CODE OF FEDERAL REGULATIONS

Title 26
Internal Revenue

Part 1 (§§ 1.441 to 1.500)

Revised as of April 1, 2016

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Table of Contents

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To cite the regulations in this volume use title, part and section number. Thus, 26 CFR 1.441–0 *refers to title 26, part 1, section 441–0.*

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Each volume of the Code is revised at least once each calendar year and issued on a quarterly basis approximately as follows:

Title 1 through Title 16..as of January 1
Title 17 through Title 27..as of April 1
Title 28 through Title 41...as of July 1
Title 42 through Title 50...as of October 1

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OLIVER A. POTTS,
Director,
Office of the Federal Register.
April 1, 2016.

THIS TITLE

Title 26—INTERNAL REVENUE is composed of twenty-two volumes. The contents of these volumes represent all current regulations issued by the Internal Revenue Service, Department of the Treasury, as of April 1, 2016. The first fifteen volumes comprise part 1 (Subchapter A—Income Tax) and are arranged by sections as follows: §§1.0–1.60; §§1.61–1.139; §§1.140–1.169; §§1.170–1.300; §§1.301–1.400; §§1.401–1.409; §§1.410–1.440; §§1.441–1.500; §§1.501–1.640; §§1.641–1.850; §§1.851–1.907; §§1.908–1.1000; §§1.1001–1.1400; §§1.1401–1.1550; and §1.1551 to end of part 1. The sixteenth volume containing parts 2–29, includes the remainder of subchapter A and all of Subchapter B—Estate and Gift Taxes. The last six volumes contain parts 30–39 (Subchapter C—Employment Taxes and Collection of Income Tax at Source); parts 40–49; parts 50–299 (Subchapter D—Miscellaneous Excise Taxes); parts 300–499 (Subchapter F—Procedure and Administration); parts 500–599 (Subchapter G—Regulations under Tax Conventions); and part 600 to end (Subchapter H—Internal Revenue Practice).

The OMB control numbers for Title 26 appear in §602.101 of this chapter. For the convenience of the user, §602.101 appears in the Finding Aids section of the volumes containing parts 1 to 599.

For this volume, Michele Bugenhagen was Chief Editor. The Code of Federal Regulations publication program is under the direction of John Hyrum Martinez, assisted by Stephen J. Frattini.

Title 26—Internal Revenue

(This book contains part 1, §§1.441 to 1.500)

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

SUBCHAPTER A—INCOME TAX (CONTINUED)

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

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

SUBCHAPTER A—INCOME TAX (CONTINUED)

PART 1—INCOME TAXES (CONTINUED)

NORMAL TAXES AND SURTAXES (CONTINUED)

DEFERRED COMPENSATION, ETC. (CONTINUED)

ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

ACCOUNTING PERIODS

METHODS OF ACCOUNTING

METHODS OF ACCOUNTING IN GENERAL

TAXABLE YEAR FOR WHICH ITEMS OF GROSS INCOME INCLUDED

TAXABLE YEAR FOR WHICH DEDUCTIONS TAKEN

AUTHORITY: 26 U.S.C. 7805.

Section 1.441–2T also issued under 26 U.S.C. 441(f).

Section 1.441–3T also issued under 26 U.S.C. 441.

Section 1.442–2T and 1.442–3T also issued under 26 U.S.C. 422, 706, and 1378.

Section 1.444–0T through 1.444–3T and

Section 1.444–4 is also issued under 26 U.S.C. 444(g).

Section 1.446–1 also issued under 26 U.S.C. 446 and 461(h).

Section 1.446–4 also issued under 26 U.S.C. 1502.

Section 1.446–6 also issued under 26 U.S.C. 446 and 26 U.S.C. 860G.

Section 1.451–5 also issued under 96 Stat. 324, 493.

Section 1.453–11 also issued under 26 U.S.C. 453(j)(1) and (k).

Section 1.453A–3 also issued under 26 U.S.C. 453A.

Section 1.458–1 also issued under 26 U.S.C. 458.

Section 1.460–1 also issued under 26 U.S.C. 460(h).

Section 1.460–2 also issued under 26 U.S.C. 460(h).
Section 1.460–3 also issued under 26 U.S.C. 460(h).
Section 1.460–4 also issued under 26 U.S.C. 460(h) and 1502.
Section 1.460–5 also issued under 26 U.S.C. 460(h).
Section 1.460–6 also issued under 26 U.S.C. 460(h).
Section 1.461–1 also issued under 26 U.S.C. 461(h).
Section 1.461–2 also issued under 26 U.S.C. 461(h).
Section 1.461–4 also issued under 26 U.S.C. 461(h).
Section 1.461–4(d) also issued under 26 U.S.C. 460 and 26 U.S.C. 461(h).
Section 1.461–5 also issued under 26 U.S.C. 461(h).
Section 1.461–6 also issued under 26 U.S.C. 461(h).
Section 1.465–8 also issued under 26 U.S.C. 465.
Section 1.465–20 also issued under 26 U.S.C. 465.
Section 1.465–27 also issued under 26 U.S.C. 465(b)(6)(B)(iii).
Section 1.466–1 through 1.466–4 also issued under 26 U.S.C. 466.
Section 1.467–1 is also issued under 26 U.S.C. 467.
Section 1.467–2 is also issued under 26 U.S.C. 467.
Section 1.467–3 is also issued under 26 U.S.C. 467.
Section 1.467–4 is also issued under 26 U.S.C. 467.
Section 1.467–5 is also issued under 26 U.S.C. 467.
Section 1.467–6 is also issued under 26 U.S.C. 467.
Section 1.467–7 is also issued under 26 U.S.C. 467.
Section 1.467–8 is also issued under 26 U.S.C. 467.
Section 1.467–9 is also issued under 26 U.S.C. 467.
Section 1.468A–5 also issued under 26 U.S.C. 468A(e)(5).
Section 1.468A–5T also issued under 26 U.S.C. 468A(e)(5).
Section 1.468B–1 also issued under 26 U.S.C. 461(h) and 468B(g).
Section 1.468B–2 also issued under 26 U.S.C. 461(h) and 468B(g).
Section 1.468B–3 also issued under 26 U.S.C. 461(h) and 468B(g).
Section 1.468B–4 also issued under 26 U.S.C. 461(h) and 468B(g).
Section 1.468B–5 also issued under 26 U.S.C. 461(h) and 468B(g).
Section 1.468B–7 also issued under 26 U.S.C. 461(h) and 468B(g).
Section 1.468B–9 also issued under 26 U.S.C. 461(h) and 468B(g).
Section 1.469–1 also issued under 26 U.S.C. 469.
Section 1.469–1T also issued under 26 U.S.C. 469.
Section 1.469–2 also issued under 26 U.S.C. 469(l).
Section 1.469–2T also issued under 26 U.S.C. 469(l).
Section 1.469–3 also issued under 26 U.S.C. 469(l).
Section 1.469–3T also issued under 26 U.S.C. 469(l).
Section 1.469–4 also issued under 26 U.S.C. 469(l).
Section 1.469–5 also issued under 26 U.S.C. 469(l).
Section 1.469–5T also issued under 26 U.S.C. 469(l).
Section 1.469–7 also issued under 26 U.S.C. 469(l).
Section 1.469–9 also issued under 26 U.S.C. 469(c)(6), (h)(2), and (l)(1).
Section 1.469–11 also issued under 26 U.S.C. 469(l).
Section 1.471 also issued under 26 U.S.C. 471.
Section 1.471–4 also issued under 26 U.S.C. 263A.
Section 1.471–5 also issued under 26 U.S.C. 263A.
Section 1.471–6 also issued under 26 U.S.C. 471.
Section 1.472–8 also issued under 26 U.S.C. 472.
Section 1.475(a)–3 also issued under 26 U.S.C. 475(e).
Section 1.475(a)–4 also issued under 26 U.S.C. 475(g).
Section 1.475(b)–1 also issued under 26 U.S.C. 475(b)(4) and 26 U.S.C. 475(e).
Section 1.475(b)–2 also issued under 26 U.S.C. 475(b)(2) and 26 U.S.C. 475(e).
Section 1.475(b)–4 also issued under 26 U.S.C. 475(b)(2), 26 U.S.C. 475(e), and 26 U.S.C. 6001.
Section 1.475(c)–1 also issued under 26 U.S.C. 475(e).
Section 1.475(c)–2 also issued under 26 U.S.C. 475(e) and 26 U.S.C. 860G(e).
Section 1.475(d)–1 also issued under 26 U.S.C. 475(e).
Section 1.475(e)–1 also issued under 26 U.S.C. 475(e).
Section 1.481–1 also issued under 26 U.S.C. 481.
Section 1.481–2 also issued under 26 U.S.C. 481.
Section 1.481–3 also issued under 26 U.S.C. 481.
Section 1.481–4 also issued under 26 U.S.C. 481.
Section 1.481–5 also issued under 26 U.S.C. 481.
Section 1.482–1 also issued under 26 U.S.C. 482 and 936.
Sections 1.482–1 and 1.482–1T also issued under 26 U.S.C. 482.

Section 1.482–2 also issued under 26 U.S.C. 482.
Section 1.482–3 also issued under 26 U.S.C. 482.
Section 1.482–4 also issued under 26 U.S.C. 482.
Section 1.482–5 also issued under 26 U.S.C. 482.
Section 1.482–7 is also issued under 26 U.S.C. 482.
Section 1.482–7T also issued under 26 U.S.C. 482.
Section 1.482–9 also issued under 26 U.S.C. 482.
Section 1.482–2A also issued under 26 U.S.C. 482.
Section 1.482–7A also issued under 26 U.S.C. 482.
Section 1.482–9 also issued under 26 U.S.C. 482.
Section 1.483–1 through 1.483–3 also issued under 26 U.S.C. 483(f).
Section 1.483–4 also issued under 26 U.S.C. 483(f).

DEFERRED COMPENSATION, ETC. (CONTINUED)

ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

ACCOUNTING PERIODS

§ 1.441–0 Table of contents.

This section lists the captions contained in §§ 1.441–1 through 1.441–4 as follows:

[T.D. 8996, 67 FR 35012, May 17, 2002]

§ 1.441–1 Period for computation of taxable income.

(a) *Computation of taxable income*—(1) *In general*. Taxable income must be computed and a return must be made for a period known as the taxable year. For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see parts II and III (section 446 and following), subchapter E, chapter 1 of the Internal Revenue Code, and the regulations thereunder.

(2) *Length of taxable year*. Except as otherwise provided in the Internal Revenue Code and the regulations thereunder (e.g., § 1.441–2 regarding 52–53-week taxable years), a taxable year may not cover a period of more than 12 calendar months.

(b) *General rules and definitions*. The general rules and definitions in this paragraph (b) apply for purposes of sections 441 and 442 and the regulations thereunder.

(1) *Taxable year*. *Taxable year* means—

(i) The period for which a return is made, if a return is made for a period of less than 12 months (short period). See section 443 and the regulations thereunder;

(ii) Except as provided in paragraph (b)(1)(i) of this section, the taxpayer's required taxable year (as defined in paragraph (b)(2) of this section), if applicable;

(iii) Except as provided in paragraphs (b)(1)(i) and (ii) of this section, the taxpayer's annual accounting period (as defined in paragraph (b)(3) of this section), if it is a calendar year or a fiscal year; or

(iv) Except as provided in paragraphs (b)(1)(i) and (ii) of this section, the calendar year, if the taxpayer keeps no books, does not have an annual accounting period, or has an annual accounting period that does not qualify as a fiscal year.

(2) *Required taxable year*—(i) *In general*. Certain taxpayers must use the particular taxable year that is required under the Internal Revenue Code and the regulations thereunder (the required taxable year). For example, the required taxable year is—

(A) In the case of a foreign sales corporation or domestic international sales corporation, the taxable year determined under section 441(h) and § 1.921–1T(a)(11), (b)(4), and (b)(6);

(B) In the case of a personal service corporation (PSC), the taxable year determined under section 441(i) and § 1.441–3;

(C) In the case of a nuclear decommissioning fund, the taxable year determined under § 1.468A–4(c)(1);

(D) In the case of a designated settlement fund or a qualified settlement fund, the taxable year determined under § 1.468B–2(j);

(E) In the case of a common trust fund, the taxable year determined under section 584(i);

(F) In the case of certain trusts, the taxable year determined under section 644;

(G) In the case of a partnership, the taxable year determined under section 706 and § 1.706–1;

(H) In the case of an insurance company, the taxable year determined under section 843 and § 1.1502–76(a)(2);

(I) In the case of a real estate investment trust, the taxable year determined under section 859;

(J) In the case of a real estate mortgage investment conduit, the taxable year determined under section 860D(a)(5) and § 1.860D–1(b)(6);

(K) In the case of a specified foreign corporation, the taxable year determined under section 898(c)(1)(A);

(L) In the case of an S corporation, the taxable year determined under section 1378 and § 1.1378–1; or

(M) In the case of a member of an affiliated group that makes a consolidated return, the taxable year determined under § 1.1502–76.

(ii) *Exceptions.* Notwithstanding paragraph (b)(2)(i) of this section, the following taxpayers may have a taxable year other than their required taxable year:

(A) *52–53-week taxable years.* Certain taxpayers may elect to use a 52–53-week taxable year that ends with reference to their required taxable year. See, for example, §§ 1.441–3 (PSCs), 1.706–1 (partnerships), 1.1378–1 (S corporations), and 1.1502–76(a)(1) (members of a consolidated group).

(B) *Partnerships, S corporations, and PSCs.* A partnership, S corporation, or PSC may use a taxable year other than its required taxable year if the taxpayer elects to use a taxable year other than its required taxable year under section 444, elects a 52–53-week taxable year that ends with reference to its required taxable year as provided in paragraph (b)(2)(ii)(A) of this section or to a taxable year elected under section 444, or establishes a business purpose to the satisfaction of the Commissioner under section 442 (such as a grandfathered fiscal year).

