natural deposit, the taxpayer may deduct under section 616(a) the development expenditures made with respect to one of such mines or deposits, and may defer under section 616(b) the development expenditures made with respect to another of such mines or deposits. Where there is more than one mine with respect to a single underlying deposit, the taxpayer may deduct under section 616(a) the development expenditures made with respect to one of such mines, and may defer under section 616(b) the development expenditures made with respect to another of such mines. The taxpayer must treat consistently all development expenditures with respect to each such mine or other natural deposit in a taxable year. The taxpayer must make a separate determination of the units of minerals or ores benefited in a mine or other natural deposit (regardless of the computation of the depletion allowance) in order that deferred expenditures with respect to such mine or deposit may be deducted on a ratable basis. See paragraph (f) of § 1.616–2.

§ 1.616–2 Election to defer.

(a) *General rule.* In lieu of taking a deduction under section 616(a), in the taxable year when the development expenditures are paid or incurred, a taxpayer may elect under section 616(b) to treat such expenditures with respect to each mine or other natural deposit as deferred expenses to be deducted ratably as the units of the produced ore or minerals benefited by such expenditures are sold. Section 616(b) is applicable to development expenditures paid or incurred both in the development and producing stage of the mine or other natural deposit. However, in the case of such expenditures made in the development stage, this election is applicable only to the excess of the amount of such expenditures over the net receipts from the ore or minerals from such mine or deposit received or accrued during the development stage and in the same taxable year as the expenditures were paid or incurred. Such development expenditures not in excess of such net receipts shall be subject to the provisions of section 616(a).

(b) *Producing stage; definition of.* The mine or other natural deposit will be considered to be in a producing stage when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine or other natural deposit is the production of developed ores or minerals rather than the development of additional ores or minerals for mining.

(c) *Expenditures made by the owner who retains a nonoperating interest.* (1) A taxpayer who elects to defer development expenditures and thereafter transfers his interest in the mine or other natural deposit, retaining an economic interest therein, shall deduct an amount attributable to such interest on a pro rata basis as the interest pays out. For example, a taxpayer who defers development expenditures and then leases his deposit, retaining a royalty interest therein, shall deduct the deferred expenditures ratably as he receives the royalties. If the taxpayer receives a bonus or advanced royalties in connection with the transfer of his interest, he shall deduct the deferred expenditures allocable to such bonus or advanced royalties in an amount which is in the same proportion to the total of such costs as the bonus or advanced royalties bears to the bonus and total royalties expected to be received. Also, in the case of a transfer of a mine or other natural deposit by a taxpayer who retains a production payment therein, he may deduct the development expenditures ratably over the payments expected to be received.

(2) Where a taxpayer receives an amount, in addition to retaining an economic interest, which amount is

treated as from the sale or exchange of a capital asset or property treated under section 1231 (except coal or iron ore to which section 631(c) applies), the deferred development expenditures shall be allocated between the interest sold and the interest retained in proportion to the fair market value of each interest as of the date of sale. The amount allocated to the interest sold may not be deducted, but shall be a part of the basis of such interest for the purpose of determining gain or loss upon the sale thereof.

(d) *Losses from abandonment.* Section 165 and the regulations thereunder contain general rules relating to the treatment of losses resulting from abandonment.

(e) *Effect of election.* (1) The election to defer development expenditures shall apply only to expenditures for the taxable year for which made. However, once made, the election shall be binding with respect to the expenditures for that taxable year. Thus, a taxpayer cannot revoke his election for any reason whatsoever.

(2) The election shall be made for each mine or other natural deposit by a clear indication on the return or by a statement filed with the district director with whom the return was filed, not later than the time prescribed by law for filing such return (including extensions thereof) for the taxable year to which such election is applicable.

(f) *Computation of amount of deduction.* The amount of the deduction allowable during the taxable year is an amount A, which bears the same ratio to B (the total deferred development expenditures for a particular mine or other natural deposit reduced by the amount of such expenditures deducted in prior taxable years) as C (the number of units of the ore or mineral benefited by such expenditures sold during the taxable year) bears to D (the number of units of ore or mineral benefited by such expenditures remaining as of the taxable year). For the purposes of this proportion, the *number of units of ore or mineral benefited by such expenditures remaining as of the taxable year* is the number of units of ore or mineral benefited by the deferred development expenditures remaining at the end of the year to be recovered from the mine or other natural deposit (including units benefited by such expenditures recovered but not sold) plus the number of units benefited by such expenditures sold within the taxable year. The principles outlined in § 1.611–2 are applicable in estimating the number of units remaining as of the taxable year and the number of units sold during the taxable year. The estimate is subject to revision in accordance with that section in the event it is ascertained, from any source, such as operations or development work, that the remaining units are materially greater or less than the number of units remaining from a prior estimate.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9307, July 27, 1965]

§ 1.616–3 Time for making election with respect to returns due on or before May 2, 1960.

In the case of any taxable year beginning after December 31, 1953, and ending after August 16, 1954, the income tax return for which is due not later than May 2, 1960, the time to deduct or defer development expenditures for such a year under section 616 (a) or (b) shall expire on May 2, 1960.

§ 1.617–1 Exploration expenditures.

(a) *General rule.* Section 617 prescribes rules for the treatment of expenditures paid or incurred after September 12, 1966, for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral for which a deduction for depletion is allowable under section 613 (other than oil or gas) paid or incurred by the taxpayer before the beginning of the development stage of the mine or other natural deposit. Such expenditures hereinafter in the regulations under section 617 will be referred to as exploration expenditures. The development stage of the mine or other natural deposit will be deemed to begin at the time when, in consideration of all the facts and circumstances (including the actions of the taxpayer), deposits of ore or other mineral are disclosed in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. For example, core drilling expenditures paid or incurred

by the taxpayer to ascertain the existence of commercially marketable ore are exploration expenditures within the meaning of this section. Also, expenditures for exploratory drilling from within a producing mine to ascertain the existence of what appears (on the basis of all of the facts and circumstances known at the time of the expenditures) to be a different ore deposit are exploration expenditures within the meaning of this section. Expenditures paid or incurred in connection with core drilling to further delineate the extent and location of an existing commercially marketable deposit to facilitate its development are development expenditures. Under section 617(a), a taxpayer may deduct exploration expenditures paid or incurred for the exploration of any deposit of ore or other mineral subject to the limitation of section 617(h). Under section 617(b), a taxpayer shall recapture the exploration expenditures previously deducted under section 617(a) either through including in income an amount equal to the amount of the adjusted exploration expenditures (as defined in section 617(f)) or through disallowance of the deduction for depletion under section 611. Certain rules are provided in section 617(c) for recapture of exploration expenditures made with respect to property for which the taxpayer later receives a bonus or royalty. Under section 617(d), gain from dispositions of mining property, with respect to which exploration expenditures have been previously deducted, is to be recognized notwithstanding certain other provisions of the Code.

(b) *Expenditures to which section 617 is not applicable.* (1) Section 617 is not applicable to expenditures which would be allowed as deductions for the taxable year without regard to section 617.

(2) Section 617 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowances for depreciation of such improvements which are used in the exploration of ores or minerals are considered exploration expenditures under section 617. If such improvements are used only in part for exploration during the taxable year, an allocable portion of the allowance for depreciation shall be treated as an exploration expenditure.

(3) Section 617 is applicable to exploration expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired by the taxpayer. The expenditures attributable to the remaining fractional share shall be considered as the cost of his acquired interest and shall be recovered through depletion allowances. For example, taxpayer A owns mineral leases on unexplored mineral lands and agrees to convey an undivided three-fourths (¾) interest in such leases to taxpayer B provided B will pay all of the expenses for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral which will be incurred before the beginning of the development stage. B may elect to treat three-fourths of such amount under section 617. B must treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) Section 617 is not applicable to costs of exploration which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Section 617 applies only to costs paid or incurred by the taxpayer for exploration undertaken directly or through a contract by the taxpayer. See, however, sections 381(a) and 381(c)(10) for special rules with respect to deferred exploration expenditures in certain corporate acquisitions.

(5) Section 617 is not applicable to amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of oil or gas or of any mineral with respect to which a deduction for percentage depletion is not allowable under section 613. The purpose of the expenditure shall be determined by reference to the facts and circumstances at the time the expenditure is paid or incurred.

(c) *Elections*—(1) *Election to deduct under section 617(a).* (i) The election to deduct exploration expenditures under section 617(a) may be made by deducting such expenditures in the taxpayer's income tax return for his first taxable year ending after September 12, 1966,

for which the taxpayer desires to deduct exploration expenditures which are paid or incurred by him during such taxable year and after September 12, 1966. This election may be exercised by deducting such exploration expenditures either in the taxpayer's return for such taxable year or in an amended return filed before the expiration of the period for filing a claim for credit or refund of income tax for such taxable year. Where the election is made in an amended return for a taxable year prior to the most recent year for which the taxpayer has filed a return, the taxpayer shall file amended income tax returns, reflecting any increase or decrease in tax attributable to the election, for all subsequent taxable years affected by the election for which he has filed income tax returns before making the election. See section 617(a)(2)(C) and subparagraph (4) of this paragraph for provisions relating to extension of the period of limitations for the assessment of any deficiency for any taxable year to the extent the deficiency is attributable to an election or revocation of an election under section 617(a). In applying the election to the years affected, there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby (such as the deduction for charitable contributions, the foreign tax credit, net operating loss, and other deductions or credits the amount of which is limited by the taxpayer's income) and the effect that adjustments of any such items have on items of other taxable years. Amended returns filed for taxable years subsequent to the taxable year for which the election under section 617(a) is made by amended return shall, where appropriate, apply the recapture rules of subsections (b), (c), and (d) of section 617. See §§1.617–3 and 1.617–4.

(ii) A taxpayer who makes or has made an election under section 617(a) shall state clearly on his income tax return for each taxable year for which he deducts exploration expenditures the amount of the deduction claimed under section 617(a) with respect to each property or mine. Such property or mine shall be identified by a description adequate to permit application of the recapture rules of section 617 (b), (c), and (d).

(iii) A taxpayer who has made an election under section 617(a) may not make an election under section 615(e) unless, within the period set forth in section 615(e), he revokes his election under section 617(a). A taxpayer who has made and has not revoked an election under section 617(a) may not, in his return for the taxable year for which the election is made or for any subsequent taxable year, charge to capital account any exploration expenditures which are deductible by him under section 617(a); and he must deduct all such expenditures as expenses in computing adjusted gross income. Any exploration expenditures paid or incurred after December 31, 1969, which are not deductible by the taxpayer under section 617(a) solely because of the application of section 617(h) shall be charged to capital account.

(2) *Time for making elections.* The election under section 617(a) may be made at any time before the expiration of the period prescribed for filing a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the taxpayer desires to deduct exploration expenditures under section 617(a).

(3) *Revocation of election to deduct.* (i) A taxpayer may revoke an election made by him under section 617(a) by filing with the Internal Revenue service center with which the taxpayer's income tax return is required to be filed, within the period set forth in subdivision (ii) of this subparagraph, a statement, signed by the taxpayer or his authorized representative, which sets forth that the taxpayer is revoking the section 617(a) election previously made by him and states with whom and where the document making the election was filed. A taxpayer revoking a section 617(a) election shall file amended income tax returns which reflect any increase or decrease in tax attributable to the revocation of election for all taxable years affected by the revocation of election for which he has filed income tax returns before revoking the election. See section 617(a)(2)(C) and subparagraph (4) of this paragraph for provisions relating to extension of the period of limitations for

the assessment of any deficiency attributable to an election or revocation of an election under section 617(a). In applying the revocation of election to the years affected, there shall be taken into account the effect that any adjustments resulting from the revocation of election shall have on other items affected thereby (such as the deduction for charitable contributions, the foreign tax credit, net operating loss, and other deductions or credits the amount of which is limited by the taxpayer's income) and the effect that adjustments of any such items have on items of other taxable years.

(ii) An election under section 617(a) may be revoked before the expiration of the last day of the third month following the month in which the final regulations under section 617(a) are published in the FEDERAL REGISTER. After the expiration of this period, a taxpayer who has made an election under section 617(a) may not revoke that election unless he obtains the prior consent of the Commissioner of Internal Revenue. Consent will not be granted where a principal purpose for the revocation of the election is to circumvent the recapture provisions of section 517 (b), (c), or (d). The request for consent shall be made in writing to the Commissioner of Internal Revenue, Attention T:I:E, Washington, DC 20224. The request shall include in detail:

(*a*) The reason or reasons for the revocation of election under section 617(a);

(*b*) An itemization of the taxpayer's deductions under section 617(a);

(*c*) A description of all properties and detailed information of the exploration activities with respect to which the taxpayer has taken deductions under section 617(a);

(*d*) A description of any development or production activities on all properties with respect to which exploration expenditures were deducted under section 617(a); and

(*e*) A recomputation of the tax for each prior taxable year affected by the revocation. A letter setting forth the Commissioner's determination will be mailed to the taxpayer. If consent is granted, a copy of the letter granting such consent shall be filed with the director of the Internal Revenue service center with which the taxpayer's income tax return is required to be filed and shall be accompanied by an amended return or returns, if necessary.

