2001, and before January 1, 2004, a plan does not fail to be an eligible plan as a result of requirements imposed by the Economic Growth and Tax Relief Reconciliation Act of 2001 (115 Stat. 385) (EGTRRA) (Public Law 107–16) June 7, 2001, if it is operated in accordance with a reasonable, good faith interpretation of EGTRRA.

(c) Special rule for distributions from rollover accounts. The last sentence of §1.457–6(a) (relating to distributions of amounts held in a separate account for eligible rollover distributions) applies for taxable years beginning after December 31, 2003.

(d) Special rule for options. Section 1.457–11(d) does not apply with respect to an option without a readily ascertainable fair market value (within the meaning of section 83(e)(3)) that was granted on or before May 8, 2002.

(e) Special rule for qualified domestic relations orders. Section 1.457–10(c) (relating to qualified domestic relations orders) applies for transfers, distributions, and payments made after December 31, 2001.

[T.D. 9075, 68 FR 41240, July 11, 2003]

§ 1.458–1 Exclusion for certain returned magazines, paperbacks, or records.

(a) In general—(1) Introduction. For taxable years beginning after September 30, 1979, section 458 allows accrual basis taxpayers to elect to use a method of accounting that excludes from gross income some or all of the income attributable to qualified sales during the taxable year of magazines, paperbacks, or records, that are returned before the close of the applicable merchandise return period for that taxable year. Any amount so excluded cannot be excluded or deducted from gross income for the taxable year in which the merchandise is returned to the taxpayer. For the taxable year in which the taxpayer first uses this method of accounting, the taxpayer is not allowed to exclude from gross income amounts attributable to merchandise returns received during the taxable year that would have been excluded from gross income for the prior taxable year had the taxpayer used this method of accounting for that prior taxable year. (See paragraph (e) of this section for rules describing how this amount should be taken into account.) The election to use this method of accounting shall be made in accordance with the rules contained in section 458(c) and in §1.458–2 and this section. A taxpayer that does not elect to use this method of accounting can reduce income for returned merchandise only for the taxable year in which the merchandise is actually returned unsold by the purchaser.

(2) Effective date. While this section is generally effective only for taxable years beginning after August 31, 1984, taxpayers may rely on the provisions of paragraphs (a) through (f) of this section in taxable years beginning after September 30, 1979.

(b) Definitions—(1) Magazine. “Magazine” means a publication, usually paper-backed and sometimes illustrated, that is issued at regular intervals and contains stories, poems, articles, features, etc. This term includes periodicals, but does not include newspapers or volumes of a single publication issued at various intervals. However, volumes of a single publication that are issued at least annually, are related by title or subject matter to a magazine, and would otherwise qualify as a magazine, will be treated as a magazine.

(2) Paperback. “Paperback” means a paperback book other than a magazine. Unlike a hardback book, which usually has stiff front and back covers that enclose pages bound to a separate spine, a paperback book is characterized by a flexible outer cover to which the pages of the book are directly affixed.

(3) Record. “Record” means a disc, tape, or similar item on which music, spoken or other sounds are recorded. However, the term does not include blank records, tapes, etc., on which it is expected the ultimate purchaser will record. The following items, provided they carry pre-recorded sound, are examples of “records”: audio and video cassettes, eight-track tapes, reel-to-reel tapes, cylinders, and flat, compact, and laser discs.

(4) Qualified sale. In order for a sale to be considered a qualified sale, both of the following conditions must be met:
(i) The taxpayer must be under a legal obligation (as determined by applicable State law), at the time of sale, to adjust the sales price of the magazine, paperback, or record on account of the purchaser's failure to resell it; and

(ii) The taxpayer must actually adjust the sales price of the magazine, paperback, or record to reflect the purchaser's failure to resell the merchandise. The following are examples of adjustments to the sales price of unsold merchandise: Cash refunds, credits to the account of the purchaser, and repurchases of the merchandise. The adjustment need not be equal to the full amount of the sales price of the item. However, a markdown of the sales price under an agreement whereby the purchaser continues to hold the merchandise for sale or other disposition (other than solely for scrap) does not constitute an adjustment resulting from a failure to resell.