(C) *Specified foreign corporations.* A specified foreign corporation (as defined in section 898(b)) may use a taxable year other than its required taxable year if it elects a 52–53-week taxable year that ends with reference to its required taxable year as provided in paragraph (b)(2)(ii)(A) of this section or makes a one-month deferral election under section 898(c)(1)(B).

(3) *Annual accounting period. Annual accounting period* means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.

(4) *Calendar year. Calendar year* means a period of 12 consecutive months ending on December 31. A taxpayer who has not established a fiscal year must make its return on the basis of a calendar year.

(5) *Fiscal year*—(i) *Definition. Fiscal year* means—

(A) A period of 12 consecutive months ending on the last day of any month other than December; or

(B) A 52–53-week taxable year, if such period has been elected by the taxpayer. See § 1.441–2.

(ii) *Recognition.* A fiscal year will be recognized only if the books of the taxpayer are kept in accordance with such fiscal year.

(6) *Grandfathered fiscal year. Grandfathered fiscal year* means a fiscal year (other than a year that resulted in a three month or less deferral of income) that a partnership or an S corporation received permission to use on or after July 1, 1974, by a letter ruling (i.e., not by automatic approval).

(7) *Books. Books* include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on the taxpayer's books and on the taxpayer's return, as for example, a reconciliation of any difference between such books and the taxpayer's return. Records that are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books. See section 6001 and the regulations thereunder for rules relating to the keeping of books and records.

(8) *Taxpayer. Taxpayer* has the same meaning as the term *person* as defined in section 7701(a)(1) (*e.g.*, an individual, trust, estate, partnership, association, or corporation) rather than the meaning of the term taxpayer as defined in section 7701(a)(14) (any person subject to tax).

(c) *Adoption of taxable year*—(1) *In general.* Except as provided in paragraph (c)(2) of this section, a new taxpayer may adopt any taxable year that satisfies the requirements of section 441 and the regulations thereunder without the approval of the Commissioner. A taxable year of a new taxpayer is adopted by filing its first Federal income tax return using that taxable year. The filing of an application for automatic extension of time to file a Federal income tax return (*e.g.*, Form 7004, ''Application for Automatic Extension of Time to File Corporation Income Tax Return''), the filing of an application for an employer identification number (*i.e.*, Form SS–4, ''Application for Employer Identification Number''), or the payment of estimated taxes, for a particular taxable year do not constitute an adoption of that taxable year.

(2) *Approval required*—(i) *Taxpayers with required taxable years.* A newly-formed partnership, S corporation, or PSC that wants to adopt a taxable year other than its required taxable year, a taxable year elected under section 444, or a 52–53-week taxable year that ends with reference to its required taxable year or a taxable year elected under section 444 must establish a business purpose and obtain the approval of the Commissioner under section 442.

(ii) *Taxpayers without books.* A taxpayer that must use a calendar year under section 441(g) and paragraph (f) of this section may not adopt a fiscal year without obtaining the approval of the Commissioner.

(d) *Retention of taxable year.* In certain cases, a partnership, S corporation, electing S corporation, or PSC will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a corporation using a June 30 fiscal year that either becomes a PSC or elects to be an S corporation and, as a result, is required to use the calendar year under section 441(i) or 1378, respectively, must obtain the approval of the Commissioner to retain its current fiscal year. Similarly, a partnership using a taxable year that corresponds to its required taxable year must obtain the approval of the Commissioner to retain such taxable year if its required taxable year changes as a result of a change in ownership. However, a partnership that previously established a business purpose to the satisfaction of the Commissioner to use a taxable year is not required to obtain the approval of the Commissioner if its required taxable year changes as a result of a change in ownership.

(e) *Change of taxable year.* Once a taxpayer has adopted a taxable year, such taxable year must be used in computing taxable income and making returns for all subsequent years unless the taxpayer obtains approval from the Commissioner to make a change or the taxpayer is otherwise authorized to change without the approval of the Commissioner under the Internal Revenue Code (e.g., section 444 or 859) or the regulations thereunder.

(f) *Obtaining approval of the Commissioner or making a section 444 election.* See §1.442–1(b) for procedures for obtaining approval of the Commissioner (automatically or otherwise) to adopt, change, or retain an annual accounting period. See §§1.444–1T and 1.444–2T for qualifications, and 1.444–3T for procedures, for making an election under section 444.

[T.D. 8996, 67 FR 35012, May 17, 2002]

§1.441–2 Election of taxable year consisting of 52–53 weeks.

(a) *In general*—(1) *Election.* An eligible taxpayer may elect to compute its taxable income on the basis of a fiscal year that—

(i) Varies from 52 to 53 weeks;

(ii) Ends always on the same day of the week; and

(iii) Ends always on—

(A) Whatever date this same day of the week last occurs in a calendar month; or

(B) Whatever date this same day of the week falls that is the nearest to the last day of the calendar month.

(2) *Effect.* In the case of a taxable year described in paragraph (a)(1)(iii)(A) of this section, the year will always end within the month and may end on the last day of the month, or as many as six days before the end of the month. In the case of a taxable year described in paragraph (a)(1)(iii)(B) of this section, the year may end on the last day of the month, or as many as three days before or three days after the last day of the month.

(3) *Eligible taxpayer.* A taxpayer is eligible to elect a 52–53-week taxable year if such fiscal year would otherwise satisfy the requirements of section 441 and the regulations thereunder. For example, a taxpayer that is required to use a calendar year under §1.441–1(b)(2)(i)(D) is not an eligible taxpayer.

(4) *Example.* The provisions of this paragraph (a) are illustrated by the following example:

Example. If the taxpayer elects a taxable year ending always on the last Saturday in November, then for the year 2001, the taxable year would end on November 24, 2001. On the other hand, if the taxpayer had elected a taxable year ending always on the Saturday nearest to the end of November, then for the year 2001, the taxable year would end on December 1, 2001.

(b) *Procedures to elect a 52–53-week taxable year*—(1) *Adoption of a 52–53-week taxable year*—(i) *In general.* A new eligible taxpayer elects a 52–53-week taxable year by adopting such year in accordance with §1.441–1(c). A newly-formed partnership, S corporation or personal service corporation (PSC) may adopt a 52–53-week taxable year without the approval of the Commissioner if such year ends with reference to either the taxpayer's required taxable year (as defined in §1.441–1(b)(2)) or the taxable year elected under section 444. See §§1.441–3, 1.706–1, and 1.1378–1. Similarly, a newly-formed specified foreign corporation (as defined in section 898(b)) may adopt a 52–53-week taxable year if such year ends with reference to the taxpayer's required taxable year, or, if the one-month deferral election under section 898(c)(1)(B) is made, with reference to the month immediately preceding the required taxable year. See §1.1502–76(a)(1) for special rules regarding subsidiaries adopting 52–53-week taxable years.

(ii) *Filing requirement.* A taxpayer adopting a 52–53-week taxable year must file with its Federal income tax return for its first taxable year a statement containing the following information—

(A) The calendar month with reference to which the 52–53-week taxable year ends;

(B) The day of the week on which the 52–53-week taxable year always will end; and

(C) Whether the 52–53-week taxable year will always end on the date on which that day of the week last occurs in the calendar month, or on the date on which that day of the week falls that is nearest to the last day of that calendar month.

(2) *Change to (or from) a 52–53-week taxable year*—(i) *In general.* An election of a 52–53-week taxable year by an existing eligible taxpayer with an established taxable year is treated as a change in annual accounting period that requires the approval of the Commissioner in accordance with §1.442–1. Thus, a taxpayer must obtain approval to change from its current taxable year to a 52–53-week taxable year, even if such 52–53-week taxable year ends with reference to the same calendar month. Similarly, a taxpayer must obtain approval to change from a 52–53-week taxable year, or to change from one 52–53-week taxable year to another 52–53-week taxable year. However, a taxpayer may obtain approval for 52–53-week taxable year changes automatically to the extent provided in administrative procedures published by the Commissioner. See §1.442–1(b) for procedures for obtaining such approval.

(ii) *Special rules for the short period required to effect the change.* If a change to or from a 52–53-week taxable year results in a short period (within the meaning of §1.443–1(a)) of 359 days or more, or six days or less, the tax computation under §1.443–1(b) does not apply. If the short period is 359 days or more, it is treated as a full taxable year. If the short period is six days or less, such short period is not a separate taxable year but instead is added to and deemed a part of the following taxable year. (In the case of a change to or from a 52–53-week taxable year not involving a change of the month with reference to which the taxable year ends, the tax computation under §1.443–1(b) does not apply because the short period will always be 359 days or more, or six days or less.) In the case of a short period which is more than six days and less than 359 days, taxable income for the short period is placed on an annual basis for purposes of §1.443–1(b) by multiplying such income by 365 and dividing the result by the number of days in the short period. In such case, the tax for the short period is the same part of the tax computed on such income placed on an annual basis as the number of days in the short period is of 365 days (unless §1.443–1(b)(2), relating to the alternative tax computation, applies). For an adjustment in deduction for personal exemption, see §1.443–1(b)(1)(v).

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

Example 1. A taxpayer having a fiscal year ending April 30, obtains approval to change to a 52–53-week taxable year ending the last Saturday in April for taxable years beginning after April 30, 2001. This change involves a short period of 362 days, from May 1, 2001, to April 27, 2002, inclusive. Because the change results in a short period of 359 days or more, it is not placed on an annual basis and is treated as a full taxable year.

Example 2. Assume the same conditions as *Example 1*, except that the taxpayer changes for taxable years beginning after April 30, 2002, to a taxable year ending on the Thursday nearest to April 30. This change results in a short period of two days, May 1 to May 2, 2002. Because the short period is less than seven days, tax is not separately computed. This short period is added to and deemed part of the following 52–53-week taxable year, which would otherwise begin on May 3, 2002, and end on May 1, 2003.

(c) *Application of effective dates*—(1) *In general.* Except as provided in paragraph (c)(3) of this section, for purposes of determining the effective date (*e.g.*, of legislative, regulatory, or administrative changes) or the applicability of any provision of the internal revenue laws that is expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month, a 52–53-week taxable year is deemed to begin on the first day of the calendar month nearest to the first day of the 52–53-week taxable year, and is deemed to end or close on the last day of the calendar month nearest to the last day of the 52–53-week taxable year, as the case may be. Examples of provisions of this title, the applicability of which is expressed in terms referred to in the preceding sentence, include the provisions relating to the time for filing returns and other documents, paying tax, or performing other acts, and the provisions of part II, subchapter B, chapter 6 (section 1561 and following) relating to surtax exemptions of certain controlled corporations.

(2) *Examples.* The provisions of paragraph (c)(1) of this section may be illustrated by the following examples:

Example 1. Assume that an income tax provision is applicable to taxable years beginning on or after January 1, 2001. For that purpose, a 52–53-week taxable year beginning on any day within the period December 26, 2000, to January 4, 2001, inclusive, is treated as beginning on January 1, 2001.

Example 2. Assume that an income tax provision requires that a return must be filed on or before the 15th day of the third month following the close of the taxable year. For that purpose, a 52–53-week taxable year ending on any day during the period May 25 to June 3, inclusive, is treated as ending on May 31, the last day of the month ending nearest to the last day of the taxable year, and the return, therefore, must be made on or before August 15.

Example 3. Assume that a revenue procedure requires the performance of an act by the taxpayer within ''the first 90 days of the taxable year,'' by ''the 75th day of the taxable year,'' or, alternately, by ''the last day of the taxable year.'' The taxpayer employs a 52–53-week taxable year that ends always on the Saturday closest to the last day of December. These requirements are not expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month, and are accordingly outside the scope of the rule stated in §1.441–2(c)(1). Accordingly, the taxpayer must perform the required act by the 90th, 75th, or last day, respectively, of its taxable year.

Example 4. X, a corporation created on January 1, 2001, elects a 52–53-week taxable year ending on the Friday nearest the end of December. Thus, X's first taxable year begins on Monday, January 1, 2001, and ends on Friday, December 28, 2001; its next taxable year begins on Saturday, December 29, 2001, and ends on Friday, January 3, 2003; and its next taxable year begins on Saturday, January 4, 2003, and ends on Friday, January 2, 2004. For purposes of applying the provisions of part II, subchapter B, chapter 6 of the Internal Revenue Code, X's first taxable year is deemed to end on December 31, 2001; its next taxable year is deemed to begin on January 1, 2002, and end on December 31, 2002, and its next taxable year is deemed to begin on January 1, 2003, and end on December 31, 2003. Accordingly, each such taxable year is treated as including one and only one December 31st.

(3) *Changes in tax rates.* If a change in the rate of tax is effective during a 52–53-week taxable year (other than on the first day of such year as determined under paragraph (c)(1) of this section), the tax for the 52–53-week taxable year must be computed in accordance with section 15, relating to effect of changes, and the regulations thereunder. For the purpose of the computation under section 15, the determination of the number of days in the period before the change, and in the period on and after the change, is to be made without regard to the provisions of paragraph (b)(1) of this paragraph.

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

Example 1. Assume a change in the rate of tax is effective for taxable years beginning after June 30, 2002. For a 52–53-week taxable year beginning on Friday, November 2, 2001, the tax must be computed on the basis of the old rates for the actual number of days from November 2, 2001, to June 30, 2002, inclusive, and on the basis of the new rates for the actual number of days from July 1, 2002, to Thursday, October 31, 2002, inclusive.

Example 2. Assume a change in the rate of tax is effective for taxable years beginning after June 30, 2001. For this purpose, a 52–53-week taxable year beginning on any of the days from June 25 to July 4, inclusive, is treated as beginning on July 1. Therefore, no computation under section 15 will be required for such year because of the change in rate.

(d) *Computation of taxable income.* The principles of section 451, relating to the taxable year for inclusion of items of gross income, and section 461, relating to the taxable year for taking deductions, generally are applicable to 52–53-week taxable years. Thus, except as otherwise provided, all items of income and deduction must be determined on the basis of a 52–53-week taxable year. However, a taxpayer may determine particular items as though the 52–53-week taxable year were a taxable year consisting of 12 calendar months, provided that practice is consistently followed by the taxpayer and clearly reflects income. For example, an allowance for depreciation or amortization may be determined on the basis of a 52–53-week taxable year, or as though the 52–53-week taxable year is a taxable year consisting of 12 calendar months, provided the taxpayer consistently follows that practice with respect to all depreciable or amortizable items.