(iii) If, before revoking his election, the taxpayer has transferred any mineral property with respect to which he deducted exploration expenditures under section 617(a), to another person in a transaction as a result of which the basis of such property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor, the statement submitted pursuant to subdivision (i) of this paragraph shall state that such property has been so transferred, shall identify the transferee, the property transferred, the date of the transfer, and shall indicate the amount of the adjusted exploration expenditures with respect to such property on such date.

(4) *Deficiency attributable to election or revocation of election*. The statutory period for the assessment of any deficiency for any taxable year, to the extent such deficiency is attributable to an election or revocation of an election under section 617(a), shall not expire before the last day of the 2-year period which begins on the day after the date on which such election or revocation of election is made; and such deficiency may be assessed at any time before the expiration of such 2-year period, notwithstanding any law or rule which would otherwise prevent such assessment.

[T.D. 7192, 37 FR 12942, June 30, 1972]

§ 1.617–2 Limitation on amount deductible.

(a) *Expenditures paid or incurred before January 1, 1970*. In the case of expenditures paid or incurred before January 1, 1970, a taxpayer may deduct exploration expenditures paid or incurred during the taxable year with respect to any deposit of ore or other mineral for which a deduction for percentage depletion is allowable under section 613 (other than oil or gas) in the United States or on the Outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U.S.C. 1331).

(b) *Expenditures paid or incurred after December 31, 1969.* In the case of exploration expenditures paid or incurred after December 31, 1969, with respect to any deposit of ore or other mineral for which a deduction for percentage depletion is allowable under section 613 (other than oil or gas), a taxpayer may deduct:

(1) The amount of such expenditures paid or incurred during the taxable year with respect to any such deposit in the United States (as defined in section 638 and the regulations thereunder), and

(2) With respect to any such deposit located outside the United States (as defined in section 638 and the regulations thereunder) the lesser of:

(i) The amount of the exploration expenditures paid or incurred with respect to such deposits during the taxable year, or

(ii) $400,000 minus the sum of the amount to be deducted under subparagraph (1) of this paragraph for the taxable year and all amounts deducted or treated as deferred expenses during all preceding taxable years under section 617 and section 615 of the Internal Revenue Code of 1954 and section 23(ff) of the Internal Revenue Code of 1939. See paragraph (d) of this section for application of the limitation in the case of a transferee of a mining property.

(c) *Examples.* The application of the provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. A, a calendar-year taxpayer who has claimed the benefits of section 615, expended $100,000 for exploration expenditures during the year 1966. For each of the years 1967, 1968, 1969, and 1970 A had exploration costs of $80,000 all with respect to coal deposits located within the United States. A deducted or deferred the maximum amounts allowable for each of the years 1966 ($100,000), 1967 ($80,000), 1968 ($80,000), and 1969 ($80,000). The $80,000 of exploration expenditures for 1970 may be deducted under section 617 by A.

Example 2. B, a calendar-year taxpayer claimed deductions of $100,000 per year under section 615 for the years 1968 and 1969. In 1970, B deducted $150,000 under section 617 for exploration conducted with respect to coal deposits in the United States. In 1971, B paid $150,000 with respect to exploration of tin deposits outside the United States. The maximum amount B may deduct with respect to the foreign exploration in 1971 is $50,000 computed as follows:

(a) Add all amounts deducted or deferred for exploration expenditures by B for all years:

Year	Expenditures	Deducted or deferred
1968	$100,000	$100,000
1969	100,000	100,000
1970	150,000	150,000
Total		350,000

(b) Subtract from $400,000 (the maximum amount allowable to B for deduction of foreign exploration expenditures) the sum of the amounts obtained in (a) $350,000:

Maximum amount allowable to taxpayer	$400,000
Sum of amounts obtained in (a)	350,000
	50,000

Example 3. Assume the same facts as in example 2 except that in 1971 in addition to the $150,000 paid with respect to exploration outside the United States, B paid $100,000 with respect to exploration within the United States. As the following computation indicates, B may not deduct any amount with respect to the foreign exploration:

(a) Add all amounts deducted or deferred for exploration expenditures in prior years and the exploration expenditures with respect to exploration in the United States to be deducted in 1971:

Year	Expenditures	Deducted or deferred
1968	$100,000	$100,000
1969	100,000	100,000
1970	150,000	150,000
1971	250,000	[1] 100,000
Total		450,000

[1] Domestic.

(b)Because the sum of the amounts obtained in (a), $450,000, exceeds $400,000 no deduction would be allowable to B with respect to foreign exploration expenditures for 1971.

(d) *Transferee of mineral property.* (1) Where an individual or corporation transfers any mining property to the taxpayer, the taxpayer shall take into account for purposes of the $400,000 limitation described in paragraph (b)(ii) of this section all amounts deducted and amounts treated as deferred expenses by the transferor if:

(i) The taxpayer acquired any mineral property from the transferor in a transaction described in section 23(ff)(3) of the Internal Revenue Code of

1939, excluding the reference therein to section 113(a)(13),

(ii) The taxpayer acquired any mineral property by reason of the acquisition of assets of a corporation in a transaction described in section 381(a) as a result of which the taxpayer succeeds to and takes into account the items described in section 381(c),

(iii) The taxpayer acquired any mineral property under circumstances which make applicable any of the following sections of the Internal Revenue Code:

(*a*) Section 334(b)(1), relating to the liquidation of a subsidiary where the basis of the property in the hands of the distributee is the same as it would be in the hands of the transferor.

(*b*) Section 362 (a) and (b), relating to property acquired by a corporation as paid-in surplus or as a contribution to capital, or in connection with a transaction to which section 351 applies.

(*c*) Section 372(a), relating to reorganization in certain receiverships and bankruptcy proceedings.

(*d*) Section 373(b)(1), relating to property of a railroad corporation acquired in certain bankruptcy or receivership proceedings.

(*e*) Section 1051, relating to property acquired by a corporation that is a member of an affiliated group.

(*f*) Section 1082, relating to property acquired pursuant to a Securities Exchange Commission order.

(2) For purposes of applying the limitations imposed by section 617(h):

(i) The partner, and not the partnership, shall be considered as the taxpayer (see paragraph (a)(8)(iii) of § 1.702–1), and

(ii) An electing small business corporation, as defined in section 1371(b), and not its shareholders, shall be considered as the taxpayer.

(3) For purposes of subparagraph (1)(iii) (*b*) of this paragraph, relating to a transaction to which section 362 (a) and (b) applies or to which section 351 applies:

(i) If mineral property is acquired from a partnership, the transfer shall be considered as having been made by the individual partners, so that the amounts which each partner has deducted or deferred under sections 615 and 617 of the Internal Revenue Code of 1954 and section 23(ff) of the Internal Revenue Code of 1939 shall be taken into account, or

(ii) If an interest in a partnership having mineral property is transferred, the transfer shall be considered as a transfer of mineral property by the partner or partners relinquishing an interest, so that the amounts which each such partner has deducted or deferred under sections 615 and 617 of the Internal Revenue Code of 1954 and section 23(ff) of the Internal Revenue Code of 1939 shall be taken into account.

(e) *Examples.* The application of the provisions of this section may be illustrated by the following example:

Example 1. A calendar year taxpayer (who has never claimed the benefits of section 617) received in 1970 a mineral deposit from X Corporation upon a distribution in complete liquidation of the latter under conditions which make the provisions of section 334(b)(1) applicable in determining the basis of the property in the hands of the taxpayer. During the year 1969, X Corporation expended $60,000 for exploration expenditures which it elected to treat under section 615(b) as deferred expenses. Subsequent to the transfer the taxpayer made similar expenditures for domestic exploration of $250,000 and $140,000, for the years 1970, and 1971, respectively, which the taxpayer elected to deduct. In 1972, the taxpayer made expenditures for domestic exploration of $100,000 and for foreign exploration of $50,000. The taxpayer may deduct the $100,000 domestic exploration expenditures but may not deduct any portion of the $50,000 of foreign exploration expenditures because the $400,000 limitation of section 617(h) applies.

Example 2. In 1971, A and B transfer assets to a corporation in a transfer to which section 351 applied. Among the assets transferred by A is a mineral lease with respect to certain coal lands. A has deducted exploration expenditures under section 615 for the years 1968 and 1969 in the amounts of $50,000 and $100,000, respectively, made with respect to other deposits not included in the transfer to the corporation. The corporation is required to take into account the deductions previously made by A for purpose of applying the $400,000 limitation on deduction of foreign exploration expenditures. Thus, if in 1970 the corporation incurred $400,000 of foreign exploration expenditures, the maximum which it could deduct under section 617(a) is $250,000.

[T.D. 7192, 37 FR 12944, June 30, 1972]

§ 1.617–3 Recapture of exploration expenditures.

(a) *In general.* (1)(i) Except as provided in subparagraphs (2) and (3) of this paragraph, if in any taxable year any mine (as defined in paragraph (c) of this section) with respect to which deductions have been allowed under section 617(a) reaches the producing stage (as defined in paragraph (c) of this section) the deduction for depletion under section 611 (whether determined under § 1.611–2 or under section 613) with respect to the property shall be disallowed for the taxable year and each subsequent taxable year until the aggregate amount of depletion which would be allowable but for section 617(b)(1)(B) and this subparagraph equals the amount of the adjusted exploration expenditures (determined under section 617(f)(1) and paragraph (d) of this section) attributable to the mine. The preceding sentence shall apply notwithstanding the fact that such mine is not in the producing stage at the close of such taxable year. In the case of a taxpayer who owns more than one property in a mine with respect to which he has been allowed deductions under section 617(a), the depletion deduction described in the second preceding sentence shall be disallowed with respect to all of the properties until the aggregate amount of depletion disallowed under section 617(b)(1)(B) is equal to the adjusted exploration expenditures with respect to the mine. In the case of a taxpayer who elects under section 614(c)(1) to aggregate a mine, with respect to which he has been allowed deductions under section 617(a), with another mine, no deduction for depletion will be allowable under section 611 with respect to the aggregated property until the amount of depletion disallowed under section 617(b)(1)(B) equals the adjusted exploration expenditures attributable to all of the producing mines included in the aggregated property.

(ii) If a taxpayer who has made an election under section 617(a) receives or accrues a bonus or royalty with respect to a mining property with respect to which deductions have been allowed under section 617(a), the deduction for depletion under section 611 with respect to such bonus or royalty (whether determined under § 1.611–2 or under section 613) shall be disallowed for the taxable year of receipt or accrual and each subsequent taxable year until the aggregate amount of the depletion disallowed under section 617(c) and this section equals the amount of the adjusted exploration expenditures with respect to the property to which the bonus or royalty relates. The preceding sentence shall not apply if the bonus or royalty is paid with respect to a mineral for which a deduction is not allowable under section 617(a). In the case of the disposal of coal or domestic iron ore with a retained economic interest, see paragraph (a)(2) of § 1.617–4.

(2) If the taxpayer so elects with respect to all mines as to which deductions have been allowed under section 617(a) and which reach the producing stage during the taxable year, he shall include in gross income (but not *gross income from the property* for purposes of section 613) for such taxable year an amount equal to the adjusted exploration expenditures (determined under section 617(f)(1) and paragraph (d) of this section) with respect to all of such mines. The amount so included in income shall be treated for purposes of subtitle A of the Internal Revenue Code as expenditures which are paid or incurred on the respective dates on which the mines reach the producing stage and which are properly chargeable to capital account. The fact that a taxpayer does not make the election described in this subparagraph for a taxable year during which mines with respect to which deductions have been allowed under section 617(a) reach the producing stage shall not preclude the taxpayer from making the election with respect to other mines which reach the producing stage during subsequent taxable years. However, the election described in this subparagraph may not be made for any taxable year with respect to any mines which reached the producing stage during a preceding taxable year.

(3) The provisions of section 617(b)(1) and subparagraphs (1) and (2) of this paragraph do not apply in the case of any deposit of oil or gas. For example, A in exploring for sulphur incurred $500,000 of exploration expenditures which he deducted under section 617(a).

In the following year, A did not find sulphur but on the same mineral property located commercially marketable quantities of oil and gas. In computing the depletion allowance with respect to the oil and gas, no depletion would be disallowed because of section 617(b)(1).

(4) In the case of exploration expenditures which are paid or incurred with respect to a mining property which contains more than one mine, the provisions of subparagraphs (1) and (2) of this paragraph shall apply only to the amount of the adjusted exploration expenditures properly chargeable to the mine or mines which reach the producing stage during the taxable year. For example, A owns a mining property which contains mines X, Y, and Z. For 1970, A deducted under section 617(a), $250,000 with respect to X, $100,000 with respect to Y and $70,000 with respect to Z. In 1971, mine X reaches the producing stage. At that time, A will only have to recapture the $250,000 attributable to mine X.

(b) *Manner and time for making election*. (1) A taxpayer will be deemed not to have elected pursuant to section 617(b)(1)(A) and paragraph (a)(2) of this section unless he clearly indicates such election on his income tax return for the taxable year in which the mine with respect to which deductions were allowed under section 617(a) reaches the producing stage.

(2) The election described in paragraph (a)(2) of this section may be made (or changed) not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year in which the mine with respect to which deductions were allowed under section 617(a) reaches the producing stage.

(c) *Definitions*—(1) *Mine*. The term *mine* includes all quarries, pits, shafts, and wells, and any other excavations or workings for the purpose of extracting any known deposit of ore or other mineral.

(2) *Producing stage*. A mine will be considered to have reached the producing stage when (i) the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or (ii) the principal activity of the mine is the production of developed ores or minerals rather than the development of additional ores or minerals for mining.