(5) Merchandise return period—(i) In general. Unless the taxpayer elects a shorter period, the “merchandise return period” is the period that ends 2 months and 15 days after the close of the taxable year for sales of magazines and 4 months and 15 days after the close of the taxable year for sales of paperbacks and records.

(ii) Election to use shorter period. The taxpayer may select a shorter merchandise return period than the applicable period set forth in paragraph (b)(5)(i) of this section.

(iii) Change in merchandise return period. Any change in the merchandise return period after its initial establishment will be treated as a change in method of accounting.

(c) Amount of the exclusion—(1) In general. Except as otherwise provided in paragraph (g) of this section, the amount of the gross income exclusion with respect to any qualified sale is equal to the lesser of—

(i) The amount covered by the legal obligation referred to in paragraph (b)(4)(i) of this section; or

(ii) The amount of the adjustment agreed to by the taxpayer before the close of the merchandise return period.

(2) Price adjustment in excess of legal obligation. The excess, if any, of the amount described in paragraph (c)(1)(ii) of this section over the amount described in paragraph (c)(1)(i) of this section should be excluded in the taxable year in which it is properly accruable under section 461.

(d) Return of the merchandise—(1) In general. (i) The exclusion from gross income allowed by section 458 applies with respect to a qualified sale of merchandise only if the seller receives, before the close of the merchandise return period, either—

(A) The physical return of the merchandise; or

(B) Satisfactory evidence that the merchandise has not been and will not be resold (as defined in paragraph (d)(2) of this section).

(ii) For purposes of this paragraph (d), evidence of a return received by an agent of the seller (other than the purchaser who purchased the merchandise from the seller) will be considered to be received by the seller at the time the agent receives the merchandise or evidence.

(2) Satisfactory evidence. Evidence that merchandise has not been and will not be resold is satisfactory only if the seller receives—

(i) Physical return of some portion of the merchandise (e.g., covers) provided under either the agreement between the seller and the purchaser or industry practice (such return evidencing the fact that the purchaser has not and will not resell the merchandise); or

(ii) A written statement from the purchaser specifying the quantities of each title not resold, provided either—

(A) The statement contains a representation that the items specified will not be resold by the purchaser; or

(B) The past dealings, if any, between the parties and industry practice indicate that such statement constitutes a promise by the purchaser not to resell the items.

(3) Retention of evidence. In the case of a return of merchandise (described in paragraph (d)(1)(i)(A) of this section) or portion thereof (described in paragraph (d)(2)(i) of this section), the seller has no obligation to retain physical evidence of the returned merchandise or portion thereof, provided the seller maintains documentary evidence that describes the quantity of physical
items returned to the seller and indicates that the items were returned before the close of the merchandise return period.

(e) Transitional adjustment—(1) In general. An election to change from some other method of accounting for the return of magazines, paperbacks, or records to the method of accounting described in section 458 is a change in method of accounting that requires a transitional adjustment. Section 458 provides special rules for transitional adjustments that must be taken into account as a result of this change. See paragraph (e)(2) of this section for special rules applicable to magazines and paragraphs (e)(3) and (4) of this section for special rules applicable to paperbacks and records of this section.

(2) Magazines: 5-year spread of decrease in taxable income. For taxpayers who have elected to use the method of accounting described in section 458 to account for returned magazines for a taxable year, section 458(d) and this paragraph (e)(2) provide a special rule for taking into account any decrease in taxable income resulting from the adjustment required by section 481(a)(2). Under these provisions, one-fifth of the transitional adjustment must be taken into account in the taxable year of the change and in each of the 4 succeeding taxable years. For example, if the application of section 481(a)(2) would produce a decrease in taxable income of $50 for 1980, the year of change, then $10 (one-fifth of $50) must be taken into account as a decrease in taxable income for 1980, 1981, 1982, 1983, and 1984.