(e) *Treatment of taxable years ending with reference to the same calendar month*—(1) *Pass-through entities.* If a pass-through entity (as defined in paragraph (e)(3)(i) of this section) or an owner of a pass-through entity (as defined in paragraph (e)(3)(ii) of this section), or both, use a 52–53-week taxable year and the taxable year of the pass-through entity and the owner end with reference to the same calendar month, then, for purposes of determining the taxable year in which items of income, gain, loss, deductions, or credits from the pass-through entity are taken into account by the owner of the pass-through, the owner's taxable year will be deemed to end on the last day of the pass-through's taxable year. Thus, if the taxable year of a partnership and a partner end with reference to the same calendar month, then for purposes of determining the taxable year in which that partner takes into account items described in section 702 and items that are deductible by the partnership (including items described in section 707(c)) and includible in the income of that partner, that partner's taxable year will be deemed to end on the last day of the partnership's taxable year. Similarly, if the taxable year of an S corporation and a shareholder end with reference to the same calendar month, then for purposes of determining the taxable year in which that shareholder takes into account items described in section 1366(a) and items that are deductible by the S corporation and includible in the income of that shareholder, that shareholder's taxable year will be deemed to end on the last day of the S corporation's taxable year.

(2) *Personal service corporations and employee-owners.* If the taxable year of a PSC (within the meaning of §1.441–3(c)) and an employee-owner (within the meaning of §1.441–3(g)) end with reference to the same calendar month, then for purposes of determining the taxable year in which an employee-owner takes into account items that are deductible by the PSC and includible in the income of the employee-owner, the employee-owner's taxable

year will be deemed to end on the last day of the PSC's taxable year.

(3) *Definitions*—(i) *Pass-through entity.* For purposes of this section, a pass-through entity means a partnership, S corporation, trust, estate, closely-held real estate investment trust (within the meaning of section 6655(e)(5)(B)), common trust fund (within the meaning of section 584(i)), controlled foreign corporation (within the meaning of section 957), foreign personal holding company (within the meaning of section 552), or passive foreign investment company that is a qualified electing fund (within the meaning of section 1295).

(ii) *Owner of a pass-through entity.* For purposes of this section, an owner of a pass-through entity generally means a taxpayer that owns an interest in, or stock of, a pass-through entity. For example, an owner of a pass-through entity includes a partner in a partnership, a shareholder of an S corporation, a beneficiary of a trust or an estate, an owner of a closely-held real estate investment trust (within the meaning of section 6655(e)(5)(A)), a participant in a common trust fund, a U.S. shareholder (as defined in section 951(b)) of a controlled foreign corporation, a U.S. shareholder (as defined in section 551(a)) of a foreign personal holding company, or a U.S. person that holds stock in a passive foreign investment company that is a qualified electing fund with respect to that shareholder.

(4) *Examples.* The provisions of paragraph (e)(2) of this section may be illustrated by the following examples:

Example 1. ABC Partnership uses a 52–53-week taxable year that ends on the Wednesday nearest to December 31, and its partners, A, B, and C, are individual calendar year taxpayers. Assume that, for ABC's taxable year ending January 3, 2001, each partner's distributive share of ABC's taxable income is $10,000. Under section 706(a) and paragraph (e)(1) of this section, for the taxable year ending December 31, 2000, A, B, and C each must include $10,000 in income with respect to the ABC year ending January 3, 2001. Similarly, if ABC makes a guaranteed payment to A on January 2, 2001, A must include the payment in income for A's taxable year ending December 31, 2000.

Example 2. X, a PSC, uses a 52–53-week taxable year that ends on the Wednesday nearest to December 31, and all of the employee-owners of X are individual calendar year taxpayers. Assume that, for its taxable year ending January 3, 2001, X pays a bonus of $10,000 to each employee-owner on January 2, 2001. Under paragraph (e)(2) of this section, each employee-owner must include its bonus in income for the taxable year ending December 31, 2000.

(5) *Transition rule.* In the case of an owner of a pass-through entity (other than the owner of a partnership or S corporation) that is required by this paragraph (e) to include in income for its first taxable year ending on or after May 17, 2002 amounts attributable to two taxable years of a pass-through entity, the amount that otherwise would be required to be included in income for such first taxable year by reason of this paragraph (e) should be included in income ratably over the four-taxable-year period beginning with such first taxable year under principles similar to §1.702–3T, unless the owner of the pass-through entity elects to include all such income in its first taxable year ending on or after May 17, 2002.

[T.D. 8996, 67 FR 35012, May 17, 2002]

§ 1.441–3 Taxable year of a personal service corporation.

(a) *Taxable year*—(1) *Required taxable year.* Except as provided in paragraph (a)(2) of this section, the taxable year of a personal service corporation (PSC) (as defined in paragraph (c) of this section) must be the calendar year.

(2) *Exceptions.* A PSC may have a taxable year other than its required taxable year (i.e., a fiscal year) if it makes an election under section 444, elects to use a 52–53-week taxable year that ends with reference to the calendar year or a taxable year elected under section 444, or establishes a business purpose for such fiscal year and obtains the approval of the Commissioner under section 442.

(b) *Adoption, change, or retention of taxable year*—(1) *Adoption of taxable year.* A PSC may adopt, in accordance with §1.441–1(c), the calendar year, a taxable year elected under section 444, or a 52–53-week taxable year ending with reference to the calendar year or a taxable year elected under section 444 without the approval of the Commissioner. *See* §1.441–1. A PSC that wants to adopt any other taxable year must establish a business purpose and obtain the approval of the Commissioner under section 442.

(2) *Change in taxable year.* A PSC that wants to change its taxable year must obtain the approval of the Commissioner under section 442 or make an election under section 444. However, a PSC may obtain automatic approval for certain changes, including a change to the calendar year or to a 52–53-week taxable year ending with reference to the calendar year, pursuant to administrative procedures published by the Commissioner.

(3) *Retention of taxable year.* In certain cases, a PSC will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a corporation using a June 30 fiscal year that becomes a PSC and, as a result, is required to use the calendar year must obtain the approval of the Commissioner to retain its current fiscal year.

(4) *Procedures for obtaining approval or making a section 444 election.* See §1.442–1(b) for procedures to obtain the approval of the Commissioner (automatically or otherwise) to adopt, change, or retain a taxable year. See §§1.444–1T and 1.444–2T for qualifications, and 1.444–3T for procedures, for making an election under section 444.

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

Example 1. X, whose taxable year ends on January 31, 2001, becomes a PSC for its taxable year beginning February 1, 2001, and does not obtain the approval of the Commissioner for using a fiscal year. Thus, for taxable years ending before February 1, 2001, this section does not apply with respect to X. For its taxable year beginning on February 1, 2001, however, X will be required to comply with paragraph (a) of this section. Thus, unless X obtains approval of the Commissioner to use a January 31 taxable year, or makes a section 444 election, X will be required to change its taxable year to the calendar year under paragraph (b) of this section by using a short taxable year that begins on February 1, 2001, and ends on December 31, 2001. Under paragraph (b)(1) of this section, X may obtain automatic approval to change its taxable year to a calendar year. See §1.442–1(b).

Example 2. Assume the same facts as in *Example 1*, except that X desires to change to a 52–53-week taxable year ending with reference to the month of December. Under paragraph (b)(1) of this section X may obtain automatic approval to make the change. See §1.442–1(b).

(c) *Personal service corporation defined*—(1) *In general.* For purposes of this section and section 442, a taxpayer is a PSC for a taxable year only if—

(i) The taxpayer is a C corporation (as defined in section 1361(a)(2)) for the taxable year;

(ii) The principal activity of the taxpayer during the testing period is the performance of personal services;

(iii) During the testing period, those services are substantially performed by employee-owners (as defined in paragraph (g) of this section); and

(iv) Employee-owners own (as determined under the attribution rules of section 318, except that the language "any" applies instead of "50 percent" in section 318(a)(2)(C)) more than 10 percent of the fair market value of the outstanding stock in the taxpayer on the last day of the testing period.

(2) *Testing period*—(i) *In general.* Except as otherwise provided in paragraph (c)(2)(ii) of this section, the testing period for any taxable year is the immediately preceding taxable year.

(ii) *New corporations.* The testing period for a taxpayer's first taxable year is the period beginning on the first day of that taxable year and ending on the earlier of—

(A) The last day of that taxable year; or

(B) The last day of the calendar year in which that taxable year begins.

(3) *Examples.* The provisions of paragraph (c)(2)(ii) of this section may be illustrated by the following examples:

Example 1. Corporation A's first taxable year begins on June 1, 2001, and A desires to use a September 30 taxable year. However, if A is a personal service corporation, it must obtain the Commissioner's approval to use a September 30 taxable year. Pursuant to paragraph (c)(2)(ii) of this section, A's testing period for its first taxable year beginning June 1, 2001, is the period June 1, 2001 through September 30, 2001. Thus, if, based upon such testing period, A is a personal service corporation, A must obtain the Commissioner's permission to use a September 30 taxable year.

Example 2. The facts are the same as in *Example 1*, except that A desires to use a March 31 taxable year. Pursuant to paragraph (c)(2)(ii) of this section, A's testing period for its first taxable year beginning June 1, 2001, is the period June 1, 2001, through December 31, 2001. Thus, if, based upon such testing period, A is a personal service corporation, A must obtain the Commissioner's permission to use a March 31 taxable year.

(d) *Performance of personal services*—(1) *Activities described in section 448(d)(2)(A).* For purposes of this section, any activity of the taxpayer described in section 448(d)(2)(A) or the regulations thereunder will be treated as the performance of personal services. Therefore, any activity of the taxpayer that involves the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (as such fields are defined in §1.448–1T) will be treated as the performance of personal services for purposes of this section.

(2) *Activities not described in section 448(d)(2)(A).* For purposes of this section, any activity of the taxpayer not described in section 448(d)(2)(A) or the regulations thereunder will not be treated as the performance of personal services.

(e) *Principal activity*—(1) *General rule.* For purposes of this section, the principal activity of a corporation for any testing period will be the performance of personal services if the cost of the corporation's compensation (the compensation cost) for such testing period that is attributable to its activities that are treated as the performance of personal services within the meaning of paragraph (d) of this section (i.e., the total compensation for personal service activities) exceeds 50 percent of the corporation's total compensation cost for such testing period.

(2) *Compensation cost*—(i) *Amounts included.* For purposes of this section, the compensation cost of a corporation for a taxable year is equal to the sum of the following amounts allowable as a deduction, allocated to a long-term contract, or otherwise chargeable to a capital account by the corporation during such taxable year—

(A) Wages and salaries; and

(B) Any other amounts, attributable to services performed for or on behalf of the corporation by a person who is an employee of the corporation (including an owner of the corporation who is treated as an employee under paragraph (g)(2) of this section) during the testing period. Such amounts include, but are not limited to, amounts attributable to deferred compensation, commissions, bonuses, compensation includible in income under section 83, compensation for services based on a percentage of profits, and the cost of providing fringe benefits that are includible in income.

(ii) *Amounts excluded.* Notwithstanding paragraph (e)(2)(i) of this section, compensation cost does not include amounts attributable to a plan qualified under section 401(a) or 403(a), or to a simplified employee pension plan defined in section 408(k).

(3) *Attribution of compensation cost to personal service activity*—(i) *Employees involved only in the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are treated as personal services under paragraph (d) of this section, or employees involved only in supporting the work of such employees, are considered to be attributable to the corporation's personal service activity.

(ii) *Employees involved only in activities that are not treated as the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are not treated as personal services under paragraph (d) of this section, or for employees involved only in supporting the work of such employees, are not considered to be attributable to the corporation's personal service activity.

(iii) *Other employees.* The compensation cost for any employee who is not described in either paragraph (e)(3)(i) or (ii) of this section (a mixed-activity employee) is allocated as follows—

(A) *Compensation cost attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that is attributable to the corporation's personal service activity equals the compensation cost for that employee multiplied by the percentage of the total time worked for the corporation by that employee during the year that is attributable to activities of the corporation that are treated as the performance of personal services under paragraph (d) of this section. That percentage is to be determined by the taxpayer in any reasonable and consistent manner. Time logs are not required unless maintained for other purposes;

(B) *Compensation cost not attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that is not considered to be attributable to the corporation's personal service activity is the compensation cost for that employee less the amount determined in paragraph (e)(3)(iii)(A) of this section.

(f) *Services substantially performed by employee-owners*—(1) *General rule.* Personal services are substantially performed during the testing period by employee-owners of the corporation if more than 20 percent of the corporation's compensation cost for that period attributable to its activities that are treated as the performance of personal services within the meaning of paragraph (d) of this section (*i.e.*, the total compensation for personal service activities) is attributable to personal services performed by employee-owners.

(2) *Compensation cost attributable to personal services.* For purposes of paragraph (f)(1) of this section—

(i) The corporation's compensation cost attributable to its activities that are treated as the performance of personal services is determined under paragraph (e)(3) of this section; and

(ii) The portion of the amount determined under paragraph (f)(2)(i) of this section that is attributable to personal services performed by employee-owners is to be determined by the taxpayer in any reasonable and consistent manner.

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

Example 1. For its taxable year beginning February 1, 2001, Corp A's testing period is the taxable year ending January 31, 2000. During that testing period, A's only activity was the performance of personal services. The total compensation cost of A (including compensation cost attributable to employee-owners) for the testing period was $1,000,000. The total compensation cost attributable to employee-owners of A for the testing period was $210,000. Pursuant to paragraph (f)(1) of this section, the employee-owners of A substantially performed the personal services of A during the testing period because the compensation cost of A's employee-owners was more than 20 percent of the total compensation cost for all of A's employees (including employee-owners).