(3) *Mining property*. The term *mining property* means any property (as the term is defined in section 614(a) after the application of subsections (c) and (e) thereof) with respect to which any expenditures allowed as deductions under section 617(a) are properly chargeable.

(d) *Adjusted exploration expenditures*—(1) *In general*. The term *adjusted exploration expenditures* means, with respect to any property or mine:

(i) The aggregate amount of the expenditures allowed as deductions under section 617(a) for the taxable year and all preceding taxable years to the taxpayer or any other person which are properly chargeable to such property or mine and which (but for the election under section 617(a)) would be reflected in the adjusted basis of such property or mine, reduced by

(ii) The excess, if any, of the amount which would have been allowable for all taxable years under section 613 but for the deduction of such expenditures over the amount allowable for depletion under section 611 (determined without regard to section 617(b)(1)(B)). The amount determined under the preceding sentence shall be reduced by the aggregate of the amounts included in gross income for the taxable year and all preceding taxable years under section 617(b) or (c) and the amount treated under section 617(d) as gain from the sale or exchange of the property which is neither a capital asset nor property described in section 1231.

(iii) If a taxpayer pays or incurs exploration expenditures on a property which contains a producing mine and if such taxpayer deducts any portion of such expenditures under section 617(a), an amount equal to the amount so deducted shall be taken into account in computing the taxpayer's *taxable income from the property* for the purposes of the limitation on the percentage depletion deduction under section 613(a) and the regulations thereunder. The amount of the adjusted exploration expenditures with respect to the producing mine shall be reduced by an amount equal to the amount by which the taxpayer's deduction under 617(a)

(described in the preceding sentence) reduces the taxpayer's deduction for depletion for the taxable year. See example 1 in subparagraph (6) of this paragraph.

(iv) For purposes of § 1.617–4, the aggregate amount of adjusted exploration expenditures with respect to a mining property includes the aggregate amount of adjusted exploration expenditures properly allocable to all mines on such property.

(v) (*a*) For purposes of paragraph (a)(1) of this section, the aggregate amount of the adjusted exploration expenditures is determined as of the close of the taxpayer's taxable year.

(*b*) For purposes of § 1.617–4, the aggregate amount of the adjusted exploration expenditures is determined as of the date of the disposition of the mining property or portion thereof.

(2) *Adjustments for certain expenditures of other taxpayers or in respect of other property.* (i) For purposes of subparagraph (1) of this paragraph, the exploration expenditures which must be taken into account in determining the adjusted exploration expenditures with respect to any property or mine are not limited to those expenditures with respect to the property disposed of or which entered the production stage nor are such expenditures limited to those deducted by the taxpayer. For the manner of determining the amount of adjusted exploration expenditures immediately after certain dispositions, see subparagraph (4) of this paragraph.

(ii) If a transferee who at the time of the transfer has not made an election under section 617(a) (including a transferee who has made an election under section 615(e)) receives mineral property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to its basis in the hands of the transferor and with respect to such property the transferor has deducted exploration expenditures under section 617(a), the adjusted exploration expenditures immediately after such transfer shall be treated as exploration expenditures allowed as deductions under section 617(a) to the transferee.

(iii) If a transferee who makes an election under section 617(a) receives mineral property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to the basis of such property in the hands of the transferor and the transferor had in effect at the time of the transfer an election under section 615(e), an amount equal to the total of the amounts allowed as deductions to the transferor under section 615 with respect to the transferred property shall be treated as expenditures allowed as deductions under section 617(a) to the transferee. The preceding sentence shall not apply to expenditures which could not have been reflected in the basis of the property in the hands of the transferee had the transferor not made the section 615(e) election.

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

Example 1. On July 14, 1969, A purchased mineral property Z for $10,000. After deducting exploration expenditures of $20,000 under section 617(a), A transferred the property to his son as a gift on July 9, 1970. Since the exception for gifts in section 617(d)(3) (by incorporation by reference of the provisions of section 1245(b)(1)) applies, A does not recognize gain under section 617(d). On September 30, 1972 after deducting exploration expenditures of $150,000 under section 617(a), the son transfers the mineral property to corporation X in a transaction under which no gain is recognized by the son under section 351. Since the exception of section 617(d)(3) (by incorporation by reference of the provisions of section 1245(b)(3)) applies, the son does not recognize gain under section 617(d). On November 14, 1972, corporation X sells the mineral property. No deductions for exploration expenditures were taken by corporation X. The amount of the adjusted exploration expenditures with respect to mineral property Z to be recaptured by corporation X upon such sale is $170,000 (the total amount deducted by A and the son).

Example 2. Assume the same facts as in example 1 except that A deducted the $20,000 of exploration expenditures under section 615(a). The amount of the adjusted exploration expenditures with respect to mineral property Z in corporation X's hands is $170,000 (the $20,000 deducted under section 615(a) by A plus the $150,000 deducted under section 617(a) by the son).

(3) *Allocation of certain expenditures.* A project area consists of that territory which the taxpayer has determined by analysis of certain variables (the size

and topography of the area to be explored, existing information with respect to that area and nearby areas, and the quantity of equipment, men, and money available) can be explored advantageously as a single integrated operation. If exploration expenditures are paid or incurred with respect to a project area and one or more areas of interest are identified within such project area, the entire amount of such expenditures shall be allocated equally to each such area of interest. If an area of interest contains one or more mines or deposits the expenditures allocable to such area of interest shall be allocated (i) if only one mine or deposit is located or identified, entirely to such mine or deposit, or (ii) if more than one mine or deposit is located or identified, equally among the various mines or deposits located. For purposes of this subparagraph, the term *area of interest* means each separable, noncontiguous portion of the project area which is identified as possessing sufficient mineral-producing potential to merit further exploration. The provisions of this subparagraph may be illustrated by the following example: A pays $100,000 for the exploration of a project area which results in the identification of two areas of interest. A pays an additional $60,000 for the exploration of one of the areas of interest in which he locates mineral deposit X and mineral deposit Y. With respect to the exploration of deposit X he incurs an additional $100,000 of expenses and with respect to deposit Y he incurs an additional $200,000 of expenses. The exploration expenditures properly attributable to deposit X would be $155,000 ($100,000 plus one-half of $50,000 plus one-half of $60,000) and the exploration expenditures properly attributable to deposit Y would be $255,000 ($200,000 plus one-half of $50,000 plus one-half of $60,000).

(4) *Partnership distributions.* The adjusted exploration expenditures with respect to any property or mine received by a taxpayer in a distribution with respect to all or part of his interest in a partnership (i) include the adjusted exploration expenditures (not otherwise included under section 617(f)(1)) with respect to such property or mine immediately prior to such distribution and (ii) shall be reduced by the amount of gain to which section 751(b) applies realized by the partnership (as constituted after the distribution) on the distribution of such property or mine. In the case of any property or mine held by a partnership after a distribution to a partner to which section 751(b) applies, the adjusted exploration expenditures with respect to such property or mine shall be reduced by the amount of gain (if any) to which section 751(b) applies realized by such partner with respect to such distribution on account of such property or mine.

(5) *Amount of transferee's adjusted exploration expenditures immediately after certain acquisitions*—(i) *Transactions in which basis is determined by reference to the cost or fair market value of the property transferred. (a)* If on the date a person acquires mining property his basis for the property is determined solely by reference to its cost (within the meaning of section 1012), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(*b*) If on the date a person acquires mining property his basis for the property is determined solely by reason of the application of section 301(d) (relating to basis of property received in corporate distribution) or section 334(a) (relating to basis of property received in a liquidation in which gain or loss is recognized), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(*c*) If on the date a person acquires mining property his basis for the property is determined solely under the provisions of section 334(b)(2) or (c) (relating to basis of property received in certain corporate liquidations), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(*d*) If on the date a person acquires mining property from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), then on

the date of acquisition the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(ii) *Gifts and certain tax-free transactions.* (*a*) If mining property is disposed of in a transaction described in (*b*) of this subdivision (ii), then the amount of the adjusted exploration expenditures for the mining property in the hands of a transferee immediately after the disposition shall be an amount equal to:

(*1*) The amount of the adjusted exploration expenditures with respect to the mining property in the hands of the transferor immediately before the disposition, minus

(*2*) The amount of any gain taken into account under section 617(d) by the transferor upon the disposition.

(*b*) The transactions referred to in (*a*) of this subdivision (ii) are:

(*1*) A disposition which is in part a sale or exchange and in part a gift, or

(*2*) A disposition which is described in section 617(d) through the incorporation by reference of the provisions of section 1245(b)(3) (relating to certain tax free transactions).

(iii) *Property acquired from a decedent.* If mining property is acquired in a transfer at death to which section 617(d) applies through incorporation by reference of the provisions of section 1245(b)(2), the amount of the adjusted exploration expenditures with respect to the mining property in the hands of the transferee immediately after the transfer shall include the amount, if any, of the exploration expenditures deducted by the transferee before the decedent's death, to the extent that the basis of the mining property (determined under section 1014(a)) is required to be reduced under the second sentence of section 1014(b)(9) (relating to adjustments to basis where the property is acquired from a decedent prior to his death).

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

Example 1. A owns the working interest in a large tract of land located in the United States. A's interest in the entire tract of land constitutes one property for purposes of section 614. In the northwest corner of this tract is an operating mine, X, producing an ore of beryllium, which is entitled to a percentage depletion rate of 22 percent under section 613(b)(2)(B). During 1971, A conducts an exploration program in the southeast corner of this same tract of land, and he incurs $400,000 of expenditures to which section 617(a)(1) applies in connection with this exploration program. A elects to deduct this amount as expenses under section 617(a). During 1971, A's *gross income from the property* computed under section 613 was $1 million, with respect to the property encompassing mine X and the area in which exploration was conducted. A's *taxable income from the property* computed under section 613, before adjustment to reflect the deductions taken with respect to the property during the year under section 617, was $400,000. The cost depletion deduction allowable and deducted with respect to the property during 1971 was $50,000. The amount of adjusted exploration expenditures chargeable to the exploratory mine (hereinafter referred to as mine Y) at the close of 1971 is $250,000, computed as follows:

Expenditures allowed as deductions under sec. 617(a)		$400,000
Gross income from the property	$1,000,000	
22 percent thereof	220,000	
Taxable income from the property, before adjustment to reflect deductions allowed under sec. 617 during year	400,000	
50 percent thereof—tentative deduction	200,000	
Taxable income from the property after adjustment to reflect deductions allowed under sec. 617 during year ($400,000 minus $400,000)	0	
Cost depletion allowed for year	50,000	
Amount by which allowance for depletion under sec. 611 was reduced on account of deductions under sec. 617 ($200,000 minus $50,000)		150,000
Adjusted exploration expenditures at end of 1971		250,000

Example 2. Assume the same facts as in example 1. Assume further that mine Y, with respect to which exploration expenditures were deducted in 1971, enters the producing stage in 1972, and that no deductions were taken under section 617 with respect to that mine after 1971. A does not make an election under section 617(b)(1)(A) during 1972. Assume that the depletion deduction which would be allowable for 1972 with respect to the property (which includes both mines) but for the application of section 617(b)(1)(B) is $100,000. Pursuant to section 617(b)(1)(B), this depletion deduction is disallowed. Therefore,

the amount of adjusted exploration expenditures with respect to mine Y at the end of 1972 is $150,000 ($250,000 less $100,000).

[T.D. 7192, 37 FR 12945, June 30, 1972]

§ 1.617–4 Treatment of gain from disposition of certain mining property.

(a) *In general.* (1) In general, section 617(d)(1) provides, that, upon a disposition of mining property, the lower of (i) the *adjusted exploration expenditures* (as defined in section 617(f)(1) and paragraph (d) of § 1.617–3) with respect to the property, or (ii) the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition, exceeds the adjusted basis of the property, shall be treated as gain from the sale of exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). However, any amount recognized under the preceding sentence shall not be included by the taxpayer in his *gross income from the property* for purposes of section 613. Generally, the ordinary income treatment applies even though in the absence of section 617(d) no gain would be recognized under any other provision of the Code. For example, if a corporation distributes mining property as a dividend, gain may be recognized as ordinary income to the corporation even though, in the absence of section 617, section 311(a) would preclude any recognition of gain to the corporation. For an exception to the recognition of gain with respect to dispositions which involve mineral production payments, see section 636 and the regulations thereunder. For the definition of the term *mining property*, see section 617(f)(2) and paragraph (c)(3), of § 1.617–3. For exceptions and limitations to the application of section 617(d)(1), see section 617(d)(3) and paragraph (c) of this section.

(2) In the case of a sale, exchange, or involuntary conversion of mining property, the gain to which section 617(d)(1) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the amount realized upon the disposition of the property over the adjusted basis of the property. In the case of a disposition of mining property other than by a manner described in the preceding sentence, the gain to which section 617(d)(1) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the fair market value of the property on the date of disposition over the adjusted basis of the property. In the case of a disposal of coal or domestic iron ore subject to a retained economic interest to which section 631(c) applies, the excess of the amount realized over the adjusted basis of the mining property shall be treated as equal to the gain, if any, referred to in section 631(c). For determination of the amount realized upon a disposition of mining property and nonmining property, see paragraph (c)(3)(i) of this section.