(3) Suspense account for paperbacks and records—(1) In general. For taxpayers who have elected to use the method of accounting described in section 458 to account for returned paperbacks and records for a taxable year, section 458(e) provides that, in lieu of applying section 481, an electing taxpayer must establish a separate suspense account for its paperback business and its record business. The initial opening balance of the suspense account is described in paragraph (e)(3)(i)(A) of this section. An initial adjustment to gross income for the year of election is described in paragraph (e)(3)(ii)(B) of this section. Annual adjustments to the suspense account are described in paragraph (e)(3)(iii)(A) of this section. Gross income adjustments are described in paragraph (e)(3)(iii)(B) of this section. Examples are provided in paragraph (e)(4) of this section. The effect of the suspense account is to defer all, or some part, of the deduction of the transitional adjustment until the taxpayer is no longer engaged in the trade or business of selling paperbacks or records, whichever is applicable.

(ii) Establishing a suspense account—(A) Initial opening balance. To compute the initial opening balance of the suspense account for the first taxable year for which an election is effective, the taxpayer must determine the section 458 amount (as defined in paragraph (e)(3)(ii)(C) of this section) for each of the three preceding taxable years. The initial opening balance of the account is the largest of the section 458 amounts.

(B) Initial year adjustment. If the initial opening balance in the suspense account exceeds the section 458 amount (as defined in paragraph (e)(3)(ii)(C) of this section) for the taxable year immediately preceding the year of election, the excess is included in the taxpayer’s gross income for the first taxable year for which the election was made.

(C) Section 458 amount. For purposes of paragraph (e)(3)(ii) of this section, the section 458 amount for a taxable year is the dollar amount of merchandise returns that would have been excluded from gross income under section 458(a) for that taxable year if the section 458 election had been in effect for that taxable year.

(iii) Annual adjustments—(A) Adjustment to the suspense account. Annual adjustments are made to the suspense account each year to account for fluctuations in merchandise returns. To compute the annual adjustment, the taxpayer must determine the amount to be excluded under the election from gross income under section 458(a) for the taxable year. If the amount is less than the opening balance in the suspense account for the taxable year, the balance in the suspense account is reduced by the difference. Conversely, if the amount is greater than the opening balance in the suspense account for the
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taxable year, the account is increased by the difference, but not to an amount in excess of the initial opening balance described in paragraph (e)(3)(ii)(A) of this section. Therefore, the balance in the suspense account will never be greater than the initial opening balance in the suspense account determined in paragraph (e)(3)(ii)(A) of this section. However, the balance in the suspense account after adjustments may be less than this initial opening balance in the suspense account.

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

(4) Example. The provisions of paragraph (e)(3) of this section may be illustrated by the following example:

Example: (i) X corporation, a paperback distributor, makes a timely section 458 election for its taxable year ending December 31, 1980. If the election had been in effect for the taxable years ending on December 31, 1977, 1978, and 1979, the dollar amounts of the qualifying returns would have been $5, $8, and $6, respectively. The initial opening balance of X’s suspense account on January 1, 1980, is $8, the largest of these amounts. Since the initial opening balance ($8), is larger than the qualifying returns for 1979 ($6), the initial adjustment to gross income for 1980 is $2 ($8–$6).

(ii) X has $5 in qualifying returns for its taxable year ending December 31, 1980. X must reduce its suspense account by $3, which is the excess of the opening balance ($8) over the amount of qualifying returns for the 1980 taxable year ($5). X also reduces its gross income for 1980 by $3. Thus, the net amount excludable from gross income for the 1980 taxable year after taking into account the qualifying returns, the gross income adjustment, and the initial year adjustment is $6 ($3+$5–$2).

(iii) X has qualifying returns of $7 for its taxable year ending December 31, 1981. X must increase its suspense account balance by $2, which is the excess of the amount of qualifying returns for 1981 ($7) over X’s opening balance in the suspense account ($5). X must also increase its gross income by $2. Thus, the net income excludable from gross income for the 1981 taxable year after taking into account the qualifying returns and the gross income adjustment is $5 ($7–$2).

(iv) X has qualifying returns of $10 for its taxable year ending December 31, 1982. The opening balance in X’s suspense account of $7 will not be increased in excess of the initial opening balance ($8). X must also increase gross income by $1. Thus, the net amount excludable from gross income for the 1982 taxable year is $9 ($10–$1).