Example 2. Corp B has the same facts as corporation A in *Example 1,* except that during the taxable year ending January 31, 2001, B also participated in an activity that would not be characterized as the performance of personal services under this section. The total compensation cost of B (including compensation cost attributable to employee-owners) for the testing period was $1,500,000 ($1,000,000 attributable to B's personal service activity and $500,000 attributable to B's other activity). The total compensation cost attributable to employee-owners of B for the testing period was $250,000 ($210,000 attributable to B's personal service activity and $40,000 attributable to B's other activity). Pursuant to paragraph (f)(1) of this section, the employee-owners of B substantially performed the personal services of B during the testing period because more than 20 percent of B's compensation cost during the testing period attributable to its personal service activities was attributable to personal services performed by employee-owners ($210,000).

(g) *Employee-owner defined*—(1) *General rule.* For purposes of this section, a person is an employee-owner of a corporation for a testing period if—

(i) The person is an employee of the corporation on any day of the testing period; and

(ii) The person owns any outstanding stock of the corporation on any day of the testing period.

(2) *Special rule for independent contractors who are owners.* Any person who is an owner of the corporation within the meaning of paragraph (g)(1)(ii) of this section and who performs personal services for, or on behalf of, the corporation is treated as an employee for purposes of this section, even if the legal form of that person's relationship to the corporation is such that the person would be considered an independent contractor for other purposes.

(h) *Special rules for affiliated groups filing consolidated returns*—(1) *In general.* For purposes of applying this section to the members of an affiliated group of corporations filing a consolidated return for the taxable year—

(i) The members of the affiliated group are treated as a single corporation;

(ii) The employees of the members of the affiliated group are treated as employees of such single corporation; and

(iii) All of the stock of the members of the affiliated group that is not owned by any other member of the affiliated group is treated as the outstanding stock of that corporation.

(2) *Examples.* The provisions of this paragraph (h) may be illustrated by the following examples:

Example 1. The affiliated group AB, consisting of corporation A and its wholly owned subsidiary B, filed a consolidated Federal income tax return for the taxable year ending January 31, 2001, and AB is attempting to determine whether it is affected by this section for its taxable year beginning February 1, 2001. During the testing period (i.e., the taxable year ending January 31, 2001), A did not perform personal services. However, B's only activity was the performance of personal services. On the last day of the testing period, employees of A did not own any stock in A. However, some of B's employees own stock in A. In the aggregate, B's employees own 9 percent of A's stock on the last day of the testing period. Pursuant to paragraph (h)(1) of this section, this section is effectively applied on a consolidated basis to members of an affiliated group filing a consolidated Federal income tax return. Because the only employee-owners of AB are the employees of B, and because B's employees do not own more than 10 percent of AB on the last day of the testing period, AB is not a PSC subject to the provisions of this section. Thus, AB is not required to determine on a consolidated basis whether, during the testing period, its principal activity is the providing of personal services, or the personal services are substantially performed by employee-owners.

Example 2. The facts are the same as in Example 1, except that on the last day of the testing period A owns only 80 percent of B. The remaining 20 percent of B is owned by employees of B. The fair market value of A, including its 80 percent interest in B, as of the last day of the testing period, is $1,000,000. In addition, the fair market value of the 20 percent interest in B owned by B's employees is $50,000 as of the last day of the testing period. Pursuant to paragraphs (c)(1)(iv) and (h)(1) of this section, AB must determine whether the employee-owners of A and B (i.e., B's employees) own more than 10 percent of the fair market value of A and B as of the last day of the testing period. Because the $140,000 [($1,000,000 × .09) + $50,000] fair market value of the stock held by B's employees is greater than 10 percent of the aggregate fair market value of A and B as of the last day of the testing period, or $105,000 [$1,000,000 + $50,000 × .10], AB may be subject to this section if, on a consolidated basis during the testing period, the principal activity of AB is the performance of personal services and the personal services are substantially performed by employee-owners.

[T.D. 8996, 67 FR 35012, May 17, 2002]

§ 1.441–4 Effective date.

Sections 1.441–0 through 1.441–3 are applicable for taxable years ending on or after May 17, 2002.

[T.D. 8996, 67 FR 35012, May 17, 2002]

§ 1.442–1 Change of annual accounting period.

(a) *Approval of the Commissioner.* A taxpayer that has adopted an annual accounting period (as defined in § 1.441–1(b)(3)) as its taxable year generally must continue to use that annual accounting period in computing its taxable income and for making its Federal income tax returns. If the taxpayer wants to change its annual accounting period and use a new taxable year, it must obtain the approval of the Commissioner, unless it is otherwise authorized to change without the approval of the Commissioner under either the Internal Revenue Code (*e.g.*, section 444 and section 859) or the regulations thereunder (*e.g.*, paragraph (c) of this section). In addition, as described in § 1.441–1(c) and (d), a partnership, S corporation, electing S corporation, or personal service corporation (PSC) generally is required to secure the approval of the Commissioner to adopt or retain an annual accounting period other than its required taxable year. The manner of obtaining approval from the Commissioner to adopt, change, or retain an annual accounting period is provided in paragraph (b) of this section. However, special rules for obtaining approval may be provided in other sections.

(b) *Obtaining approval*—(1) *Time and manner for requesting approval.* In order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period, a taxpayer must file an application, generally on Form 1128, ''Application To Adopt, Change, or Retain a Tax Year,'' with the Commissioner within such time and in such manner as is provided in administrative procedures published by the Commissioner.

(2) *General requirements for approval.* An adoption, change, or retention in annual accounting period will be approved where the taxpayer establishes a business purpose for the requested annual accounting period and agrees to the Commissioner's prescribed terms, conditions, and adjustments for effecting the adoption, change, or retention. In determining whether a taxpayer has established a business purpose and which terms, conditions, and adjustments will be required, consideration will be given to all the facts and circumstances relating to the adoption, change, or retention, including the tax consequences resulting therefrom. Generally, the requirement of a business purpose will be satisfied, and adjustments to neutralize any tax consequences will not be required, if the requested annual accounting period coincides with the taxpayer's required taxable year (as defined in §1.441–1(b)(2)), ownership taxable year, or natural business year. In the case of a partnership, S corporation, electing S corporation, or PSC, deferral of income to partners, shareholders, or employee-owners will not be treated as a business purpose.

(3) *Administrative procedures.* The Commissioner will prescribe administrative procedures under which a taxpayer may be permitted to adopt, change, or retain an annual accounting period. These administrative procedures will describe the business purpose requirements (including an ownership taxable year and a natural business year) and the terms, conditions, and adjustments necessary to obtain approval. Such terms, conditions, and adjustments may include adjustments necessary to neutralize the tax effects of a substantial distortion of income that would otherwise result from the requested annual accounting period including: a deferral of a substantial portion of the taxpayer's income, or shifting of a substantial portion of deductions, from one taxable year to another; a similar deferral or shifting in the case of any other person, such as a beneficiary in an estate; the creation of a short period in which there is a substantial net operating loss, capital loss, or credit (including a general business credit); or the creation of a short period in which there is a substantial amount of income to offset an expiring net operating loss, capital loss, or credit. See, for example, Rev. Proc. 2002–39, 2002–22 I.R.B., procedures for obtaining the Commissioner's prior approval of an adoption, change, or retention in annual accounting period through application to the national office; Rev. Proc. 2002–37, 2002–22 I.R.B., automatic approval procedures for certain corporations; Rev. Proc. 2002–38, 2002–22 I.R.B., automatic approval procedures for partnerships, S corporations, electing S corporations, and PSCs; and Rev. Proc. 66–50, 1966–2 C.B. 1260, automatic approval procedures for individuals. For availability of Revenue Procedures and Notices, see §601.601(d)(2) of this chapter.

(4) *Taxpayers to whom section 441(g) applies.* If section 441(g) and §1.441–1(b)(1)(iv) apply to a taxpayer, the adoption of a fiscal year is treated as a change in the taxpayer's annual accounting period under section 442. Therefore, that fiscal year can become the taxpayer's taxable year only with the approval of the Commissioner. In addition to any other terms and conditions that may apply to such a change, the taxpayer must establish and maintain books that adequately and clearly reflect income for the short period involved in the change and for the fiscal year proposed.

(c) *Special rule for change of annual accounting period by subsidiary corporation.* A subsidiary corporation that is required to change its annual accounting period under §1.1502–76, relating to the taxable year of members of an affiliated group that file a consolidated return, does not need to obtain the approval of the Commissioner or file an application on Form 1128 with respect to that change.

(d) *Special rule for newly married couples.* (1) A newly married husband or wife may obtain automatic approval under this paragraph (d) to change his or her annual accounting period in order to use the annual accounting period of the other spouse so that a joint return may be filed for the first or second taxable year of that spouse ending after the date of marriage. Such automatic approval will be granted only if the newly married husband or wife adopting the annual accounting period of the other spouse files a Federal income tax return for the short period required by that change on or before the 15th day of the 4th month following the close of the short period. See section 443 and the regulations thereunder. If the due date for any such short-period return occurs before the date of marriage, the first taxable year of the other spouse ending after the date of marriage cannot be adopted under this paragraph (d). The short-period return must contain a statement at the top of page one of the return that it is filed under the authority of this paragraph (d). The newly married husband or wife need not file Form 1128 with respect to a change described in this paragraph (d). For a change of annual accounting period by a husband or wife that does not qualify under this paragraph (d), see paragraph (b) of this section.

(2) The provisions of this paragraph (d) may be illustrated by the following example:

Example. H & W marry on September 25, 2001. H is on a fiscal year ending June 30, and W is on a calendar year. H wishes to change to a calendar year in order to file joint returns with W. W's first taxable year after marriage ends on December 31, 2001. H may not change to a calendar year for 2001 since, under this paragraph (d), he would have had to file a return for the short period from July 1 to December 31, 2000, by April 16, 2001. Since the date of marriage occurred subsequent to this due date, the return could not be filed under this paragraph (d). Therefore, H cannot change to a calendar year for 2001. However, H may change to a calendar year for 2002 by filing a return under this paragraph (d) by April 15, 2002, for the short period from July 1 to December 31, 2001. If H files such a return, H and W may file a joint return for calendar year 2002 (which is W's second taxable year ending after the date of marriage).

(e) *Effective date.* The rules of this section are applicable for taxable years ending on or after May 17, 2002.

[T.D. 8996, 67 FR 35019, May 17, 2002]

§ 1.443–1 Returns for periods of less than 12 months.

(a) *Returns for short period.* A return for a short period, that is, for a taxable year consisting of a period of less than 12 months, shall be made under any of the following circumstances:

(1) *Change of annual accounting period.* In the case of a change in the annual accounting period of a taxpayer, a separate return must be filed for the short period of less than 12 months beginning with the day following the close of the old taxable year and ending with the day preceding the first day of the new taxable year. However, such a return is not required for a short period of six days or less, or 359 days or more, resulting from a change from or to a 52–53-week taxable year. See section 441(f) and § 1.441–2. The computation of the tax for a short period required to effect a change of annual accounting period is described in paragraph (b) of this section. In general, a return for a short period resulting from a change of annual accounting period shall be filed and the tax paid within the time prescribed for filing a return for a taxday of the short period. For rules applicable to a subsidiary corporation which becomes a member of an affiliated group which files a consolidated return, see § 1.1502–76.

(2) *Taxpayer not in existence for entire taxable year.* If a taxpayer is not in existence for the entire taxable year, a return is required for the short period during which the taxpayer was in existence. For example, a corporation organized on August 1 and adopting the calendar year as its annual accounting period is required to file a return for the short period from August 1 to December 31, and returns for each calendar year thereafter. Similarly, a dissolving corporation which files its returns for the calendar year is required to file a return for the short period from January 1 to the date it goes out of existence. Income for the short period is not required to be annualized if the taxpayer is not in existence for the entire taxable year, and, in the case of a taxpayer other than a corporation, the deduction under section 151 for personal exemptions (or deductions in lieu thereof) need not be reduced under section 443(c). In general, the requirements with respect to the filing of returns and the payment of tax for a short period where the taxpayer has not been in existence for the entire taxable year are the same as for the filing of a return and the payment of tax for a taxable year of 12 months ending

on the last day of the short period. Although the return of a decedent is a return for the short period beginning with the first day of his last taxable year and ending with the date of his death, the filing of a return and the payment of tax for a decedent may be made as though the decedent had lived throughout his last taxable year.

(b) *Computation of tax for short period on change of annual accounting period*—(1) *General rule.* (i) If a return is made for a short period resulting from a change of annual accounting period, the taxable income for the short period shall be placed on an annual basis by multiplying such income by 12 and dividing the result by the number of months in the short period. Unless section 443(b)(2) and subparagraph (2) of this paragraph apply, the tax for the short period shall be the same part of the tax computed on the annual basis as the number of months in the short period is of 12 months.

(ii) If a return is made for a short period of more than 6 days, but less than 359 days, resulting from a change from or to a 52–53-week taxable year, the taxable income for the short period shall be annualized and the tax computed on a daily basis, as provided in section 441(f)(2)(B)(iii) and §1.441–2(b)(2)(ii).

(iii) For method of computation of income for a short period in the case of a subsidiary corporation required to change its annual accounting period to conform to that of its parent, see §1.1502–76(b).

(iv) An individual taxpayer making a return for a short period resulting from a change of annual accounting period is not allowed to take the standard deduction provided in section 141 in computing his taxable income for the short period. See section 142(b)(3).

(v) In computing the taxable income of a taxpayer other than a corporation for a short period (which income is to be annualized in order to determine the tax under section 443(b)(1)) the personal exemptions allowed individuals under section 151 (and any deductions allowed other taxpayers in lieu thereof, such as the deduction under section 642(b)) shall be reduced to an amount which bears the same ratio to the full amount of the exemptions as the number of months in the short period bears to 12. In the case of the taxable income for a short period resulting from a change from or to a 52–53-week taxable year to which section 441(f)(2)(B)(iii) applies, the computation required by the preceding sentence shall be made on a daily basis, that is, the deduction for personal exemptions (or any deduction in lieu thereof) shall be reduced to an amount which bears the same ratio to the full deduction as the number of days in the short period bears to 365.