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

Example 1. On July 14, 1970, A purchased undeveloped mining property for $100,000. During 1970, A incurred with respect to the property, $50,000 of exploration expenditures which he deducts under section 617(a). In 1971, A incurred $150,000 of exploration expenditures with respect to the property which he deducts on his income tax return. On January 2, 1972, A sells the mining property to B for $250,000. A's gain on the sale is $150,000 ($250,000 amount realized minus $100,000 basis). Since the excess of the amount realized over the adjusted basis of the mining property is less than the adjusted exploration expenditures with respect to the property ($200,000), the entire gain is treated as ordinary income under section 617(d)(1).

Example 2. Assume the same facts as in example 1 except that A sells the mining property to B for $400,000, thereby realizing gain of $300,000 ($400,000 minus $100,000 basis). Since the amount of adjusted exploration expenditures with respect to the mining property ($200,000) is less than the amount realized upon its disposition ($300,000), an amount equal to the amount of adjusted exploration expenditures is treated as ordinary income under section 617(d)(1). The remaining $100,000 is treated by A without regard to section 617(d)(1).

(4) Section 617(d) does not apply to losses. Thus, section 617(d) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of mining property, nor does section 617(d) apply to a disposition of mining property other than by way of sale, exchange, or involuntary conversion if at

the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(b) *Disposition of portion of mining property.* (1) For purposes of section 617(d)(1) and paragraph (a) of this section, except as provided in subparagraph (3) of this paragraph, in the case of the disposition of a portion of a mining property (other than an undivided interest), the entire amount of the adjusted exploration expenditures with respect to such property shall be treated as attributable to such portion to the extent of the amount of the gain to which section 617(d)(1) applies. If the amount of the gain to which section 617(d)(1) applies is less than the amount of the adjusted exploration expenditures with respect to the property, the balance of the adjusted exploration expenditures shall remain subject to recapture in the hands of the taxpayer under the provisions of section 617 (b), (c), and (d). The disposition of a portion of a mining property (other than an undivided interest) includes the disposition of a geographical portion of a mining property. For example, assume that A owns an 80-acre tract of land with respect to which he has deducted exploration expenditures under section 617(a). If A were to sell the north 40 acres, the entire amount of the adjusted exploration expenditures with respect to the 80-acre tract would be treated as attributable to the 40-acre portion sold (to the extent of the amount of the gain to which section 617(d)(1) applies).

(2) For purposes of section 617(d)(1), except as provided in subparagraph (3) of this paragraph, in the case of the disposition of an undivided interest in a mining property (or portion thereof) a proportionate part of the adjusted exploration expenditures with respect to such property shall be treated as attributable to such undivided interest to the extent of the amount of the gain to which section 617(d)(1) applies. For example, assume that A owns an 80-acre tract of land with respect to which he has deducted exploration expenditures under section 617(a). If A were to sell an undivided 40 percent interest in such tract, 40 percent of the adjusted exploration expenditures with respect to the 80-acre tract would be treated as attributable to the 40 percent of the 80-acre tract disposed of (to the extent of the amount of the gain to which section 617(d)(1) applies).

(3) Section 617(d)(2) and subparagraphs (1) and (2) of this paragraph shall not apply to any expenditure to the extent that such expenditure relates neither to the portion (or interest therein) disposed of nor to any mine, in the property held by the taxpayer before the disposition, which has reached the producing stage. In any case where a taxpayer disposes of a mining property (or interest therein) and treats adjusted exploration expenditures with respect to the mining property as if they relate neither to the portion (or interest therein) disposed of nor to any mine, in the property held by the taxpayer before the disposition, which has reached the producing stage, the taxpayer shall attach to its return for the taxable year in which the disposition occurred, a statement which includes:

(i) A description of the portion (or interest therein) disposed of;

(ii) A description of the mineral property which included the portion (or interest therein) disposed of;

(iii) An itemization of all expenditures deducted under sections 617 and 615 with respect to such mineral property; and

(iv) A description of the location of all producing mines on such mineral property.

(c) *Exceptions.* (1)(i) Section 617(d)(3) provides, through incorporation by reference of the provisions of section 1245(b)(1), that no gain shall be recognized under section 617(d) upon a disposition by gift of mining property. For purposes of this subparagraph, the term *gift* means, except to the extent that subdivision (ii) of this subparagraph applies, a transfer of mining property which, in the hands of the transferee, has a basis determined under the provisions of section 1015 (a) or (d) (relating to basis of property acquired by gift). For reduction in amount of the charitable contribution in case of a gift of section 617 property, see section 170(e) and paragraph (c)(3) of § 1.170–1.

(ii) Where a disposition of mining property is in part a sale or exchange and in part a gift, the gain to which

section 617(d) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the amount realized upon the disposition of the property over the adjusted basis of such property.

(2) Section 617(d)(3) provides, through incorporation by reference of the provisions of section 1245(b)(2), that, except as provided in section 691 (relating to income in respect to a decedent), no gain shall be recognized under section 617(d) upon a transfer at death. For purposes of this paragraph, the term *transfer at death* means a transfer of mining property which property, in the hands of the transferee, has a basis determined under the provisions of section 1014(a) (relating to basis of property acquired from a decedent) because of the death of the transferor.

(3)(i) Section 617(d) provides, through incorporation by reference of the provisions of section 1245(b)(3), that upon a transfer of property described in subdivision (ii) of this subparagraph, the amount of gain taken into account by the transferor under section 617(d) shall not exceed the amount of gain recognized to the transferor on the transfer (determined without regard to section 617). For purposes of this subdivision, in case of a transfer of mining property and nonmining property in one transaction, the amount realized from the disposition of the mining property shall be deemed to be equal to the amount which bears the same ratio to the total amount realized as the fair market value of the mining property bears to the aggregate fair market value of all of the property transferred. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 617) which shall be recognized as ordinary income under section 617(d). Section 617(d)(3) does not apply to a disposition of mining property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code.

(ii) The transfers referred to in subdivision (i) of this subparagraph are transfers of mining property in which the basis of the mining property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(*a*) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). See subdivision (iii) of this subparagraph.

(*b*) Section 351 (relating to transfer to a corporation controlled by transferor).

(*c*) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(*d*) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(*e*) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(*f*) Section 721 (relating to transfers to a partnership in exchange for a partnership interest).

(*g*) Section 731 (relating to distributions by a partnership to a partner).

(iii) In the case of a distribution in complete liquidation of an 80-percent-or-more controlled subsidiary to which section 332 applies, the limitation provided in section 617(d)(3), through incorporation by reference of the provisions of section 1245(b)(3), is confined to instances in which the basis of the mining property in the hands of the transferee is determined under section 334(b)(1), by reference to its basis in the hands of the transferor. Thus, for example, the limitation may apply in respect of a liquidating distribution of mining property by an 80-percent-or-more controlled corporation to the parent corporation, but does not apply in respect of a liquidating distribution of mining property to a minority shareholder. Section 617(d)(3) does not apply to a liquidating distribution of property by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis in the stock of the subsidiary.

[T.D. 7192, 37 FR 12947, June 30, 1972]

EXCLUSIONS FROM GROSS INCOME

§ 1.621–1 Payments to encourage exploration, development, and mining for defense purposes.

(a) *General rule.* (1) Under section 621, a taxpayer shall exclude from gross income amounts which are paid to him:

(i) By the United States or by an agency or instrumentality of the United States,

(ii) As a grant, gift, bounty, bonus, premium, incentive, subsidy, loan, or advance,

(iii) For the encouragement of exploration for, or development or mining of, a critical and strategic mineral or metal,

(iv) Pursuant to or in connection with an undertaking by the taxpayer to explore for, or develop or produce, such mineral or metal and to expend or use any amounts so received for the purpose and in accordance with the terms and conditions upon which such amounts are paid, which undertaking has been approved by the United States or by an agency or instrumentality of the United States, and

(v) For which the taxpayer has accounted, or is required to account, to an appropriate agency of the United States Government for the expenditure or use thereof for the purpose and in accordance with the terms and conditions upon which such amounts are paid

In order for section 621 to apply, such amount must qualify under each of the foregoing subdivisions of this paragraph. Under section 621, there shall also be excluded from gross income any income attributable to the forgiveness or discharge of any indebtedness arising from amounts to which such section applies.

(2) Section 621 is applicable whether or not the payee is obligated to repay to the United States any portion or all of the amount so received. However, such section is not applicable to any loan or advance for the repayment of which the borrower's liability is unconditional and legally enforceable.

(3) Except as provided in paragraph (e) of this section any expenditure attributable to an amount received by a taxpayer to which section 621 applies shall not be deductible by the taxpayer as an expense under subtitle A of the Code, nor shall any such expenditure increase the basis of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition, or for computing depletion or depreciation (including amortization under section 168).

(b) *Allowance as part of purchase price.* (1) Section 621 is not applicable to any part of the purchase price of a critical and strategic mineral or metal which amount is received, whether before, on, or after delivery from the United States or any agency or instrumentality thereof, and irrespective of whether such purchase price is below, at, or above the currently prevailing market price.

(2) However, a payment of a separate and specific amount for the encouragement of exploration for, or development or mining of, a critical and strategic mineral or metal shall not be considered to be a part of the purchase price of such mineral or metal merely because such payment is added to, or included with, the payment of such purchase price.

(c) *Payments for expenditures previously deducted or capitalized.* (1) Where amounts described in section 621 and this section are paid to a taxpayer in reimbursement for expenditures previously allowed as a deduction, the taxpayer shall include in gross income that portion of such amounts which is equivalent to the deduction for such expenditures allowed to the taxpayer and which deduction resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws.

(2) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been deferred under sections 615 and 616 (relating to exploration and development expenditures) the taxpayer shall include in gross income that portion of such amounts which is equivalent to any deduction for such expenditures allowed to the taxpayer and which deduction resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A

of the Code (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws. The portion of such amounts, equivalent to expenditures which are reflected in the adjusted basis of the assets to which charged, shall be excluded from gross income, and such adjusted basis shall be decreased by the amount of such exclusion.

(3) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been charged to capital account (either to a depletable or depreciable account), there shall be included in the taxpayer's gross income that portion of such amounts which is equivalent to such capital expenditures that have been recovered through cost depletion or depreciation deductions and which deductions have resulted in a reduction of the taxpayer's taxes for any taxable year under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws. The portion of such amounts which is equivalent to the expenditures which are reflected in the adjusted basis of the asset to which charged shall be excluded from gross income. The adjusted basis of such assets shall be reduced by the amount of such exclusion from gross income.

(4) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been charged to a depletable capital account, such amounts shall be excluded to the extent such expenditures are recovered through depletion deductions computed under section 613 (relating to percentage depletion).

(5) The amount of reimbursed expenditures charged to an account (depletable or depreciable) and recovered through depletion or depreciation deductions for any taxable year shall be that proportion of the total deductions allowed with respect to such account that such reimbursed expenditures bear to the total amount in the account. For example, in 1956 A incurs exploration expenditures of $12,000 which he charges to a depletable capital account. This brings the total amount in this account to $36,000 which is the adjusted basis of the property on January 1, 1957. In 1957, A is allowed a deduction for cost depletion of $9,000 which resulted in a reduction of A's income taxes. One-third of this deduction is attributable to the $12,000 of exploration expenditures since they were a third of the total in the capital account on January 1, 1957. Therefore, on January 1, 1958, these exploration expenditures make up $9,000 of the remaining $27,000 in the account. If on January 1, 1958, A receives $12,000, which qualifies under section 621, in reimbursement for these exploration expenditures, he must report $3,000 as income and reduce the capital account by $9,000.

(d) *Definition*. As used in section 621 and this section, the term *critical and strategic minerals or metals* means minerals and metals which are considered by those departments, agencies, and instrumentalities of the United States charged with the encouragement of exploration for, and development and mining of, critical and strategic minerals and metals, to constitute critical and strategic minerals and metals for defense purposes. See, for example, 30 CFR 301.3 (Regulations for Obtaining Federal Assistance in Financing Explorations for Mineral Reserves, Excluding Organic Fuels, in the United States, its Territories and Possessions).

(e) *Repayments of amounts excluded under section 621*. Upon the repayment by the taxpayer of any portion of any amount to which section 621 applies and which portion has been expended for the purpose and in accordance with the terms and conditions upon which it was paid to the taxpayer, any expenditures attributable to such amount made by the taxpayer shall be treated as if such expenditures had been made at the time of such repayment. Such expenditures shall to the extent of the repayment be expensed or capitalized, as the case may be, in the order in which they were actually made or in such other manner as may be adopted by the taxpayer with the approval of the Commissioner.

SALES AND EXCHANGES

§ 1.631–1 Election to consider cutting as sale or exchange.

(a) *Effect of election.* (1) Section 631 (a) provides an election to certain taxpayers to treat the difference between the actual cost or other basis of certain timber cut during the taxable year and its fair market value as standing timber on the first day of such year as gain or loss from a sale or exchange under section 1231. Thereafter, any subsequent gain or loss shall be determined in accordance with paragraph (e) of this section.

(2) For the purposes of section 631(a) and this section, timber shall be considered cut at the time when in the ordinary course of business the quantity of timber felled is first definitely determined.

(3) The election may be made with respect to any taxable year even though such election was not made with respect to a previous taxable year. If an election has been made under the provisions of section 631(a), or corresponding provisions of prior internal revenue laws, such election shall be binding upon the taxpayer not only for the taxable year for which the election is made but also for all subsequent taxable years, unless the Commissioner on showing by the taxpayer of undue hardship permits the taxpayer to revoke his election for such subsequent taxable years. If the taxpayer has revoked a previous election, such revocation shall preclude any further elections unless the taxpayer obtains the consent of the Commissioner.