(v) This example is summarized by the following table:

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<td>Initial year adjustment</td>
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<td>Amount excludable as qualifying returns in merchandise return period</td>
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<td>5</td>
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<td>Adjustment for decrease in suspense account</td>
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<td>3</td>
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</tbody>
</table>
Subchapter C transactions—(1) General rule. If a transfer of substantially all the assets of a trade or business in which paperbacks or records are sold is made to an acquiring corporation, and if the acquiring corporation determines its basis in these assets, in whole or part, with reference to the basis of these assets in the hands of the transferor, then for the purposes of section 458(e) the principles of section 381 and §1.381(c)(4)–1 will apply. The application of this rule is not limited to the transactions described in section 381(a).

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

(2) Special rules. If, in the case of a transaction described in paragraph (f)(1) of this section, an acquiring corporation acquires assets that were used in a trade or business that was not subject to a section 458 election from a transferor that is owned or controlled directly (or indirectly through a chain of corporations) by the same interests, and if the acquiring corporation uses the acquired assets in a trade or business for which the acquiring corporation later makes an election to use section 458, then the acquiring corporation must establish a suspense account by taking into account both the transferor’s experience for the 3 immediately preceding taxable years. Thus, the initial opening balance of S’s suspense account is $170. S must also make an initial year adjustment of $10 ($170—$160), which S must include in income for S’s taxable year ending December 31, 1983. Thus, the initial opening balance of S’s suspense account is $170. S must also make an initial year adjustment of $10 ($170—$160), which S must include in income for S’s taxable year ending December 31, 1983. P is not entitled to a deduction or exclusion for merchandise received by S during the first 4 months and 15 days of 1983.

(g) Adjustment to inventory and cost of goods sold. (1) If a taxpayer makes adjustments to gross receipts for a taxable year under the method of accounting described in section 458, the taxpayer, in determining excludable gross income, is also required to make appropriate correlative adjustments to purchases or closing inventory and to cost of goods sold for the same taxable year. Adjustments are appropriate, for example, where the taxpayer holds the merchandise returned for resale or where the taxpayer is entitled to receive a price adjustment from the person or entity that sold the merchandise to the taxpayer. Cost of goods sold must be properly adjusted in accordance with
the provisions of §1.61–3 which provides, in pertinent part, that gross income derived from a manufacturing or merchandising business equals total sales less cost of goods sold.

(2) The provisions of this paragraph (g) may be illustrated by the following examples. These examples do not, however, reflect any required adjustments under paragraph (e)(3) of this section.

Example 1. (i) In 1986, P, a publisher, properly elects under section 458 of the Code not to include in its gross income in the year of sale, income attributable to qualified sales of paperback books returned within the specified statutory merchandise return period of 4 months and 15 days. P and D, a distributor, agree that P shall provide D with a full refund for paperback books that D purchases from P. D is unable to resell. D and R, a retailer, agree that D shall provide a full refund for paperback books returned within the specified statutory merchandise return period of 4 months and 15 days. D and R, a retailer, agree that D shall provide a full refund for paperback books that R purchases from it and is unable to resell. D and R, a retailer, agree that D shall provide a full refund for paperback books that R purchases from it and is unable to resell. D and R, a retailer, agree that D shall provide a full refund for paperback books that R purchases from it and is unable to resell.

Example 2. (i) In 1986, D, a distributor, properly elects under section 458 of the Code not to include in its gross income in the year of sale, income attributable to qualified sales of paperback books returned within the specified statutory merchandise return period of 4 months and 15 days. D and R, a retailer, agree that D shall provide a full refund for paperback books that R purchases from it and is unable to resell. D and R, a retailer, agree that D shall provide a full refund for paperback books that R purchases from it and is unable to resell. D and R, a retailer, agree that D shall provide a full refund for paperback books that R purchases from it and is unable to resell.

(ii) If D returns the paperback books, rather than the covers, to P and these same books are then held by P for resale to other customers, paragraph (g)(1) of this section applies. Under paragraph (g)(1), P is required to decrease its cost of goods sold by $25, the amount of refund from D. P's proper amount excluded from its 1989 gross income under section 458 is $75, resulting from adjustments to sales and cost of sales ($100—$25).

(ii) If D is instead only entitled to a 50 percent refund from P, D is required under paragraph (g)(1) of this section to decrease its costs of goods sold by $25, the amount of refund from P. D's proper amount excluded from its 1989 gross income under section 458 is $75, resulting from adjustments to sales and cost of sales ($100—$25).