(vi) If the amount of a credit against the tax (for example, the credits allowable under section 34 (for dividends received on or before December 31, 1964), and 35 (for partially tax-exempt interest)) is dependent upon the amount of any item of income or deduction, such credit shall be computed upon the amount of the item annualized separately in accordance with the foregoing rules. The credit so computed shall be treated as a credit against the tax computed on the basis of the annualized taxable income. In any case in which a limitation on the amount of a credit is based upon taxable income, taxable income shall mean the taxable income computed on the annualized basis.

(vii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. A taxpayer with one dependent who has been granted permission under section 442 to change his annual accounting period files a return for the short period of 10 months ending October 31, 1956. He has income and deductions as follows:

Income			
Interest income			$10,000.00
Partially tax-exempt interest with respect to which a credit is allowable under section 35			500.00
Dividends to which sections 34 and 116 are applicable			750.00
			11,250.00
Deductions			
Real estate taxes			200.00
2 personal exemptions at $600 on an annual basis			1,200.00
The tax for the 10-month period is computed as follows:			
Total income as above			11,250.00
Less:			
Exclusion for dividends received		$50.00	
2 personal exemptions ($1,200 × 10/12)		1,000.00	

Real estate taxes		200.00	
			1,250.00
Taxable income for 10-month period before annualizing			10,000.00
Taxable income annualized (10,000 × 12/10)			12,000.00
Tax on $12,000 before credits			3,400.00
Deduct credits:			
Dividends received for 10-month period	$750.00		
Less: Excluded portion	50.00		
Included in gross income	700.00		
Dividend income annualized ($700 × 12/10)	840.00		
Credit (4 percent of $840)		33.60	
Partially tax-exempt interest included in gross income for 10-month period	500.00		
Partially tax-exempt interest (annualized) ($500 × 12/10)	600.00		
Credit (3 percent of $600)		18.00	
			51.60
Tax on $12,000 (after credits)			3,348.40
Tax for 10-month period ($3,348.40 × 10/12)			2,790.33

Example 2. The X Corporation makes a return for the one-month period ending September 30, 1956, because of a change in annual accounting period permitted under section 442. Income and expenses for the short period are as follows:

Gross operating income		$126,000
Business expenses		130,000
Net loss from operations		(4,000)
Dividends received from taxable domestic corporations		30,000
Gross income for short period before annualizing		26,000
Dividends received deduction (85 percent of $30,000, but not in excess of 85 percent of $26,000)		22,100
Taxable income for short period before annualizing		3,900
Taxable income annualized ($8,900 × 12)		46,800
Tax on annual basis:		
$46,800 at 52 percent	$24,336	
Less surtax exemption	5,500	
		$18,836
Tax for 1-month period ($18,836 × 1/12)		1,570

Example 3. The Y Corporation makes a return for the six-month period ending June 30, 1957, because of a change in annual accounting period permitted under section 442. Income for the short period is as follows:

Taxable income exclusive of net long-term capital gain		$40,000
Net long-term capital gain		10,000
Taxable income for short period before annualizing		50,000
Taxable income annualized ($50,000 × 12/6)		100,000
Regular tax computation		
Taxable income annualized		100,000
Tax on annual basis:		
$100,000 at 52 percent	$52,000	
Less surtax exemption	5,500	
	46,500	
Tax for 6-month period ($46,500 × 6/12)		23,250
Alternative tax computation		
Taxable income annualized		100,000
Less annualized capital gain ($10,000 × 12/6)		20,000
Annualized taxable income subject to partial tax		80,000
Partial tax on annual basis		
$60,000 at 52 percent	$41,600	
Less surtax exemption	5,500	
		36,100
25 percent of annualized capital gain ($20,000)		5,000
Alternative tax on annual basis		41,100
Alternative tax for 6-month period ($41,100 × 6/12)		20,550

Since the alternative tax of $20,550 is less than the tax computed in the regular manner ($23,250), the corporation's tax for the 6-month short period is $20,550.

(2) *Exception: computation based on 12-month period.* (i) A taxpayer whose tax would otherwise be computed under section 443(b)(1) (or section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52–53-week taxable year) for the short period resulting from a change of annual accounting period may apply to the district director to have his tax computed under the provisions of section 443(b)(2) and this subparagraph. If such application is made, as provided in subdivision (v) of this subparagraph, and if the taxpayer establishes the amount of his taxable income for the 12-month period described in subdivision (ii) of this subparagraph, then the tax for the short period shall be the greater of the following—

(*a*) An amount which bears the same ratio to the tax computed on the taxable income which the taxpayer has established for the 12-month period as the taxable income computed on the basis of the short period bears to the taxable income for such 12-month period; or (*b*) The tax computed on the taxable income for the short period without placing the taxable income on an annual basis.

However, if the tax computed under section 443(b)(2) and this subparagraph is not less than the tax for the short period computed under section 443(b)(1) (or section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52–53-week taxable year), then section 443(b)(2) and this subparagraph do not apply.

(ii) The term ''12-month period'' referred to in subdivision (i) of this subparagraph means the 12-month period beginning on the first day of the short period. However, if the taxpayer is not in existence at the end of such 12-month period, or if the taxpayer is a corporation which has disposed of substantially all of its assets before the end of such 12-month period, the term ''12-month period'' means the 12-month period ending at the close of the last day of the short period. For the purposes of the preceding sentence, a corporation which has ceased business and distributed so much of the assets used in its business that it cannot resume its customary operations with the remaining assets, will be considered to have disposed of substantially all of its assets. In the case of a change from a 52–53-week taxable year, the term ''12-month period'' means the period of 52 or 53 weeks (depending on the taxpayer's 52–53-week taxable year) beginning on the first day of the short period.

(iii)(*a*) The taxable income for the 12-month period is computed under the same provisions of law as are applicable to the short period and is computed as if the 12-month period were an actual annual accounting period of the taxpayer. All items which fall in such 12-month period must be included even if they are extraordinary in amount or of an unusual nature. If the taxpayer is a member of a partnership, his taxable income for the 12-month period shall include his distributive share of partnership income for any taxable year of the partnership ending within or with such 12-month period, but no amount shall be included with respect to a taxable year of the partnership ending before or after such 12-month period. If any other item partially applicable to such 12-month period can be determined only at the end of a taxable year which includes only part of the 12-month period, the taxpayer, subject to review by the Commissioner, shall apportion such item to the 12-month period in such manner as will most clearly reflect income for the 12-month period.

(*b*) In the case of a taxpayer permitted or required to use inventories, the cost of goods sold during a part of the 12-month period included in a taxable year shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for such part of the 12-month period is of the gross receipts from sales for the entire taxable year. For example, the 12-month period of a corporation engaged in the sale of merchandise, which has a short period from January 1, 1956, to September 30, 1956, is the calendar year 1956. The three-month period, October 1, 1956, to December 31, 1956, is part of the taxpayer's taxable year ending September 30, 1957. The cost of goods sold during the three-month period, October 1, 1956, to December 31, 1956, is such part of the cost of goods sold during the entire fiscal year ending September 30, 1957, as the gross receipts from sales for such three-month period are of the gross receipts from sales for the entire fiscal year.

(*c*) The Commissioner may, in granting permission to a taxpayer to change his annual accounting period, require, as a condition to permitting the change, that the taxpayer must take a closing inventory upon the last day of the 12-month period if he wishes to obtain the benefits of section 443(b)(2). Such closing inventory will be used only for the purposes of section 443(b)(2), and the taxpayer will not be required to use such inventory in computing the taxable income for the taxable year in which such inventory is taken.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. The taxpayer in Example 1 under paragraph (b)(1)(vii) of this section establishes his taxable income for the 12-

month period from January 1, 1956, to December 31, 1956. The taxpayer has a short period of 10 months, from January 1, 1956, to October 31, 1956. The taxpayer files an application in accordance with subdivision (v) of this subparagraph to compute his tax under section 443(b)(2). The taxpayer's income and deductions for the 12-month period, as so established, follow:

Income		
Interest income		$11,000
Partially tax-exempt interest with respect to which a credit is allowable under section 35		600
Dividends to which sections 34 and 116 are applicable		850
		12,450
Deductions		
Real estate taxes		200
2 personal exemptions at $600		1,200
Tax computation for short period under section 443(b)(2)(A)(i)		
Total income as above		$12,450
Less:		
Exclusion for dividends received	$50	
Personal exemptions	1,200	
Deduction for taxes	200	
		1,450
Taxable income for 12-month period		11,000
Tax before credits		3,020
Credit for partially tax-exempt interest (3 percent of $600)	18	
Credit for dividends received (4 percent of ($850 − 50))	32	
		50
Tax under section 443(b)(2)(A)(i) for 12-month period		2,970
Taxable income for 10-month short period from Example 1 of paragraph (b)(1)(vii) of this section before annualizing		10,000
Tax for short period under section 443(b)(2)(A)(i) ($2,970 × $10,000 (taxable income for short period)/$11,000 (taxable income for 12-month period))		2,700
Tax computation for short period under section 443(b)(2)(A)(ii)		
Total income for 10-month short period		11,250
Less:		
Exclusion for dividends received	50	
2 personal exemptions	1,200	
Real estate taxes	200	
		1,450
Taxable income for short period without annualizing and without proration of personal exemptions		9,800
Tax before credits		2,572
Less credits:		
Partially tax-exempt interest (3 percent of $500)	15	
Dividends received (4 percent of ($750 − 50))	28	
		43
Tax for short period under section 443(b)(2)(A)(ii)		2,529

The tax of $2,700 computed under section 443(b)(2)(A)(i) is greater than the tax of $2,529, computed under section 443(b)(2)(A)(ii), and is, therefore, the tax under section 443(b)(2). Since the tax of $2,700 (computed under section 443(b)(2)) is less than the tax of $2,790.33 (computed under section 443(b)(1)) on the annualized income of the short period (see Example 1 of paragraph (b)(1)(vii) of this section), the taxpayer's tax for the 10-month short period is $2,700.

Example 2. Assume the same facts as in Example 1 of this subdivision, except that, during the month of November 1956, the taxpayer suffered a casualty loss of $5,000. The tax computation for the short period under section 443(b)(2) would be as follows:

Tax computation for short period under section 443(b)(2)(A)(i)		
Taxable income for 12-month period from Example 1		$11,000
Less: Casualty loss		5,000
Taxable income for 12-month period		6,000
Tax before credits	$1,360	
Credits from Example 1	50	
Tax under section 443(b)(2)(A)(i) for 12-month period	1,310	
Tax for short period ($1,310 × $10,000/$6,000) under section 443(b)(2)(A)(i)	2,183	
Tax computation for short period under section 443(b)(2)(A)(ii)		
Total income for the short period	11,250	
Less:		
Exclusion for dividends received	50	
2 personal exemptions	1,200	
Real estate taxes	200	
		1,450
Taxable income for short period without annualizing and without proration of personal exemptions		9,800
Tax before credits		2,572
Less credits:		
Partially tax-exempt interest (3 percent of $500)	15	
Dividends received (4 percent of $750 − 50))	28	
		43
Tax for short period under section 443(b)(2)(A)(ii)		2,529

The tax of $2,529, computed under section 443(b)(2)(A)(ii) is greater than the tax of $2,183 computed under section 443(b)(2)- (A)(i) and is, therefore, the tax under section 443(b)(2). Since this tax is less than the tax of $2,790.33, computed under section 443(b)(1) (see Example 1 of paragraph (b)(1)(vii) of this section), the taxpayer's tax for the 10-month short period is $2,529.

(v)(*a*) A taxpayer who wishes to compute his tax for a short period resulting from a change of annual accounting period under section 443(b)(2) must make an application therefor. Except as provided in (*b*) of this subdivision, the taxpayer shall first file his return for the short period and compute his tax under section 443(b)(1). The application for the benefits of section 443(b)(2) shall subsequently be made in the form of a claim for credit or refund. The claim shall set forth the computation of the taxable income and the tax thereon for the 12-month period and must be filed not later than the time (including extensions) prescribed for filing the return for the taxpayer's first taxable year which ends on or after the day which is 12 months after the beginning of the short period. For example, assume that a taxpayer changes his annual accounting period from the calendar year to a fiscal year ending September 30, and files a return for the short period from January 1, 1956, to September 30, 1956. His application for the benefits of section 443(b)(2) must be filed not later than the time prescribed for filing his return for his first taxable year which ends on or after the last day of December 1956, the twelfth month after the beginning of the short period. Thus, the taxpayer must file his application not later than the time prescribed for filing the return for his fiscal year ending September 30, 1957. If he obtains an extension of time for filing the return for such fiscal year, he may file his application during the period of such extension. If the district director determines that the taxpayer has established the amount of his taxable income for the 12-month period, any excess of the tax paid for the short period over the tax computed under section 443(b)(2) will be credited or refunded to the taxpayer in the same manner as in the case of an overpayment.

(*b*) If at the time the return for the short period is filed, the taxpayer is able to determine that the 12-month period ending with the close of the short period (see section 443(b)(2)(B)(ii) and subparagraph (2)(ii) of this paragraph) will be used in the computations under section 443(b)(2), then the tax on the return for the short period may be determined under the provisions of section 443(b)(2). In such case, a return covering the 12-month period shall be attached to the return for the short period as a part thereof, and the return and attachment will then be considered as an application for the benefits of section 443(b)(2).

(c) *Adjustment in deduction for personal exemption.* For adjustment in the deduction for personal exemptions in computing the tax for a short period resulting from a change of annual accounting period under section 443(b)(1) (or under section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52–53-week taxable year), see paragraph (b)(1)(v) of this section.

(d) *Adjustments in exclusion of computing minimum tax for tax preferences.* (1) If a return is made for a short period on account of any of the reasons specified in subsection (a) of section 443, the $30,000 amount specified in section 56 (relating to minimum tax for tax preferences), modified as provided by section 58 and the regulations thereunder, shall be reduced to the amount which bears the same ratio to such specified amount as the number of days in the short period bears to 365.