(4) Such election shall apply with respect to all timber which the taxpayer has owned, or has had a contract right to cut, for a period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) prior to when such timber is cut for sale or for use in the taxpayer's trade or business, irrespective of whether such timber or contract right was acquired before or after the election. (For purposes of the preceding sentence, the rules with respect to the holding period of property contained in section 1223 shall be applicable.) However, timber which is not cut for sale or for use in the taxpayer's trade or business (for example, firewood cut for the taxpayer's own household consumption) shall not be considered to have been sold or exchanged upon the cutting thereof.

(b) *Who may make election.* (1) A taxpayer who has owned, or has held a contract right to cut, timber for a period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) prior to when the timber is cut may elect under section 631(a) to consider the cutting of such timber during such year for sale or for use in the taxpayer's trade or business as a sale or exchange of the timber so cut. In order to have a *contract right to cut timber* within the meaning of section 631(a) and this section, a taxpayer must have a right to sell the timber cut under the contract on his own account or to use such cut timber in his trade or business.

(2) For purposes of section 631(a) and this section, the term *timber* includes evergreen trees which are more than six years old at the time severed from their roots and are sold for ornamental purposes, such as Christmas decorations. Section 631(a) is not applicable to evergreen trees which are sold in a live state, whether or not for ornamental purposes. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631(a). The term *evergreen trees* is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

(c) *Manner of making election.* The election under section 631(a) must be made by the taxpayer in his income tax return for the taxable year for which the election is applicable, and such election cannot be made in an amended return for such year. The election in the return shall take the form of a computation under the provisions of section 631(a) and section 1231.

(d) *Computation of gain or loss under the election.* (1) If the cutting of timber is considered as a sale or exchange pursuant to an election made under section 631(a), gain or loss shall be recognized to the taxpayer in an amount equal to the difference between the adjusted basis for depletion in the hands

of the taxpayer of the timber which has been cut during the taxable year and the fair market value of such timber as of the first day of the taxable year in which such timber is cut. The adjusted basis for depletion of the cut timber shall be based upon the number of units of timber cut during the taxable year which are considered to be sold or exchanged and upon the depletion unit of the timber in the timber account or accounts pertaining to the timber cut, and shall be computed in the same manner as is provided in section 611 and the regulations thereunder with respect to the computation of the allowance for depletion.

(2) The fair market value of the timber as of the first day of the taxable year in which such timber is cut shall be determined, subject to approval or revision by the district director upon examination of the taxpayer's return, by the taxpayer in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, methods of exploitation, degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer as of that particular day. Due consideration will be given to the factors and the principles involved in the determination of the fair market value of timber as described in the regulations under section 611.

(3) The fair market value as of the beginning of the taxable year of the standing timber cut during the year shall be considered to be the cost of such timber, in lieu of the actual cost or other basis of such timber, for all purposes for which such cost is a necessary factor. See paragraph (e) of this section.

(4) For any taxable year for which the cutting of timber is considered to be a sale or exchange of such timber under section 631(a), the timber so cut shall be considered as property used in the trade or business for the purposes of section 1231, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether the gain or loss considered to have resulted from the cutting of the timber will be considered to be gain or loss resulting from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) depends upon the application of section 1231 to the taxpayer for the taxable year. See section 1231 and the regulations thereunder.

(e) *Computation of subsequent gain or loss.* (1) In case the products of the timber are sold after cutting, either in the form of logs or lumber or in the form of manufactured products, the income from such actual sales shall be considered ordinary income. When the election under section 631(a) is in effect, the cost of standing timber cut during the taxable year is determined as if the taxpayer had purchased such timber on the first day of the taxable year. Thus, in determining the cost of the products so sold, the cost of the timber shall be the fair market value on the first day of the taxable year in which the standing timber was cut, in lieu of the actual cost or other basis of such timber.

(2) This is also the rule in case the products of the timber cut during one taxable year, with respect to which an election has been made under section 631(a), are sold during a subsequent taxable year, whether or not the election provided in section 631(a) is applicable with respect to such subsequent year. If the products of the timber cut during a taxable year with respect to which an election under section 631(a) was made were not sold during such year and are included in inventory at the close of such year, the fair market value as of the beginning of the year of the timber cut during the year shall be used in lieu of the actual cost of such timber in computing the closing inventory for such year and the opening inventory for the succeeding year. With respect to the costs applicable in the determination of the amount of such inventories, there shall be included the

fair market value of the timber cut, the costs of cutting, logging, and all other expenses incident to the cost of converting the standing timber into the products in inventory. See section 471 and the regulations thereunder. The fact that the fair market value as of the first day of the taxable year in which the timber is cut is deemed to be the cost of such timber shall not preclude the taxpayer from computing its inventories upon the basis of cost or market, whichever is lower, if such is the method used by the taxpayer. Nor shall it preclude the taxpayer from computing its inventories under the last-in, first-out inventory method provided by section 472 if such section is applicable to, and has been elected by, the taxpayer.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7730, 45 FR 72650, Nov. 3, 1980]

§ 1.631–2 Gain or loss upon the disposal of timber under cutting contract.

(a) *In general.* (1) If an owner disposes of timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal, under any form or type of contract whereby he retains an economic interest in such timber, the disposal shall be considered to be a sale of such timber. The difference between the amounts realized from disposal of such timber in any taxable year and the adjusted basis for depletion thereof shall be considered to be a gain or loss upon the sale of such timber for such year. Such adjusted basis shall be computed in the same manner as provided in section 611 and the regulations thereunder with respect to the allowance for depletion. See paragraph (e)(2) of this section for definition of *owner*. For the purpose of determining whether or not the timber disposed of was held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal the rules with respect to the holding period of property contained in section 1223 shall be applicable.

(2) In the case of such a disposal, the provisions of section 1231 apply and such timber shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) will depend upon the application of section 1231 to the taxpayer for the taxable year.

(b) *Determination of date of disposal.* (1) For purposes of section 631(b) and this section, the date of disposal of timber shall be deemed to be the date such timber is cut. However, if payment is made to the owner under the contract for timber before such timber is cut the owner may elect to treat the date of payment as the date of disposal of such timber. Such election shall be effective only for purposes of determining the holding period of such timber. Neither section 631(b) nor the election thereunder has any effect on the time of reporting gain or loss. See subchapter E, chapter 1 of the Code and the regulations thereunder. See paragraph (c)(2) of this section for the effect of exercising the election with respect to the payment for timber held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less. See paragraph (d) of this section for the treatment of payments received in advance of cutting.

(2) For purposes of section 631(b) and this section, the *date such timber is cut* means the date when in the ordinary course of business the quantity of timber felled is first definitely determined.

(c) *Manner and effect of election to treat date of payment as the date of disposal.* (1) The election to treat the date of payment as the date of disposal of timber shall be evidenced by a statement attached to the taxpayer's income tax return filed on or before the due date (including extensions thereof)

for the taxable year in which the payment is received. The statement shall specify the advance payments which are subject to the election and shall identify the contract under which the payments are made. However, in no case shall the time for making the election under section 631(b) expire before the close of March 21, 1958.

(2) Where the election to treat the date of payment as the date of disposal is made with respect to a payment made in advance of cutting, and such payment is made 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less from the date the timber disposed of was acquired, section 631(b) shall not apply to such payment irrespective of the date such timber is cut, since the timber was not held for more than six months prior to disposal.

(d) *Payments received in advance of cutting.* (1) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to cutting (such as advance royalty payments or minimum royalty payments) shall be treated under section 631(b) as realized from the sale of timber if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut. Such amounts will be so treated irrespective of whether or not an election has been made under paragraph (c) of this section to treat the date of payment as the date of disposal. For example, if no election has been made under paragraph (c) of this section, amounts received or accrued prior to cutting will be treated as realized from the sale of timber, provided the timber paid for is cut more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the date of acquisition of such timber.

(2) However, if the right to cut timber under the contract expires, terminates, or is abandoned before the timber which has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not as received from the sale of timber under section 631(b). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received or accrued. The recomputation shall be made in the form of an amended return where necessary.

(3)(i) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631(b) as amounts realized from the sale of timber to the extent attributable to timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(ii) The adjusted depletion basis attributable to the bonus shall be determined under the provisions of section 612 and the regulations thereunder. This subdivision may be illustrated as follows:

Example. Taxpayer A has held timber having a depletion basis of $90,000 for two months when he enters into a contract of disposal with B. B pays A a bonus of $5,000 upon the execution of the contract and agrees to pay X dollars per unit of timber to A as the timber is cut. A does not exercise the election to treat the date of payment as the date of disposal. It is estimated that there are 50,000 units of timber subject to the contract and that the total estimated royalties to be paid to A will be $95,000. A must report the bonus in the taxable year it is received or accrued by him. The portion of the basis of the timber attributable to the bonus is determined by the following formula:

$$\frac{\text{Bonus}}{\text{Bonus} + \text{amount of expected royalties}} \times \text{Basis of timber} = \text{Basis attributable to bonus}$$

$$\frac{\$5{,}000}{\$100{,}000} \times \$90{,}000 = \$4{,}500$$

(iii) To the extent attributable to timber not held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), such bonuses shall be treated as ordinary income subject to depletion. In order to determine the amount of the bonus allocable to timber not held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), the bonus shall be apportioned ratably over the estimated number of units of timber covered by the contract of disposal. This subdivision may be illustrated as follows:

Example. Assume under the facts stated in the example in subdivision (ii) of this subparagraph that B cuts 10,000 units of timber that have been held by A for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), or less. The amount of the bonus (as well as the royalties) attributable to these units must be reported as ordinary income subject to depletion. The amount of the bonus attributable to these units is determined by the following formula:

$$\frac{\text{Number of units cut held for six months or less}}{\text{Total units covered by the contract}} \times \text{Amount of bonus} = \text{Amount of bonus treated as ordinary income subject to depletion}$$

$$\frac{10{,}000}{50{,}000} \times \$5{,}000 = \$1{,}000$$

The amount of the depletion attributable to the portion of the bonus received for timber held for six months or less is determined by the following formula:

$$\frac{\text{Amount of bonus attributable to timber held for six month or less}}{\text{Total bonus}} \times \text{Adjusted basis for depletion of bonus} = \text{Depletion allowance on timber held for six months or less}$$

$$\frac{\$1{,}000}{\$5{,}000} \times \$4{,}500 = \$900$$

The amount of the bonus attributable to timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and which is treated under section 631 (b) as realized from the sale of timber would be $4,000. The gain on such amount is $400 ($4,000 − $3,600).

(iv) If the right to cut timber under the contract of disposal expires, terminates, or is abandoned before any timber is cut, the taxpayer shall treat the bonus received under such contract as ordinary income, not subject to depletion. Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such bonus was received. The recomputation shall be made in the form of an amended return where necessary.

(e) *Other rules for application of section.* (1) Amounts paid by the lessee for timber or the acquisition of timber cutting rights, whether designated as such or as a rental, royalty, or bonus, shall be treated as the cost of timber and constitute part of the lessee's depletable basis of the timber, irrespective of the treatment accorded such payments in the hands of the lessor.

(2) The provisions of section 631(b) apply only to an owner of timber. An owner of timber means any person who owns an interest in timber, including a sublessor and a holder of a contract to cut timber. Such owner of timber must

have a right to cut timber for sale on his own account or for use in his trade or business in order to own an interest in timber within the meaning of section 631(b).

(3) For purposes of section 631(b) and this section, the term *timber* includes evergreen trees which are more than 6 years old at the time severed from their roots and are sold for ornamental purposes such as Christmas decorations. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631(b). The term *evergreen trees* is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.631–3 Gain or loss upon the disposal of coal or domestic iron ore with a retained economic interest.

(a) *In general.* (1) The provisions of section 631(c) apply to an owner who disposes of coal (including lignite), or iron ore mined in the United States, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal under any form or type of contract whereby he retains an economic interest in such coal or iron ore. The difference between the amount realized from disposal of the coal or iron ore in any taxable year, and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272, shall be gain or loss upon the sale of the coal or iron ore. See paragraph (b)(4) of this section for the definition of *owner*. See paragraph (e) of this section for special rules relating to iron ore.

(2) In the case of such a disposal, the provisions of section 1231 apply, and the coal or iron ore shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether the coal or iron ore is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the coal or iron ore which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) will depend on the application of section 1231 to the taxpayer for the taxable year; *i.e.*, if the gains do not exceed the losses, they shall not be considered as gains and losses from sales or exchanges of capital assets but shall be treated as ordinary gains and losses.

(b) *Rules for application of section.* (1) For purposes of section 631(c) and this section, the date of disposal of the coal or iron ore shall be deemed to be the date the coal or iron ore is mined. If the coal or iron ore has been held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) on the date it is mined, it is immaterial that it had not been held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) on the date of the contract. There shall be no allowance for percentage depletion provided in section 613 with respect to amounts which are considered to be realized from the sale of coal or iron ore under section 631(c).