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

Example. A taxpayer who is an unmarried individual has been granted permission under section 442 to change his annual accounting period files a return for the short period of 4 months ending April 30, 1970. The $30,000 amount specified in section 56 is reduced as follows:

$$(120/365) \times \$30,000 = \$9,835.89.$$

(e) *Cross references.* For inapplicability of section 443(b) and paragraph (b) of this section in computing—

(1) Accumulated earnings tax, see section 536 and the regulations thereunder;

(2) Personal holding company tax, see section 546 and the regulations thereunder;

(3) Undistributed foreign personal holding company income, see section 557 and the regulations thereunder;

(4) The taxable income of a regulated investment company, see section 852(b)(2)(E) and the regulations thereunder; and

(5) The taxable income of a real estate investment trust, see section

857(b)(2)(C) and the regulations thereunder.

[T.D. 6500, 25 FR 11705, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4093, Apr. 28, 1962; T.D. 6777, 29 FR 17808, Dec. 16, 1964; T.D. 7244, 37 FR 28897, Dec. 30, 1972, T.D. 7564, 43 FR 40494, Sept. 12, 1978; T.D. 7575, 43 FR 58816, Dec. 18, 1978; T.D. 7767, 465 FR 11265, Feb. 6, 1981; T.D. 8996, 67 FR 35012, May 17, 2002]

§ 1.444–0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 444.

§ 1.444–3T Manner and time of making section 444 election (temporary).

(a) In general.
(b) Manner and time of making election.
(1) General rule.
(2) Special extension of time for making an election.
(3) Corporation electing to be an S corporation.
(i) In general.
(ii) Examples.
(4) Back-up section 444 election.
(i) General rule.
(ii) Procedures for making a back-up section 444 election.
(iii) Procedures for activating a back-up section 444 election.
(A) Partnership and S corporations.
(*1*) In general.
(*2*) Special rule if Form 720 used to satisfy return requirement.
(B) Personal service corporations.
(iv) Examples.
(c) Administrative relief.
(1) Extension of time to file income tax returns.
(i) Automatic extension.
(ii) Additional extensions.
(iii) Examples.
(2) No penalty for certain late payments.
(i) In general.
(ii) Example.
(d) Effective date.

[T.D. 8205, 53 FR 19693, May 27, 1988]

§ 1.444–1T Election to use a taxable year other than the required taxable year (temporary).

(a) *General rules*—(1) *Year other than required year*. Except as otherwise provided in this section and § 1.444–2T, a partnership, S corporation, or personal service corporation (as defined in § 1.441–3(c)) may make or continue an election (a ''section 444 election'') to have a taxable year other than its required taxable year. See paragraph (b) of this section for limitations on the taxable year that may be elected. See § 1.444–2T for rules that generally prohibit a partnership, S corporation, or personal service corporation that is a member of a tiered structure from making or continuing a section 444 election. See § 1.444–3T for rules explaining how and when to make a section 444 election.

(2) *Effect of section 444 election*—(i) *In general*. A partnership or S corporation that makes or continues a section 444 election shall file returns and make payments as required by §§ 1.7519–1T and 1.7519–2T. A personal service corporation that makes or continues a section 444 election is subject to the deduction limitation of § 1.280H–1T.

(ii) *Duration of section 444 election*. A section 444 election shall remain in effect until the election is terminated pursuant to paragraph (a)(5) of this section.

(3) *Section 444 election not required for certain years*. A partnership, S corporation, or personal service corporation is not required to make a section 444 election to use—

(i) A taxable year for which such entity establishes a business purpose to the satisfaction of the Commissioner (*i.e.*, approved under section 4 or 6 of Rev. Proc. 87–32, 1987–28 I.R.B. 14, or any successor revenue ruling or revenue procedure), or

(ii) A taxable year that is a ''grandfathered fiscal year,'' within the meaning of section 5.01(2) of Rev. Proc. 87–32 or any successor revenue ruling or revenue procedure.

Although a partnership, S corporation or personal service corporation qualifies to use a taxable year described in paragraph (a)(3) (i) or (ii) of this section, such entity may, if otherwise qualified, make a section 444 election to use a different taxable year. Thus, for example, assume that a personal service corporation that historically used a January 31 taxable year established to the satisfaction of the Commissioner, under section 6 of Rev. Proc. 87–32, a business purpose to use a September 30 taxable year for its taxable year beginning February 1, 1987. Pursuant to this paragraph (a)(3), such personal service corporation may use a September 30 taxable year without making a section 444 election. However, the corporation may, if otherwise qualified, make a section 444 election to use a year ending other than September 30 for its taxable year beginning February 1, 1987.

(4) *Required taxable year*. For purposes of this section, the term ''required taxable year'' means the taxable year determined under section 706(b), 1378, or 441(i) without taking into account any taxable year which is allowable either—

(i) By reason of business purpose (*i.e.*, approved under section 4 or 6 of Rev.

Proc. 87–32 or any successor revenue ruling or procedure), or

(ii) As a ''grandfathered fiscal year'' within the meaning of section 5.01(2) of Rev. Proc. 87–32, or any successor revenue ruling or procedure.

(5) *Termination of section 444 election*—(i) *In general.* A section 444 election is terminated when—

(A) A partnership, S corporation, or personal service corporation changes to its required taxable year; or

(B) A partnership, S corporation, or personal service corporation liquidates (including a deemed liquidation of a partnership under §1.708–1 (b)(1)(iv)); or

(C) A partnership, S corporation, or personal service corporation willfully fails to comply with the requirements of section 7519 or 280H, whichever is applicable; or

(D) A partnership, S corporation, or personal service corporation becomes a member of a tiered structure (within the meaning of §1.444–2T), unless it is a partnership or S corporation that meets the same taxable year exception under §1.444–2T (e); or

(E) An S corporation's S election is terminated; or

(F) A personal service corporation ceases to be a personal service corporation.

However, if a personal service corporation, that has a section 444 election in effect, elects to be an S corporation, the S corporation may continue the section 444 election of the personal service corporation. Similarly, if an S corporation that has a section 444 election in effect terminates its S election and immediately becomes a personal service corporation, the personal service corporation may continue the section 444 election of the S corporation. If a section 444 election is terminated under this paragraph (a)(5), the partnership, S corporation, or personal service corporation may not make another section 444 election for any taxable year.

(ii) *Effective date of termination.* A termination of a section 444 election shall be effective—

(A) In the case of a change to the required year, on the first day of the short year caused by the change;

(B) In the case of a liquidating entity, on the date the liquidation is completed for tax purposes;

(C) In the case of willful failure to comply, on the first day of the taxable year (determined as if a section 444 election had never been made) determined in the discretion of the District Director;

(D) In the case of membership in a tiered structure, on the first day of the taxable year in which the entity is considered to be a member of a tiered structure, or such other taxable year determined in the discretion of the District Director;

(E) In the case of termination of S status, on the first day of the taxable year for which S status no longer exists;

(F) In the case of a personal service corporation that changes status, on the first day of the taxable year, for which the entity is no longer a personal service corporation.

In the case of a termination under this paragraph (a)(5) that results in a short taxable year, an income tax return is required for the short period. In order to allow the Service to process the affected income tax return in an efficient manner, a partnership, S corporation, or personal service corporation that files such a short period return should type or legibly print at the top of the first page of the income tax return for the short taxable year—''SECTION 444 ELECTION TERMINATED.'' In addition, a personal service corporation that changes its taxable year to the required taxable year is required to annualize its income for the short period.

(iii) *Example.* The provisions of paragraph (a)(5)(ii) of this section may be illustrated by the following example.

Example. Assume a partnership that is 100 percent owned, at all times, by calendar year individuals has historically used a June 30 taxable year. Also assume the partnership makes a valid section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. However, for its taxable year beginning July 1, 1988, the partnership changes to a calendar year, its required year. Based on these facts, the partnership's section 444 election is terminated on July 1, 1988, and the partnership must file a short period return for the period July 1, 1988–December 31, 1988. Furthermore, pursuant to

§ 1.702–3T(a)(1), the partners in such partnership are not entitled to a 4-year spread with respect to partnership items of income and expense for the taxable year beginning July 1, 1988 and ending December 31, 1988.

(iv) *Special rule for entity that liquidates or is sold prior to making a section 444 election, required return, or required payment.* A partnership, S corporation, or personal service corporation that is liquidated or sold for tax purposes before a section 444 election, required return, or required payment is made for a particular year may, nevertheless, make or continue a section 444 election, if otherwise qualified. (See §§ 1.7519–2T (a)(2) and 1.7519–1T (a)(3), respectively, for a description of the required return and a definition of the term ''required payment.'') However, the partnership, S corporation, or personal service corporation (or a trustee or agent thereof) must comply with the requirements for making or continuing a section 444 election. Thus, if applicable, required payments must be made and a subsequent claim for refund must be made in accordance with § 1.7519–2T(a)(6). The following examples illustrate the application of this paragraph (a)(5)(iv).

Example 1. Assume an existing S corporation historically used a June 30 taxable year and desires to make a section 444 election for its taxable year beginning July 1, 1987. Assume further that the S corporation is liquidated for tax purposes on February 15, 1988. If otherwise qualified, the S corporation (or a trustee or agent thereof) may make a section 444 election to have a taxable year beginning July 1, 1987, and ending February 15, 1988. However, if the S corporation makes a section 444 election, it must comply with the requirements for making a section 444 election, including making required payments.

Example 2. The facts are the same as in Example 1, except that instead of liquidating on February 15, 1988, the shareholders of the S corporation sell their stock to a corporation on February 15, 1988. Thus, the corporation's S election is terminated on February 15, 1988. If otherwise qualified, the corporation may make a section 444 election to have a taxable year beginning July 1, 1987, and ending February 14, 1988.

Example 3. The facts are the same as in Example 2, except that the new shareholders are individuals. Furthermore, the corporation's S election is not terminated. Based on these facts, the S corporation, if otherwise qualified, may make a section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. Furthermore, the S corporation may, if otherwise qualified, continue its section 444 election for subsequent taxable years.

(6) *Re-activating certain S elections*—(i) *Certain corporations electing S status that did not make a back-up calendar year request.* If a corporation that timely filed Form 2553, Election by a Small Business Corporation, effective for its first taxable year beginning in 1987—

(A) Requested a fiscal year based on business purpose,

(B) Did not agree to use a calendar year in the event its business purpose request was denied, and

(C) Such business purpose request is denied or withdrawn,

such corporation may retroactively re-activate its S election by making a valid section 444 election for its first taxable year beginning in 1987 and complying with the procedures in paragraph (a)(6)(iii) of this section.

(ii) *Certain corporations that revoked their S status.* If a corporation that used a fiscal year revoked its S election (pursuant to section 1362(d)(1)) for its first taxable year beginning in 1987, such corporation may retroactively re-activate its S election (*i.e.* rescind its revocation) by making a valid section 444 election for its first taxable year beginning in 1987 and complying with the procedures in paragraph (a)(6)(iii) of this section.

(iii) *Procedures for re-activating an S election.* A corporation re-activating its S election pursuant to paragraph (a)(6)(i) or (ii) of this section must—

(A) Obtain the consents of all shareholders who have owned stock in the corporation since the first day of the first taxable year of the corporation beginning after December 31, 1986,

(B) Include the following statement at the top of the first page of the corporation's Form 1120S for its first taxable year beginning in 1987—''SECTION 444 ELECTION—RE-ACTIVATES S STATUS,'' and

(C) Include the following statement with Form 1120S—''RE-ACTIVATION CONSENTED TO BY ALL SHAREHOLDERS WHO HAVE OWNED STOCK AT ANY TIME SINCE THE FIRST DAY OF THE FIRST TAXABLE YEAR OF THIS CORPORATION BEGINNING AFTER DECEMBER 31, 1986.''

(iv) *Examples.* The provisions of this paragraph (a)(6) may be illustrated by the following examples.

Example 1. Assume a corporation historically used a June 30 taxable year and such corporation timely filed Form 2553, Election by a Small Business Corporation, to be effective for its taxable year beginning July 1, 1987. On its Form 2553, the corporation requested permission to retain its June 30 taxable year based on business purpose. However, the corporation did not agree to use a calendar year in the event its business purpose request was denied. On April 1, 1988, the Internal Revenue Service notified the corporation that its business purpose request was denied and therefore the corporation's S election was not effective. Pursuant to paragraph (a)(6)(i) of this section, the corporation may re-activate its S election by making a valid section 444 election and complying with the procedures in paragraph (a)(6)(iii) of this section.

Example 2. The facts are the same as in Example 1, except that as of July 26, 1988, the Internal Revenue Service has not yet determined whether the corporation has a valid business purpose to retain a June 30 taxable year. Based on these facts, the corporation may, if otherwise qualified, make a back-up section 444 election as provided in §1.444–3T(b)(4). If the corporation's business purpose request is subsequently denied, the corporation should follow the procedures in §1.444–3T(b)(4)(iii) for activating a back-up section 444 election rather than the procedures provided in this paragraph (a)(6 for reactivating an S election.

Example 3. Assume a corporation has historically been an S corporation with a March 31 taxable year. However, for its taxable year beginning April 1, 1987, the corporation revoked its S election pursuant to section 1362 (d)(1). Pursuant to paragraph (a)(6)(ii) of this section, such corporation may retroactively rescind its S election revocation by making a valid section 444 election for its taxable year beginning April 1, 1987, and complying with the procedures provided in paragraph (a)(6)(iii) of this section. If the corporation retroactively rescinds its S revocation, the corporation shall file a Form 1120S for its taxable year beginning April 1, 1987.

(b) *Limitation on taxable years that may be elected*—(1) *General rule.* Except as provided in paragraphs (b)(2) and (3) of this section, a section 444 election may be made only if the deferral period (as defined in paragraph (b)(4) of this section) of the taxable year to be elected is not longer than three months.

(2) *Changes in taxable year*—(i) *In general.* In the case of a partnership, S corporation, or personal service corporation changing its taxable year, such entity may make a section 444 election only if the deferral period of the taxable year to be elected is not longer than the shorter of—

(A) Three months, or

(B) The deferral period of the taxable year that is being changed, as defined in paragraph (b)(2)(iii) of this section.

(ii) *Special rule for certain existing corporations electing S status.* If a corporation with a taxable year other than the calendar year—

(A) Elected after September 18, 1986, and before January 1, 1988, under section 1362 of the Code to be an S corporation, and

(B) Elected to have the calendar year as the taxable year of the S corporation,

then, for taxable years beginning before 1989, paragraph (b)(2)(i) of this section shall be applied by taking into account the deferral period of the last taxable year of the corporation prior to electing to be an S corporation, rather than the deferral period of the taxable year that is being changed. Thus, the provisions of the preceding sentence do not apply to a corporation that elected to be an S corporation for its first taxable year.

(iii) *Deferral period of the taxable year that is being changed.* For purposes of paragraph (b)(2)(i)(B) of this section, the phrase ''deferral period of the taxable year that is being changed'' means the deferral period of the taxable year immediately preceding the taxable year for which the taxpayer desires to make a section 444 election. Furthermore, the deferral period of such year will be determined by using the required taxable year of the taxable year for which the taxpayer desires to make a section 444 election. For example, assume P, a partnership that has historically used a March 31 taxable year, desires to change to a September 30 taxable year by making a section 444 election for its taxable year beginning April 1, 1987. Furthermore, assume that pursuant to paragraph (a)(4) of this section, P's required taxable year for the taxable year beginning April 1, 1987 is a year ending December 31. Based on these facts the deferral period of the taxable year being changed is nine months (the period from March 31 to December 31).

(iv) *Examples.* See paragraph (d)(1) of this section for examples that illustrate the provisions of this paragraph (b)(2).

(3) *Special rule for entities retaining 1986 taxable year.* Notwithstanding paragraph (b)(2) of this section, a partnership, S corporation, or personal service corporation may, for its first taxable year beginning after December 31, 1986, if otherwise qualified, make a section 444 election to have a taxable year that is the same as the entity's last taxable year beginning in 1986. See paragraph (d)(2) of this section for examples that illustrate the provisions of this paragraph (b)(3).

(4) *Deferral period*—(i) *Retentions of taxable year.* For a partnership, S corporation, or personal service corporation that desires to retain its taxable year by making a section 444 election, the term ''deferral period'' means the months between the beginning of such year and the close of the first required taxable year (as defined in paragraph (a)(4) of this section). The following example illustrates the application of this paragraph (b)(4)(i).

Example. AB partnership has historically used a taxable year ending July 31. AB desires to retain its July 31 taxable year by making a section 444 election for its taxable year beginning August 1, 1987. Calendar year individuals, A and B, each own 50 percent of the profits and capital of AB; thus, under paragraph (a)(4) of this section AB's required taxable year is the year ending December 31. Pursuant to this paragraph (b)(4)(i), if AB desires to retain its year ending July 31, the deferral period is five months (the months between July 31 and December 31).

(ii) *Adoptions of and changes in taxable year*—(A) *In general.* For a partnership, S corporation, or personal service corporation that desires to adopt or change its taxable year by making a section 444 election, the term ''deferral period'' means the months that occur after the end of the taxable year desired under section 444 and before the close of the required taxable year.

(B) *Special rule.* If a partnership, S corporation or personal service corporation is using the required taxable year as its taxable year, the deferral period is deemed to be zero.

(C) *Examples.* The provisions of this paragraph (b)(4)(ii) may be illustrated by the following examples.

Example 1. Assume that CD partnership has historically used the calendar year and that CD's required taxable year is the calendar year. Under the special rule provided in paragraph (b)(4)(ii)(B) of this section, CD's deferral period is zero. See paragraph (b)(2)(i) of this section for rules that preclude CD from making a section 444 election to change its taxable year.

Example 2. E, a newly formed partnership, began operations on December 1, 1987, and is owned by calendar year individuals. E desires to make a section 444 election to adopt a September 30 taxable year. E's required taxable year is December 31. Pursuant to paragraph (b)(4)(ii)(A) of this section E's deferral period for the taxable year beginning December 1, 1987, is three months (the number of months between September 30 and December 31).

Example 3. Assume that F, a personal service corporation, has historically used a June 30 taxable year. F desires to make a section 444 election to change to an August 31 taxable year, effective for its taxable year beginning July 1, 1987. For purposes of determining the availability of a section 444 election for changing to the taxable year ending August 31, the deferral period of an August 31 taxable year is four months (the number of months between August 31 and December 31). The deferral period for F's existing June 30 taxable year is six months (the number of months between June 30 and December 31). Pursuant to §1.444–1T(b)(2)(i), F may not make a section 444 election to change to an August 31 taxable year.

(5) *Miscellaneous rules*—(i) *Special rule for determining the taxable year of a corporation electing S status.* For purposes of this section, and only for purposes of this section, a corporation that elected to be an S corporation for a taxable year beginning in 1987 or 1988 and which elected to be an S corporation prior to September 26, 1988, will not be considered to have adopted or changed its taxable year by virtue of information included on Form 2553, Election by a Small Business Corporation. See Example 8 in paragraph (d) of this section.

(ii) *Special procedure for cases where an income tax return is superseded*—(A) *In general.* In the case of a partnership, S corporation, or personal service corporation that filed an income tax return for its first taxable year beginning after December 31, 1986, but subsequently makes a section 444 election that would result in a different year end for such taxable year, the income tax return filed pursuant to the section 444 election will supersede the original return. However, any payments of income tax made with respect to such superseded return will be credited to the taxpayer's superseding return and the taxpayer may file a claim for refund for such payments. See examples (5) and (7) in paragraph (d)(2) of this section.

(B) *Procedure for superseding return.* In order to allow the Service to process the affected income tax returns in an efficient manner, a partnership, S corporation, or personal service corporation that desires to supersede an income tax return in accordance with paragraph (b)(5)(ii)(A) of this section, should type or legibly print at the top of the first page of the income tax return for the taxable year elected—''SECTION 444 ELECTION—SUPERSEDES PRIOR RETURN.''

(iii) *Anti-abuse rule*—If an existing partnership, S corporation or personal service corporation (''predecessor entities''), or the owners thereof, transfer assets to a related party and the principal purpose of such transfer is to—

(A) Create a deferral period greater than the deferral period of the predecessor entity's taxable year, or

(B) Make a section 444 election following the termination of the predecessor entity's section 444 election,

then such transfer will be disregarded for purposes of section 444 and this section, even if the deferral created by such change is effectively eliminated by a required payment (within the meaning of section 7519) or deferral of a deduction (to a personal service corporation under section 280H). The following example illustrates the application of this paragraph (b)(5)(iii).

Example. Assume that P1 is a partnership that historically used the calendar year and is owned by calendar year partners. Assume that P1 desires to make a section 444 election to change to a September year for the taxable year beginning January 1, 1988. P1 may not make a section 444 election to change taxable years under section 444(b)(2) because its current deferral period is zero. Assume further that P1 transfers a substantial portion of its assets to a newly-formed partnership (P2), which is owned by the partners of P1. Absent paragraph (b)(5)(iii) of this section, P2 could, if otherwise qualified, make a section 444 election under paragraph (b)(1) of this section to use a taxable year with a three month or less deferral period (*i.e.*, a September 30, October 31, or November 30 taxable year). However, if the principal purpose of the asset transfer was to create a one-, two-, or three-month deferral period by P2 making a section 444 election, the section 444 election shall not be given effect, even if the deferral would be effectively eliminated by P2 making a required payment under section 7519.

(iv) *Special rules for partial months and 52–53-week taxable years.* Except as otherwise provided in §1.280H–1T(c)(2)(i)(A), for purposes of this section and §§1.7519–1T, 1.7519–2T and 1.280H–1T—

(A) A month of less than 16 days is disregarded, and a month of more than 15 days is treated as a full month; and

(B) A 52–53-week taxable year with reference to the end of a particular month will be considered to be the same as a taxable year ending with reference to the last day of such month.

(c) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

(d) *Examples*—(1) *Changes in taxable year.* The following examples illustrate the provisions of paragraph (b)(2) of this section.

Example 1. A is a personal service corporation that historically used a June 30 taxable year. A desires to make a section 444 election to change to an August 31 taxable year, effective with its taxable year beginning July 1, 1987. Under paragraph (b)(4)(ii) of this section, the deferred period of the taxable year to be elected is four months (the number of months between August 31 and December 31). Furthermore, the deferral period of the taxable year that is being changed is six months (the number of months between June 30 and December 31). Pursuant to paragraph (b)(2)(i) of this section, a taxpayer may, if otherwise qualified, make a section 444 election to change to a taxable year only if the deferral period of the taxable year to be elected is not longer than the shorter of three months or the deferred period of the taxable year being changed. Since the deferral period of the taxable year to be elected (August 31) is greater than three months, A may not make a section 444 election to change to the taxable year ending August 31, However, since the deferral period of the taxable year that is being changed is three months or more, A may, if otherwise qualified, make a section

444 election to change to a year ending September 30, 1987 (three-month deferral period), a year ending October 31, 1987 (two-month deferral period), or a year ending November 30, 1987 (one-month deferral period). In addition, instead of making a section 444 election to change its taxable year, A could, if otherwise qualified, make a section 444 election to retain its June end, pursuant to paragraph (b)(3) of this section.

Example 2. B, a corporation that historically used an August 31 taxable year, elected on November 1, 1986 to be an S corporation for its taxable year beginning September 1, 1986. As a condition to having the S election accepted, B agreed on Form 2553 to use calendar year. Pursuant to the general effective date provided in paragraph (c) of this section, B may not make a section 444 election for its taxable year beginning in 1986. Thus, B must file a short period income tax return for the period September 1 to December 31, 1986.

Example 3. The facts are the same as in Example 2, except that B desires to make a section 444 election for its taxable year beginning January 1, 1987. Absent paragraph (b)(2)(ii) of this section, B would not be allowed to change its taxable year because the deferral period of the taxable year being changed (*i.e.*, the calendar year) is zero. However, pursuant to the special rule provided in paragraph (b)(2)(ii) of this section, B shall apply paragraph (b)(2)(i) of this section by taking into account the deferral period of the last taxable year of B prior to B's election to be an S corporation (four months), rather than the deferral period of B's taxable year that is being changed (zero months). Thus, if otherwise qualified, B may make a section 444 election to change to a taxable year ending September 30, October 31, or November 30, for its taxable year beginning January 1, 1987.

Example 4. The facts are the same as in Example 3, except that B files a calendar year income tax return for 1987 rather than making a section 444 election. However, for its taxable year beginning January 1, 1988, B desires to change its taxable year by making a section 444 election. Given that the special rule provided in paragraph (b)(2)(ii) of this section applies to section 444 elections made in taxable years beginning before 1989, B may, if otherwise qualified, make a section 444 election to change to a taxable year ending September 30, October 31, or November 30 for its taxable year beginning January 1, 1988.

Example 5. C, a corporation that historically used a June 30 taxable year, elected on December 15, 1986 to be an S corporation for its taxable year beginning July 1, 1987. As a condition to having the S election accepted, C agreed on Form 2553 to use a calendar year. Although pursuant to paragraph (b)(3) of this section, C would, if otherwise qualified, be allowed to retain its June 30 taxable year, C desires to change to a September 30 taxable year by making a section 444 election. Pursuant to paragraph (b)(2) of this section, a taxpayer may, if otherwise qualified, make a section 444 election to change to a taxable year only if the deferral period of the taxable year to be elected is not longer than the shorter of three months or the deferral period of the taxable year being changed. Given these facts, the deferral period of the taxable year to be elected is 3 months (September 30 to December 31) while the deferral period of the taxable year being changed is 6 months (June 30 to December 31). Thus, C may, if otherwise qualified, change to a September 30 taxable year for its taxable year beginning July 1, 1987, by making a section 444 election. The fact that C agreed on Form 2553 to use a calendar year is not relevant.

Example 6. D, a corporation that historically used a March 31 taxable year, elects on June 1, 1988 to be an S corporation for its taxable year beginning April 1, 1988. D desires to change to a June 30 taxable year by making a section 444 election for its taxable year beginning April 1, 1988. Pursuant to paragraph (b)(2)(i) of this section, D may not change to a June 30 taxable year because such year would have a deferral period greater than 3 months. However, if otherwise qualified, D may make a section 444 election to change to a taxable year ending September 30, October 31, or November 30 for its taxable year beginning April 1, 1988.

Example 7. E, a corporation that began operations on November 1, 1986, elected to be an S corporation on December 15, 1986, for its taxable year beginning November 1, 1986. E filed a short period income tax return for the period November 1 to December 31, 1986. E desires to change to a September 30 taxable year by making a section 444 election for its taxable year beginning January 1, 1987. Although E elected to be an S corporation after September 18, 1986, and before January 1, 1988, paragraph (b)(2)(ii) of this section does not apply to E since E was not a C corporation prior to electing S status. Thus, E may not change its taxable year for the taxable year beginning January 1, 1987, by making a section 444 election.

Example 8. The facts are the same as in Example 7, except that E began operations on April 15, 1987, and elected to be an S corporation on June 1, 1987, for its taxable year beginning April 15, 1987. As a condition to being an S corporation, E agreed on Form 2553 to use a calendar year. E desires to make a section 444 election to use a year ending September 30 for its taxable year beginning April 15, 1987. Pursuant to paragraph (b)(5)(i) of this section, E's agreement to use a calendar year on Form 2553 does not mean that E has adopted a calendar year. Thus, E's desire to make a section 444 election to use a

September 30 taxable year will not be considered a change in taxable year and thus paragraph (b)(2) of this section will not apply. Instead, E will be subject to paragraph (b)(1) of this section. Since a September 30 taxable year would result in only a three-month deferral period (September 30 to December 31), E may, if otherwise qualified, make a section 444 election to use a year ending September 30 for its taxable year beginning April 15, 1987.