(2) The term *adjusted depletion basis* as used in section 631(c) and this section means the basis for allowance of cost depletion provided in section 612 and the regulations thereunder. Such *adjusted depletion basis* shall include exploration or development expenditures treated as deferred expenses under section 615(b) or 616(b), or corresponding provisions of prior income tax laws, and be reduced by adjustments under section 1016(a) (9) and (10), or corresponding provisions of prior income tax laws, relating to deductions of deferred expenses for exploration or development expenditures in the taxable year or any prior taxable years. The depletion unit of the coal or iron ore disposed of shall be determined under the rules provided in the regulations under section 611, relating to cost depletion.

(3)(i) In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties (except rents and royalties paid by a lessee with respect to coal or iron ore disposed of by the lessee as an *owner* under section 631(c)) shall be determined without regard to the provisions of section 631(c). Thus, the amounts of rents and royalties paid or incurred by a lessee with respect to coal or iron ore shall be excluded from the lessee's gross income from the property for the purpose of determining his percentage depletion without regard to the treatment of such rents or royalties in the hands of the recipient under this section. See section 613 and the regulations thereunder.

(ii)(*a*) However, a lessee who is also a sublessor may dispose of coal or iron ore as an *owner* under section 631(c). Rents and royalties paid with respect to coal or iron ore disposed of by such a lessee under section 631(c) shall increase the adjusted depletion basis of the coal or iron ore and are not otherwise deductible.

(*b*) The provisions of this subdivision may be illustrated by the following example:

Example. B is a sublessor of a coal lease; A is the lessor; and C is the sublessee. B pays A a royalty of 50 cents per ton. C pays B a royalty of 60 cents per ton. The amount realized by B under section 631(c) is 60 cents per ton and will be reduced by the adjusted depletion basis of 50 cents per ton, leaving a gain of 10 cents per ton taxable under section 631(c).

(4)(i) The provision of this section apply only to an owner who has disposed of coal or iron ore and retained an economic interest. For the purposes of section 631(c) and this section, the word *owner* means any person who owns an economic interest in coal or iron ore in place, including a sublessor thereof. A person who merely acquires an economic interest and has not disposed of coal or iron ore under a contract retaining an economic interest does not qualify under section 631(c). A successor to the interest of a person who has disposed of coal or iron ore under a contract by virtue of which he retained an economic interest in such coal or iron ore is also entitled to the benefits of this section. Section 631(c) and this section shall not apply with respect to any income realized by any owner as co-adventurer, partner, or principal in the mining of such coal or iron ore.

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

Example 1. A owns a tract of coal land in fee. A leases to B the right to mine all the coal in this tract in return for a royalty of 30 cents per ton. B subleases his right to mine coal in this tract to C, who agrees to pay A 30 cents per ton and to pay to B an additional royalty of 10 cents per ton. Section 631(c) applies to the royalties of both A and B, if the other requisites of the section have been met.

Example 2. Assume the same facts as in example 1, except that A dies leaving his royalty interest to D. D has an economic interest in the coal in place and qualifies for section 631(c) treatment with respect to his share of the royalties since he is a successor in title to A.

Example. Assume the same facts as in example 1, except that E agrees to pay a sum of money to C in return for 10 cents per ton on the coal mined by C. E has an economic interest, since he must look solely to the extraction of the coal for the return of his investment. However, E has not made a disposal of coal under a contract wherein he retains an economic interest, and, therefore does not qualify under section 631(c). E is entitled to depletion on his royalties.

(c) *Payments received in advance of mining.* (1)(i) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to mining shall be treated under section 631(c) as received from the sale of coal or iron ore if the contract of disposal provides that such amounts are to be applied as payment for coal or iron ore subsequently mined. For example, advance royalty payments or minimum royalty payments received by an owner of coal or iron ore qualify under section 631(c) where the contract of disposal grants the lessee the right to apply such royalties in payment of coal or iron ore mined at a later time.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. A acquires coal rights on January 1. On January 30, A enters into a contract of disposal providing that mining shall begin

July 2, and mining actually begins no earlier. Any advance payments which A receives qualify under section 631(c).

(2) However, if the right to mine coal or iron ore under the contract expires, terminates, or is abandoned before the coal or iron ore which had been paid for is mined, the taxpayer shall treat payments attributable to the unmined coal or iron ore as ordinary income and not as received from the sale of coal or iron ore under section 631(c). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received. The recomputation shall be made in the form of an amended return where necessary.

(3) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631(c) as received from the sale of coal or iron ore to the extent attributable to coal or iron ore held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). The rules contained in paragraph (d) of § 1.631–2 relating to bonuses in the case of contracts for the disposal of timber shall be equally applicable in the case of bonuses received for the grant of a contract of disposal of coal or iron ore under this section.

(d) *Nonapplication of section.* Section 631(c) shall not affect the application of the provisions of subchapter G, chapter 1 of the Code, relating to corporations used to avoid income tax on shareholders. For example, for the purposes of applying section 543 (relating to personal holding companies), the amounts received from a disposal of coal or iron ore subject to section 631(c) shall be considered as mineral royalties. The determination of whether an amount received under a contract to which section 631(c) applies is *personal holding company income* shall be made in accordance with section 543 and the regulations thereunder, without regard to section 631(c) or this section. See also paragraph (e) of § 1.272–1.

(e) *Special rules with regard to iron ore.* (1) With regard to iron ore, section 631(c) and this section apply only to amounts received or accrued in taxable years beginning after December 31, 1963, attributable to iron ore mined in such taxable years.

(2) Section 631(c) and this section apply only to disposals of iron ore mined in the United States.

(3) For the purposes of section 631(c) and this section, iron ore is any ore which is used as a source of iron, including but not limited to taconite and jaspilite.

(4) Section 631(c) shall not apply to any disposal of iron ore to a person whose relationship to the person disposing of such iron ore would result in the disallowance of losses under section 267 or 707(b).

(5) Section 631(c)(2) results in the denial of section 631(c) treatment in the case of a contract for disposal of iron ore entered into with a person owned or controlled, directly or indirectly, by the same interests which own or control the person disposing of the iron ore, even though section 631(c) treatment would not be denied under the provisions of section 631(c)(1). For example, section 631(c) treatment is denied in the case of a contract for disposal of iron ore entered into between two *brother and sister* corporations, or a parent corporation and its subsidiary. The presence or absence of control shall be determined by applying the same standards as are applied under section 482 (relating to the allocation of income and deductions between taxpayers).

[T.D. 6841, 30 FR 9307, July 27, 1965, as amended by T.D. 7730, 45 FR 72650, Nov. 3, 1980]

§ 1.632–1 Tax on sale of oil or gas properties.

(a) If the taxpayer, by prospecting and locating claims or by exploring or discovering undeveloped claims, has demonstrated the principal value of oil or gas property, which prior to his efforts had a relatively minor value, the portion of the tax (or, in the case of taxable years beginning before Jan. 1, 1971, the surtax) imposed by section 1 attributable to a sale of such property, or of any interest of the taxpayer therein, shall not exceed 33 percent (or, in the case of taxable year beginning before Jan. 1, 1971, 30 percent) of the selling price of such property or such interest. Shares of stock in a corporation owning oil or gas property do not constitute an interest in such property. To determine the application of section

632 to a particular case, the taxpayer should first compute the tax (or surtax) imposed by section 1 upon his entire taxable income, including the taxable income from any sale of such property or interest therein, without regard to section 632. The proportion of the tax (or surtax) so computed, indicated by the ratio which the taxpayer's taxable income from the sale of the property or interest therein, computed as prescribed in this section, bears to his total taxable income is the portion of the tax attributable to such sale and, if it exceeds 33 percent (or 30 percent) of the selling price of such property or interest, such portion of the tax (or surtax) shall be reduced to that amount.

(b) In determining the portion of the taxable income attributable to the sale of such oil or gas property or interest therein, the taxpayer shall allocate to the gross income derived from such sale, and to the gross income derived from all other sources, the expenses, losses, and other deductions properly appertaining thereto and shall apply any general expenses, losses, and deductions (which cannot properly be otherwise allocated) ratably to the gross income from all sources. The gross income derived from the sale of such oil or gas property or interest therein, less the deductions properly appertaining thereto and less its proportion of any general deductions, shall be the taxable income attributable to such sale. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7117, 36 FR 9421, May 25, 1971]

MINERAL PRODUCTION PAYMENTS

§ 1.636–1 Treatment of production payments as loans.

(a) *In general.* (1)(i) For purposes of subtitle A of the Internal Revenue Code of 1954, a production payment (as defined in paragraph (a) of § 1.636–3) to which this section applies shall be treated as a loan on the mineral property (or properties) burdened thereby and not as an economic interest in mineral in place, except to the extent that § 1.636–2 or paragraph (b) of this section applies. See paragraph (b) of § 1.611–1. A production payment carved out of mineral property which remains in the hands of the person carving out the production payment immediately after the transfer of such production payment shall be treated as a mortgage loan on the mineral property burdened thereby. A production payment created and retained upon the transfer of the mineral property burdened by such production payment shall be treated as a purchase money mortgage loan on the mineral property burdened thereby. Such production payments will be referred to hereinafter in the regulations under section 636 as carved-out production payments and retained production payments, respectively. Moreover, in the case of a transaction involving a production payment treated as a loan pursuant to this section, the production payment shall constitute an item of income (not subject to depletion), consideration for a sale or exchange, a contribution to capital, or a gift if in the transaction a debt obligation used in lieu of the production payment would constitute such an item of income, consideration, contribution to capital, or gift, as the case may be. For the definition of the term *transfer* see paragraph (c) of § 1.636–3.

(ii) The payer of a production payment treated as a loan pursuant to this section shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income and *gross income from the property* (see section 613(a)) for the taxable year so applied. The payee shall include in his gross income (but not *gross income from the property*) amounts received with respect to such production payment to the extent that such amounts would be includible in gross income if such production payment were a loan. The payer and payee shall determine their allowable deductions as if such production payment were a loan. See section 483, relating to interest on certain deferred payments in the case of a production payment created and retained upon the transfer of the mineral property burdened thereby, or in the case of a production payment transferred in exchange for

property. See section 1232 in the case of a production payment which is originally transferred by a corporation at a discount and is a capital asset in the hands of the payee. In the case of a carved-out production payment treated as a mortgage loan pursuant to this section, the consideration received for such production payment by the taxpayer who created it is not included in either gross income or *gross income from the property* by such taxpayer.

(2) If a production payment is treated as a loan pursuant to this section, no transfer of such production payment or any property burdened thereby (other than a transfer between the payer and payee of the production payment which, if the production payment were a loan, would extinguish the loan) shall cause it to cease to be so treated. For example, A sells operating mineral interest X to B for $100,000, subject to a $500,000 retained production payment payable out of X. Subsequently, A sells the production payment to C, and B sells X to D. C and D must treat the production payment as a purchase money mortgage loan.

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

Example 1. On December 22, 1972, A, a cash-basis calendar-year taxpayer who owns operating mineral interest X, carves out of X a production payment in favor of B for $300,000 plus interest, payable out of 50 percent of the first oil produced and sold from X. In 1972, A treats the $300,000 received from B for the production payment as the proceeds of a mortgage loan on X. In 1973, A produces and sells 125,000 barrels of oil for $373,500. A pays B $186,750 with respect to the production payment, $168,750 being principal and $18,000 being interest. In computing his gross income and *gross income from the property* for the year 1973, A includes the $373,500 and takes as deductions the allowable expenses paid in production of such mineral. A also takes a deduction under section 163 for the $18,000 interest paid with respect to the production payment. For 1973, B would treat $18,000 as ordinary income not subject to the allowance for depletion under section 611.

Example 2. Assume the same facts as in example 1 except that the principal amount of the production payment is to be increased by the amount of the ad valorem tax on the mineral attributable to the production payment which is paid by B. Under State law, the ad valorem tax with respect to the mineral attributable to the production payment is a liability of the owner of the production payment. For 1973, B inlcudes the amount received with respect to such taxes as income and takes a deduction under section 164 for the taxes paid by him. Since the ad valorem taxes paid by B are his liability under State law, A may not take a deduction under section 164 for such taxes.

Example 3. On December 31, 1974, C, a calendar-year taxpayer and owner of the operating mineral interest Y, sells Y to D for $10,000 cash and retains a $40,000 production payment payable out of Y. At the time D acquires the property, it is estimated that 500,000 tons of mineral are recoverable from the property. In 1975, D produces a total of 50,000 tons from the property. D's cost depletion for 1975 is $5,000 determined as follows:

Basis in property: $50,000	
Total recoverable units: 500,000	
Rate of depletion per ton:	$0.10 ($50,000 ÷ 500,000)
Cost depletion for year:	$5,000 ($0.10 × 50,000)

(b) *Exception.* (1) A production payment carved out of a mineral property (or properties) for exploration or development of such property (or properties) shall not be treated as a mortgage loan under section 636(a) and this section to the extent *gross income from the property* (for purposes of section 613) would not be realized by the taxpayer creating such production payment, under the law existing at the time of the creation of such production payment, in the absence of section 636(a). See section 83 and the regulations thereunder, relating to property transferred in connection with the performance of services. For purposes of section 636(a) and this paragraph, an expenditure is for exploration or development to the extent that it is necessary for ascertaining the existence, location, extent, or quality of any deposit of mineral or is incident to and necessary for the preparation of a deposit for the production of mineral. However, an expenditure which relates primarily to the production of mineral (as, for example, in the case of a pilot water flood program with respect to the secondary recovery of oil) is not for exploration or development as those terms are used in section 636(a) and this paragraph. Whether or not a production payment is carved out for exploration or development shall be determined in light of all relevant facts and circumstances, including any prior production of mineral from the

mineral deposit burdened by the production payment. However, a production payment shall not be treated as carved out for exploration or development to the extent that the consideration for the production payment:

(i) Is not pledged for use in the future exploration or development of the mineral property (or properties) which is burdened by the production payment;

(ii) May be used for the exploration or development of any other property, or for any other purpose than that described in subdivision (i) of this subparagraph;

(iii) Does not consist of a binding obligation of the payee of the production payment to pay expenses of the exploration or development described in subdivision (i) of this subparagraph; or

(iv) Does not consist of a binding obligation of the payee of the production payment to provide services, materials, supplies, or equipment for the exploration or development described in subdivision (i) of this subparagraph.

(2) In the case of a carved-out production payment only a portion of which is subject to the exception provided in this paragraph, the rules contained in paragraph (a) of this section with respect to the treatment of income and deductions where a production payment is treated as a loan shall apply to the portion of the taxpayer's income or expenses attributable to the production payment which bears the same ratio to the total amount of such income or expenses, as the case may be, as the amount of the consideration for the production payment which would have been realized as income in the absence of section 636(a), by the taxpayer creating such production payment, bears to the total consideration to the taxpayer for the production payment. For example, A, owner of a mineral property, carves out a production payment in favor of B for $600,000 plus interest in return for $600,000 cash. A pledges to use $400,000 for the development of the burdened mineral property. In each of the payout years loan treatment applies to one-third of the income and expenses of A and B attributable to the production payment.

(c) *Treatment upon disposition or termination of mineral property burdened by production payment.* (1)(i) In the case of a sale or other disposition of the mineral property burdened by a production payment treated as a loan pursuant to this section, there shall be included in determining the amount realized upon such disposition an amount equal to the outstanding principal balance of such production payment on the date of such disposition. However, if such a production payment is created in connection with the disposition, the amount to be so included shall be the fair market value of the production payment, rather than its principal amount, if the fair market value is established by clear and convincing evidence to be an amount which differs from the principal amount. See section 1001 and the regulations thereunder. In determining the cost of the transferred mineral property to the transferee for purposes of section 1012, the outstanding principal balance of the production payment shall be included in the cost.

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

Example 1. A, the owner of mineral property X which is burdened by a carved-out production payment to which section 636(a) applies having an outstanding principal balance of $10,000, sells property X to B, an individual, for $100,000 cash. The amount realized by A on the sale of property X is $110,000. B's basis in property X for cost depletion and other purposes is also $110,000.

Example 2. Assume the same facts as in example 1 except that the production payment is retained by A in connection with the sale of property X to B, that section 636(b) applies to the production payment, that the production payment includes, in addition to the $10,000 principal amount, an additional amount equivalent to interest at a rate which precludes application of section 483, and that the fair market value of the production payment is $9,000. The amount realized by A on the sale of property X is $109,000. B's basis in property X for cost depletion and other purposes is $110,000. A's basis in the retained production payment is $9,000. If the production payment is paid in full, A realizes income of $1,000 plus the amount equivalent to interest, which income is includible in A's gross income at the time when such amounts would be so includible if such production payment were a loan.

Example 3. C, the owner of mineral property Y, sells the mineral property to D for $500,000 cash. Property Y is burdened by a

carved-out production payment with an outstanding principal balance of $600,000, 40 percent of the consideration for which was pledged for the development of property Y. The amount realized by C on the sale is $860,000 ($500,000 plus $600,000 × .60). D's basis in property Y for cost depletion and other purposes is $860,000.

(2) In the case of the expiration, termination, or abandonment of a mineral property burdened by a production payment treated as a loan pursuant to this section, for purposes of determining the amount of any loss under section 165 with respect to the burdened mineral property the adjusted basis of such property shall be reduced (but not below zero) by an amount equal to the outstanding principal balance of such production payment on the date of such expiration, termination, or abandonment. Thus, in example 2 in subparagraph (1)(ii) of this paragraph, if B abandons the mineral property at a time when $5,000 of the principal amount of the production payment remains unsatisfied, B's adjusted basis immediately before the abandonment would be reduced by $5,000 for determining his loss on abandonment under section 165.

(3) In the case of a transfer of a portion of the mineral property burdened by a production payment treated as a loan pursuant to this section, such production payment shall be apportioned between the transferred portion and the retained portion by allocating to such transferred portion that part of the outstanding principal balance of the production payment which bears the same ratio to such balance as the value of such transferred portion (exclusive of any value not related to the burdened mineral) bears to the total value of the burdened mineral property (exclusive of any value not related to the burdened mineral).

(4) In general, the entire amount of gain or loss realized pursuant to this paragraph shall be recognized in the taxable year of such realization. See section 1211 for limitation on capital losses. This subparagraph shall not affect the applicability of rules providing exceptions to the recognition of gain or loss which has been realized (e.g., a transfer to which section 351 or 1031 applies). However, see section 357(c) with respect to the assumption of liabilities in excess of basis in certain tax-free exchanges. Furthermore, in the case of a transaction which otherwise qualifies, gain realized on a transfer of a mineral property to which section 636(b) applies may be returned on the installment method under section 453.

[T.D. 7261, 38 FR 5463, Mar. 1, 1973]

§ 1.636–2 Production payments retained in leasing transactions.

(a) *Treatment by lessee.* In the case of a production payment (as defined in paragraph (a) of § 1.636–3) which is retained by the lessor in a leasing transaction (including a sublease or the exercise of an option to acquire a lease or sublease), the lessee (or his successors in interest) shall treat the retained production payment for purposes of subtitle A of the Code as if it were a bonus granted by the lessee to the lessor payable in installments. Accordingly, the lessee shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income for the taxable year so applied. The lessee shall capitalize each payment (including any interest and any amounts added on to the production payment other than amounts for which the lessee would be liable in the absence of the production payment) paid or incurred with respect to such production payment. See paragraph (c)(5)(ii) of § 1.613–2 for rules relating to computation of percentage depletion with respect to a mineral property burdened by a production payment treated as a bonus under section 636(c) and this section.

(b) *Treatment by lessor.* The lessor who retains a production payment in a leasing transaction (or his successors in interest) shall treat the production payment without regard to the provisions of section 636 and § 1.636–1. Thus, the production payment will be treated as an economic interest in the mineral in place in the hands of the lessor (or his successors in interest) and the receipts in discharge of the production payment will constitute ordinary income subject to depletion.

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

Example. In 1971, A leases a mineral property to B reserving a one-eighth royalty and a production payment (as defined in §1.636–3(a)) with a principal amount of $300,000 plus an amount equivalent to interest. In 1972, B pays to A $60,000 with respect to the principal amount of the production payment plus $16,350 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1972 and subsequent years will include (subject to proper adjustment under section 1016) the $76,350 paid to A. In 1973, B pays to A $60,000 with respect to the principal amount of the production payment plus $12,750 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1973 and subsequent years will include (subject to proper adjustment under section 1016) the $72,750 paid to A. The $76,350 received by A in 1972, and the $72,750 received by A in 1973, will constitute ordinary income subject to depletion in the hands of A in the years of receipt of such amounts by A.

[T.D. 7261, 38 FR 5465, Mar. 1, 1973]

§ 1.636–3 Definitions.

For purposes of section 636 and the regulations thereunder:

(a) *Production payment*. (1) The term *production payment* means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in such mineral in place. It may burden more than one mineral property, and the burdened mineral property need not be an operating mineral interest. Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby. A right to mineral in place which can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment may be limited by a dollar amount, a quantum of mineral, or a period of time. A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property. The term *production payment* includes payments which are commonly referred to as *in-oil payments*, *gas payments*, or *mineral payments*.

(2) A right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of section 636 and the regulations thereunder, regardless of the language used to describe such right, the method of creation of such right, or the form in which such right is cast (even though such form is that of an operating mineral interest). Whether or not a right is in substance economically equivalent to a production payment shall be determined from all the facts and circumstances. An example of an interest which is to be treated as a production payment under this subparagraph is that portion of a *royalty* which is attributable to so much of the rate of the royalty which exceeds the lowest possible rate of the royalty at any subsequent time (disregarding any reductions in the rate of the royalty which are based solely upon changes in volume of production within a specified period of no more than 1 year). For example, assume that A creates a royalty with respect to a mineral property owned by A equal to 5 percent for 5 years and thereafter equal to 4 percent for the balance of the life of the property. An amount equal to 1 percent for 5 years shall be treated as a production payment. On the other hand, if A leases a coal mine to B in return for a royalty of 30 cents per ton on the first 500,000 tons of coal produced from the mine in each year and 20 cents per ton on all coal in excess of 500,000 tons produced from the mine in each year, the fact that the royalty may decline to 20 cents per ton on some of the coal in each year does not result in a production payment of 10 cents per ton of coal on the first 500,000 tons in any year. Another example of an interest which is to be treated as a production payment under this subparagraph is the interest in a partnership engaged in operating oil properties of a partner who provides capital for the partnership if such interest is subject to a right of another person or persons to acquire or terminate it upon terms which merely provide for such partner's recovery of

his capital investment and a reasonable return thereon.

(b) *Property*. The term *property* has the meaning assigned to it in section 614(a), without the application of section 614 (b), (c), or (e).

(c) *Transfer*. The term *transfer* means any sale, exchange, gift, bequest, devise, or other disposition (including a distribution by an estate or a contribution to or distribution by a corporation, partnership, or trust).

[T.D. 7261, 38 FR 5465, Mar. 1, 1973]

§ 1.636–4 Effective dates of section 636.

(a) *In general*. Except as provided hereinafter in this section, section 636 and §§ 1.636–1, 1.636–2, and 1.636–3 apply to production payments created on or after August 7, 1969, other than production payments created before January 1, 1971, pursuant to a binding contract entered into before August 7, 1969.

(b) *Election*. Under section 503(c)(2) of the Tax Reform Act of 1969, if the taxpayer so elects, section 636(a) of the Code and §§ 1.636–1 and 1.636–3 apply to all production payments carved out by him after the beginning of his last taxable year ending before August 7, 1969, including such production payments created after such date pursuant to a binding contract entered into before such date. No interest shall be allowed on any refund or credit of any overpayment of tax resulting from an election under section 503(c)(2) for any taxable year ending before August 7, 1969. The provisions of this paragraph may be illustrated by the following example:

Example. A, a fiscal-year taxpayer whose taxable year ends on October 31, carved out and sold (from a producing property) production payments on October 1, 1967, and on July 9, 1969. On August 1, 1969, A entered into a binding contract to create another carved-out production payment (from a different producing property) and the production payment was carved out on December 22, 1969. If A elects under section 503(c)(2), the production payments carved out on July 9, 1969, and December 22, 1969, are treated as mortgage loans under section 636(a). The production payment carved out on October 1, 1967, is not treated as a mortgage loan under section 636(a) because it was carved out before the beginning of A's last taxable year ending before August 7, 1969.

(c) *Time and manner of making election*. (1) Any election under section 503(c)(2) of the Tax Reform Act of 1969 must be made not later than May 30, 1973.

(2) An election under section 503(c)(2) shall be made by a statement attached to the taxpayer's income tax return (or amended return) for the first taxable year in which the taxpayer created a production payment (i) to which the election applies, and (ii) which, in the absence of section 636, would not have been treated as a loan. A statement shall also be attached to an amended return for each subsequent taxable year for which he has filed his income tax return before making the election, but only if his tax liability for such year is affected by the election. Each such statement shall indicate the taxpayer's election under section 503(c)(2), and shall identify by date, amount, parties, and burdened mineral properties all production payments described in subdivisions (i) and (ii) of this subparagraph which have been created by the date on which the statement is filed. However, a taxpayer who, prior to the date on which permanent regulations under this section are published in the FEDERAL REGISTER, made a valid election under section 503(c)(2) pursuant to §§ 301.9100–17T and 301.9100–18T of this chapter are not required to amend statements previously furnished which meet the requirements of § 301.9100–17T(b)(1)(ii) of this chapter unless requested to do so by the district director. In applying the election to the taxable years affected, there shall be taken into account the effect that any adjustments resulting therefrom have on other items affected thereby and the effect that adjustments of any such items have on other taxable years. In the case of a member of a consolidated return group (as defined in paragraph (a) of § 1.1502–1), section 503(c)(2) and paragraphs (b), (c), and (d) of this section shall be applied as if such member filed a separate return.

(d) *Revocation of election*. A valid election under section 503(c)(2) shall be binding upon the taxpayer unless consent to revoke the election is obtained from the Commissioner. The application to revoke such election must be made in writing to the Commissioner of Internal Revenue, Washington, D.C. 20224, not later than May 30, 1973. Such

application must set forth the reasons therefor and a recomputation of the tax reflecting such revocation for each prior taxable year affected by the revocation, whether or not the period of limitations for credit or refund or assessment and collection has expired with respect to such taxable year. Consent shall not be given in any case in which the revocation would result in an increase in the taxpayer's tax liability for a taxable year for which such period of limitations has expired unless the taxpayer waives his right to assert the statute of limitations.

(e) *Special rule.* (1) Except as provided in subparagraph (2) of this paragraph, in the case of a taxpayer who does not make the election provided in section 503(c)(2) of the Tax Reform Act of 1969, section 636 of the Code applies to production payments carved out during the taxable year which includes August 7, 1969, as provided in paragraph (a) of this section, only to the extent that the aggregate amount of such production payments exceeds the lesser of:

(i) The excess of:

(*a*) The aggregate amount of production payments carved out and sold by the taxpayer during the 12-month period immediately preceding his taxable year which includes August 7, 1969, over

(*b*) The aggregate amount of production payments carved out and sold before August 7, 1969, by the taxpayer during his taxable year which includes such date, or

(ii) The amount necessary to increase the amount of the taxpayer's gross income within the meaning of chapter 1 of subtitle A of the Code, for his taxable year which includes August 7, 1969, to an amount equal to the amount of his deductions (other than any deduction under section 172) allowable for such year under such chapter

In applying the preceding sentence, production payments carved out for exploration or development are to be taken into account only to the extent, if any, that *gross income from the property* (for purposes of section 613) would have been realized by the taxpayer creating such production payment under the law existing at the time of the creation of such production payment, in the absence of section 636(a).

(2) Subparagraph (1) of this paragraph shall not apply for any taxable year for purposes of determining the amount of any deduction for cost or percentage depletion allowable under section 611 or the limitation on any foreign tax credit under section 904.

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

Example 1. (a) A, a calendar-year taxpayer who does not make the election provided in section 503(c)(2) of the Tax Reform Act of 1969, carves out and sells on December 31, 1968, a $500,000 production payment. Further, A carves out and sells on March 4, 1969, a $300,000 production payment, and on November 14, 1969, a $150,000 production payment. None of the production payments are carved out for exploration or development. During 1969, A has gross income of $600,000 (determined initially for this purpose by treating the $150,000 production payment carved out on November 14, 1969, as a loan) and allowable deductions of $700,000.

(b) The provisions of section 636 do not apply to a portion of the November 14, 1969, production payment for purposes other than section 611 and section 904 of the Code, determined as follows:

(1) Amount of production payment carved out in 1969 on or after August 7, 1969	$150,000
(2) Amount of production payment carved out during 1968	500,000
(3) Amount of production payment carved out during 1969 taxable year before August 7, 1969	300,000
(4) Item (2) minus item (3)	200,000
(5) Excess of allowable deductions over gross income for 1969	100,000
(6) Amount of production payment carved out in 1969 on or after August 7, 1969, to which section 636 does not apply (lesser of items (1), (4), and (5))	100,000

Thus, A will not treat $100,000 of the consideration received for the production payment carved out on November 14, 1969, as a loan and as a result his gross income for 1969 will be $700,000. However, in computing percentage depletion, A will not include the $100,000 in *gross income from property* and in computing cost depletion A will not include the mineral units attributable thereto. Nor, will A include the $100,000 in determining the limitation on foreign tax credit under section 904.

Example 2. Assume the same facts as in example 1 except that for taxable year 1969 A's gross income (determined initially for this purpose by treating the November 14, 1969, production payment as a loan) exceeds the amount of his allowable deductions under

chapter 1 of subtitle A of the Code. The entire amount of the November 14, 1969, production payment is treated as a mortgage loan under section 636(a).

[T.D. 7261, 38 FR 5465, Mar. 1, 1973, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

CONTINENTAL SHELF AREAS

§ 1.638–1 Continental Shelf areas.

(a) *General rule*. For purposes of applying any provision of chapter 1, 2, 3, or 24 (including section 861(a)(3), 862(a)(3), 1441, 3402, or other provisions dealing with the performance of personal services), with respect to mines, oil and gas wells, and other natural deposits:

(1) *United States and possession of the United States*. The terms *United States* and *possession of the United States* when used in a geographical sense include the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States or such possession and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration for, and exploitation of, natural resources. The terms *Continental Shelf of the United States* and *Continental Shelf of a possession of the United States*, as used in this section, refer to the seabed and subsoil included, respectively, in the terms *United States* and *possession of the United States*, as provided in the preceding sentence.

(2) *Foreign country*. The term *foreign country* when used in a geographical sense includes the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the foreign country and over which such foreign country has exclusive rights, in accordance with international law, with respect to the exploration for, and exploitation of, natural resources, but this sentence applies only if such foreign country exercises, directly or indirectly, taxing jurisdiction with respect to such exploration or exploitation. The term *foreign continental shelf*, as used in this section, refers to the seabed and subsoil described in the preceding sentence. A foreign country is not to be treated as a country contiguous to the United States by reason of the application of section 638 and this section.

(b) *Exercise of taxing jurisdiction*. For purposes of paragraph (a)(2) of this section, the exercise, directly or indirectly, of taxing jurisdiction with respect to the exploration for, or exploitation of, natural resources is deemed to include (but is not limited to) those cases in which a foreign country:

(1) Imposes a tax upon assets, equipment, or other property connected with or income derived from such exploration or exploitation, or

(2) Requires natural resources referred to in paragraph (a)(2) of this section to be transported to points within its landward boundaries and then levies a tax upon such natural resources or upon the income derived from the sale thereof

A foreign country which, for purposes of paragraph (a)(2) of this section, exercises taxing jurisdiction by the imposition of tax upon any person, property, or activity engaged in or related to the exploration for, or exploitation of, natural resources in the seabed or subsoil referred to in paragraph (a)(2) of this section, or the income therefrom of any taxpayer, is deemed to exercise taxing jurisdiction over all such persons, property, and activities and over all income therefrom of all such taxpayers; thus, for example, a foreign country which imposes tax upon a person engaged in exploitation of oil and gas wells in its seabed and subsoil referred to in paragraph (a)(2) of this section is deemed to exercise taxing jurisdiction over property related to exploration for other natural deposits in such seabed and subsoil. A foreign country is deemed to be imposing tax upon a person, property, activity, or income described in the preceding sentence if such foreign country exempts such person, property, activity, or income from tax for a period not in excess of 10 years from the commencement of such exploration or exploitation. Except in the case of a foreign country which is deemed under the preceding sentence to impose tax by virtue of an exemption for a period not in excess of 10 years, a foreign country which exempts all persons, property, and activities engaged in or related to the exploration for, or exploitation of, natural resources in the seabed or subsoil referred to in paragraph (a)(2) of

this section and the income therefrom, from taxation is deemed not to be exercising, directly or indirectly, taxing jurisdiction for purposes of paragraph (a)(2) of this section. For purposes of paragraph (a)(2) of this section, the exercise of taxing jurisdiction with respect to any type of tax constitutes the exercise of taxing jurisdiction with respect to all types of taxes. However, a royalty or other charge (whether payable in a lump sum or over a period of time or in amounts dependent upon the volume of production of natural resources) for the right to explore for or exploit natural resources does not constitute a tax.

(c) *Scope.* (1) For purposes of applying this section, persons, property, or activities which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits need not be physically upon, connected, or attached to the seabed or subsoil referred to in subparagraph (1) or (2) of paragraph (a) of this section to be deemed to be within the United States, a possession of the United States, or a foreign country, as the case may be, to the extent provided in subparagraph (2) or (3) and subparagraph (4) of this paragraph.

(2) Persons, property, or activities which are not in a foreign country (determined without regard to section 638 or this section), and which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits of the seabed or subsoil referred to in paragraph (a)(1) of this section, are generally within the United States or a possession of the United States, as the case may be, unless such persons, property, or activities are solely involved in or constitute transportation to (or from) the site of exploration or exploitation from (or to) a foreign country, other than transportation on a regular basis from (or to) a base of operations.

(3) Persons, property, or activities which are not in the United States or in a third country (determined in each case without regard to section 638 or this section), and which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits of the seabed or subsoil of a foreign country referred to in paragraph (a)(2) of this section, are generally within such foreign country, unless such persons, property, or activities are solely involved in or constitute transportation to (or from) the site of exploration or exploitation from (or to) the United States or a possession of the United States or a third country, as the case may be, other than transportation on a regular basis from (or to) a base of operations.

(4) Persons, property, or activities are within the United States, a possession of the United States, or a foreign country, as the case may be, pursuant to this paragraph, only to the extent such persons, property, or activities are engaged in or related to the exploration for or exploitation of, mines, oil and gas wells, or other natural deposits.

(d) *Natural deposits and natural resources.* For purposes of this section, the terms *natural deposits* and *natural resources* mean nonliving resources to which section 611(a) applies. Such terms do not include sedentary species (organisms which, at the harvestable stage, either are immovable on or under the seabed or are unable to move except in constant physical contact with the seabed or subsoil), fish or other animal or plant life.

(e) *Rights under international law.* Nothing in this section shall prejudice or affect the freedoms of the high seas and other rights under international law, or the exercise of such freedoms and rights by the United States or foreign countries.

(f) *Examples.* The application of the provisions of section 638 and this section may be illustrated by the following examples:

Example 1. A, a citizen of the United States employed as an engineer, is engaged in the exploitation of oil and is physically present on an offshore oil drilling platform operated by employees of L Corporation. Such platform is affixed to the foreign continental shelf of foreign country X. Assuming that foreign country X exercises taxing jurisdiction as provided in paragraph (b) of this section, A is to be treated as being employed in foreign country X with respect to compensation for his employment for purposes of chapters 1 and 24.

Example 2. The facts are the same as in example 1 except that B, a citizen of the United States engaged in the private practice of law, is physically present on such platform

for the sole purpose of interviewing his client, A, whom he represents in a domestic relations matter. Since B is not engaged in activities related to the exploration for, or exploitation of, natural deposits, he is not to be treated as being in foreign country X for purposes of chapters 1 and 2.

Example 3. The facts are the same as in example 1 except that C, a citizen of the United States engaged in the private practice of medicine, is physically present on such platform for the purpose of making routine physical examinations of L Corporation's employees who are engaged in the exploitation of oil on the platform. C is paid by L Corporation to give such examinations on the platform at regular intervals in order to determine whether the state of any employee's health is such that he should not continue work on the platform. The balance of C's medical practice is conducted at his office on the U.S. mainland. Since C is engaged in activities related to the exploitation of oil, he is treated as being in foreign country X under section 638 and this section while making physical examinations on L Corporation's platform, provided that foreign country X exercise taxing jurisdiction as provided in paragraph (b) of this section. For purposes of chapters 1 and 2, amounts paid by L Corporation to C are treated as derived from sources within foreign country X.

Example 4. C, a nonresident alien individual employed as an engineer in a foreign country, designs equipment for use on oil drilling platforms affixed to the continental shelf of the United States and engaged in the exploitation of oil. Although C's activities in this respect are related to the exploitation of oil, C is not treated as being in the United States under section 638 and this section by reason of such activities.

Example 5. M Corporation, a domestic corporation, chartered a ship from N Corporation, also a domestic corporation, under a time charter under which N Corporation's personnel continued to navigate and manage the shop. M Corporation equipped the ship with special oil exploration equipment and furnished its personnel to operate the equipment. The ship then commenced to explore for oil in the foreign Continental Shelf of foreign country Y. Foreign country Y exercises taxing jurisdiction as provided in paragraph (b) of this section. The ship is treated as being within foreign country Y under section 638 and this section for the period it was engaged in the exploration for oil in such foreign Continental Shelf. Thus, the entire income derived during such period by N Corporation from the charter is income derived from sources within foreign country Y, since N Corporation had property and employees engaged in the exploration for oil in such foreign Continental Shelf.

Example 6. The facts are the same as in example 5 except that C, a citizen of the United States, was employed by N Corporation as a cook and was physically present on the ship. C's sole duties consisted of cooking meals for personnel aboard such ship. In such case, as C's activities are related to the exploration for oil, C is to be treated as being in foreign country Y under section 638 and this section for the period he was aboard such ship while it was engaged in activities relating to the exploration for oil in the foreign Continental Shelf referred to in example 5. For purposes of chapters 1 and 24, C's compensation as a cook for such period is treated as derived from sources without the United States.

Example 7. Z Corporation, a foreign corporation, entered into a contract with Y Corporation, a United States corporation, to engage in exploratory oil drilling activities on a leasehold held by Y Corporation. Such leasehold was located in the Continental Shelf of the United States. Since Z Corporation is engaged in and has property and activities which are engaged in the exploration for oil, such property and activities are to be treated as being in the United States under section 638 and this section for the period such property and activities were engaged in or related to the exploration for oil in the Continental Shelf of the United States and were not in a foreign country. For purposes of chapters 1 and 3, amounts paid to Z Corporation pursuant to the contract are treated as derived from sources within the United States.

Example 8. M Corporation is a controlled foreign corporation (within the meaning of section 957(b)) for its entire taxable year beginning in 1972. During such taxable year, M Corporation issues a policy of insurance relating to fire damage to an offshore oil drilling platform, owned by N Corporation (a foreign corporation), which is attached to the Continental Shelf of the United States. The income attributable to the issuing of such policy would be taxed under subchapter L, chapter 1, subtitle A of the Code (as modified, for this purpose, by section 953(b) (1), (2), and (3)) if such income were the income of a domestic insurance corporation. Since N Corporation's oil drilling platform is located within the United States under section 638 and this section, M Corporation's income attributable to the issuing of the insurance in connection with such platform is income derived from the insurance of United States risks, within the meaning of section 953(a)(1)(A).

[T.D. 7277, 38 FR 12740, May 15, 1973]

§ 1.638–2 Effective date.

The specific requirements and limitations of § 1.638–1 apply on and after December 30, 1969.

[T.D. 7277, 38 FR 12742, May 15, 1973]

§§ 1.639–1.640 [Reserved]