(2) *Special rule for entities retaining their 1986 taxable year*. The following examples illustrate the provisions of paragraph (b)(3) of this section.

Example 1. F, an S corporation that elected to be an S corporation several years ago, has historically used a June 30 taxable year. F desires to retain its June 30 taxable year by making a section 444 election for its taxable year beginning July 1, 1987. Pursuant to paragraph (b)(4)(i) of this section, the deferral period of the taxable year being retained is 6 months (June 30 to December 31, F's required taxable year). Absent the special rule provided in paragraph (b)(3) of this section, F would be subject to the general rule provided in paragraph (b)(1) of this section which limits the deferral period of the taxable year elected to three months or less. However, pursuant to paragraph (b)(3) of this section, F may, if otherwise qualified, make a section 444 election to retain its year ending June 30 for its taxable year beginning July 1, 1987.

Example 2. The facts are the same as in Example 1, except that F received permission from the Commissioner to change its taxable year to the calendar year, and filed a short period income tax return for the period July 1 to December 31, 1986. F desires to make a section 444 election to use a year ending June 30 for its taxable year beginning January 1, 1987. Given that F had a December 31 taxable year for its last taxable year beginning in 1986, the special rule provided in paragraph (b)(3) of this section does not allow F to use a June 30 taxable year for its taxable year beginning January 1, 1987. Furthermore, pursuant to paragraph (b)(2)(i) of this section, F is not allowed to change its taxable year from December 31 to June 30 because the deferral period of the taxable year being changed is zero months.

Example 3. G, a corporation that historically used an August 31 taxable year, elected be an S corporation on November 15, 1986, for its taxable year beginning September 1, 1986. As a condition to obtaining S status, G agreed to use a calendar year. Thus, G filed its first S corporation return for the period September 1 to December 31, 1986. G desires to make a section 444 election to use a year ending August 31 for its taxable year beginning January 1, 1987. Since G's last taxable year beginning in 1986 was a calendar year, G cannot use paragraph (b)(3) of this section, relating to retentions of taxable years, to elect an August 31 taxable year. Thus, G is subject to paragraph (b)(2)(i) of this section, relating to changes in taxable year. Although G, if otherwise qualified, may use the special rule provided in paragraph (b)(2)(ii) of this section, G may only change from its current taxable year (*i.e.*, the calendar year) to a taxable year that has no more than a three-month deferral period (*i.e.*, September 30, October 31, or November 30).

Example 4. The facts are the same as in Example 3, except that G elected to be an S corporation for its taxable year beginning September 1, 1987, rather than its taxable year beginning September 1, 1986. As a condition to making its S election, G agreed, on Form 2553, to use the calendar year. However, G has not yet filed a short period income tax return for the period September 1 to December 31, 1987. Given these facts, paragraph (b)(3) of this section would allow G, if otherwise qualified, to make a section 444 election to retain an August 31 taxable year for its taxable year beginning September 1, 1987.

Example 5. The facts are the same as in Example 4, except that G has already filed a short period income tax return for the period September 1 to December 31, 1987. Pursuant to paragraph (b)(5)(ii)(A) of this section, G may supersede the return it filed for the period September 1 to December 31, 1987. Thus, pursuant to paragraph (b)(3) of this section, G may, if otherwise qualified, make a section 444 election to retain an August 31 taxable year for the taxable year beginning September 1, 1987. In addition, G should follow the special procedures set forth in paragraph (b)(5)(ii)(B) of this section.

Example 6. H, a corporation that historically used a May 31 taxable year, elects to be an S corporation on June 15, 1988 for its taxable year beginning June 1, 1988. H desires to make a section 444 election to use a taxable year other than the calendar year. Since the taxable year in issue is not H's first taxable year beginning after December 31, 1986, H may not use the special rule provided in paragraph (b)(3)(i) and thus may not retain its May 31 year. However, H may, if otherwise qualified, make a section 444 election under paragraph (b)(2)(i) of this section, to change to a taxable year that has no more than a three-month deferral period (*i.e.*, September 30, October 31, or November 30) for its taxable year beginning June 1, 1988.

Example 7. I is a partnership that has historically used a calendar year. Sixty percent of the profits and capital of I are owned by Q, a corporation (that is neither an S corporation nor a personal service corporation) that has a June 30 taxable year, and 40 percent of the profits and capital are owned by

R, a calendar year individual. Since the partner that has more than a fifty percent interest in I has a June 30 taxable year, I's required taxable year is June 30. Accordingly, I filed an income tax return for the period January 1 to June 30, 1987. Based on these facts, I may, pursuant to paragraph (b)(5)(ii)(A) of this section, disregard the income tax return filed for the period January 1 to June 30, 1987. Thus, if otherwise qualified, I may make a section 444 election under paragraph (b)(2)(i) of this section to use a calendar year for its taxable year beginning January 1, 1987. If I makes such a section 444 election, I should follow the special procedures set forth in paragraph (b)(5)(ii)(B) of this section.

[T.D. 8205, 53 FR 19694, May 27, 1988, as amended by T.D. 8996, 67 FR 35012, May 17, 2002]

§ 1.444–2T Tiered structure (temporary).

(a) *General rule.* Except as provided in paragraph (e) of this section, no section 444 election shall be made or continued with respect to a partnership, S corporation, or personal service corporation that is a member of a tiered structure on the date specified in paragraph (d) of this section. For purposes of this section, the term ''personal service corporation'' means a personal service corporation as defined in § 1.441–3(c).

(b) *Definition of a member of a tiered structure*—(1) *In general.* A partnership, S corporation, or personal service corporation is considered a member of a tiered structure if—

(i) The partnership, S corporation, or personal service corporation directly owns any portion of a deferral entity, or

(ii) A deferral entity directly owns any portion of the partnership, S corporation, or personal service corporation.

However, see paragraph (c) of this section for certain de minimis rules, and see paragraph (b)(3) of this section for an anti-abuse rule. In addition, for purposes of this section, a beneficiary of a trust shall be considered to own an interest in the trust.

(2) *Deferral entity*—(i) *In general.* For purposes of this section, the term ''deferral entity'' means an entity that is a partnership, S corporation, personal service corporation, or trust. In the case of an affiliated group of corporations filing a consolidated income tax return that is treated as a personal service corporation pursuant to § 1.441–4T (i), such affiliated group is considered to be a single deferral entity.

(ii) *Grantor trusts.* The term ''deferral entity'' does not include a trust (or a portion of a trust) which is treated as owned by the grantor or beneficiary under Subpart E, part I, subchapter J, chapter 1, of the Code (relating to grantor trusts), including a trust that is treated as a grantor trust pursuant to section 1361(d)(1)(A) of the Code (relating to qualified subchapter S trusts). Thus, any taxpayer treated under subpart E as owning a portion of a trust shall be treated as owning the assets of the trust attributable to that ownership. The following examples illustrate the provisions of this paragraph (b)(2)(ii).

Example 1. A, an individual, is the sole beneficiary of T. T is a trust that owns 50 percent of the profits and capital of X, a partnership that desires to make a section 444 election. Furthermore, pursuant to Subpart E, Part I, subchapter J, chapter 1 of the Code, A is treated as an owner of X. Based upon these facts, T is not a deferral entity and 50 percent of X is considered to be directly owned by A.

Example 2. The facts are the same as in Example 1, except that A is a personal service corporation rather than an individual. Given these facts, 50 percent of X is considered to be directly owned by A, a deferral entity. Thus, X is considered to be a member of a tiered structure.

(3) *Anti-abuse rule.* Notwithstanding paragraph (b)(1) of this section, a partnership, S corporation, or personal service corporation is considered a member of a tiered structure if the partnership, S corporation, personal service corporation, or related taxpayers have organized or reorganized their ownership structure or operations for the principal purpose of obtaining a significant unintended tax benefit from making or continuing a section 444 election. For purposes of the preceding sentence, a significant unintended tax benefit results when a partnership, S corporation, or personal service corporation makes a section 444 election and, as a result, a taxpayer (not limited to the entity making the election) obtains a significant deferral of income

substantially all of which is not eliminated by a required payment under section 7519. See examples (15) through (19) in paragraph (f) of this section.

(c) *De minimis rules*—(1) *In general*. For rules relating to a de minimis exception to paragraph (b)(1)(i) of this section (the ''downstream de minimis rule''), see paragraph (c)(2) of this section. For rules relating to a de minimis exception to paragraph (b)(1)(ii) of this section (the ''upstream de minimis rule''), see paragraph (c)(3) of this section. For rules relating to the interaction of the de minimis rules provided in this paragraph (c) and the ''same taxable year exception'' provided in paragraph (e) of this section, see paragraph (e)(5) of this section.

(2) *Downstream de minimis rule*—(i) *General rule*. If a partnership, S corporation, or personal service corporation directly owns any portion of one or more deferral entities as of the date specified in paragraph (d) of this section, such ownership is disregarded for purposes of paragraph (b)(1)(i) of this section if, in the aggregate, all such deferral entities accounted for—

(A) Not more than 5 percent of the partnership's, S corporation's, or personal service corporation's adjusted taxable income for the testing period (''5 percent adjusted taxable income test''), or

(B) Not more than 2 percent of the partnership's, S corporation's, or personal service corporation's gross income for the testing period (''2 percent gross income test''). See section 702 (c) for rules relating to the determination of gross income of a partner in a partnership.

See examples (3) through (5) in paragraph (f) of this section.

(ii) *Definition of testing period*. For purposes of this paragraph (c)(2), the term ''testing period'' means the taxable year that ends immediately prior to the taxable year for which the partnership, S corporation, or personal service corporation desires to make or continue a section 444 election. However, see the special rules provided in paragraph (c)(2)(iv) of this section for certain special cases (*e.g.*, the partnership, S corporation, personal service corporation or deferral entity was not in existence during the entire testing period). The following example illustrates the application of this paragraph (c)(2)(ii).

Example. A partnership desires to make a section 444 election for its taxable year beginning November 1, 1987. The testing period for purposes of determining whether deferral entities owned by such partnership are de minimis under paragraph (c)(2) of this section is the taxable year ending October 31, 1987. If either the partnership or the deferral entities were not in existence for the entire taxable year ending October 1, 1987, see the special rules provided in paragraph (c)(2)(iv) of this section.

(iii) *Definition of adjusted taxable income*—(A) *Partnership*. In the case of a partnership, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(*1*) Aggregate amount of the partnership items described in section 702(a) (other than credits and tax-exempt income),

(*2*) Applicable payments defined in section 7519(d)(3) that are deducted in determining the amount described in paragraph (c)(2)(iii)(A)(*1*) of this section, and

(*3*) Guaranteed payments defined in section 707(c) that are deducted in determining the amount described in paragraph (c)(2)(iii)(A)(*1*) of this section and are not otherwise included in paragraph (c)(2)(iii)(A)(*2*) of this section. For purposes of determining the aggregate amount of partnership items under paragraph (c)(2)(iii)(A)(*1*) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 702(a) a partnership has $1,000 of ordinary taxable income, $500 of specially allocated deductions, and $300 of capital loss, the partnership's aggregate amount of partnership items under paragraph (c)(2)(iii)(A)(*1*) of this section is $200 ($1,000–$500–$300).

(B) *S corporation*. In the case of an S corporation, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(*1*) Aggregate amount of the S corporation items described in section 1366(a) (other than credits and tax-exempt income), and

(*2*) Applicable payments defined in section 7519(d)(3) that are deducted in determining the amount described in paragraph (c)(2)(iii)(B)(*1*) of this section.

For purposes of determining the aggregate amount of S corporation items under paragraph (c)(2)(iii)(B)(*1*) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 1366(a) an S corporation has $2,000 of ordinary taxable income, $1,000 of deductions described in section 1366(a)(1)(A) of the Code, and $500 of capital loss, the S corporation's aggregate amount of S corporation items under paragraph (c)(2)(iii)(B)(*1*) of this section is $500 ($2,000–$1,000–$500).

(C) *Personal service corporation.* In the case of a personal service corporation, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(*1*) Taxable income of the personal service corporation, and

(*2*) Applicable amounts defined in section 280H(f)(1) that are deducted in determining the amount described in paragraph (c)(2)(iii)(C)(*1*) of this section.

(iv) *Special rules*—(A) *Pro-forma rule.* Except as provided in paragraph (c)(iv)(C)(*2*) of this section, if a partnership, S corporation, or personal service corporation directly owns any interest in a deferral entity as of the date specified in paragraph (d) of this section and such ownership interest is different in amount from the partnership's, S corporation's, or personal service corporation's interest on any day during the testing period, the 5 percent adjusted taxable income test and the 2 percent gross income test must be applied on a pro-forma basis (*i.e.*, adjusted taxable income and gross income must be calculated for the testing period assuming that the partnership, S corporation, or personal service corporation owned the same interest in the deferral entity that it owned as of the date specified in paragraph (d) of this section). The following example illustrates the application of this paragraph (c)(2)(iv)(A).

Example. A personal service corporation desiring to make a section 444 election for its taxable year beginning October 1, 1987, acquires a 25 percent ownership interest in a partnership on or after October 1, 1987. Furthermore, the partnership has been in existence for several years. The personal service corporation must modify its calculations of the 5 percent adjusted taxable income test and the 2 percent gross income test for the testing period ended September 30, 1987, by assuming that the personal service corporation owned 25 percent of the partnership during such testing period and the personal service corporation's adjusted taxable income and gross income were correspondingly adjusted.

(B) *Reasonable estimates allowed.* If the information necessary to complete the pro-forma calculation described in paragraph (c)(2)(iv)(A) of this section is not readily available, the partnership, S corporation, or personal service corporation may make a reasonable estimate of such information.

(C) *Newly formed entities*—(*1*) *Newly formed deferral entities.* If a partnership, S corporation, or personal service corporation owns any portion of a deferral entity on the date specified in paragraph (d) of this section and such deferral entity was not in existence during the entire testing period (hereinafter referred to as a ''newly formed deferral entity''), both the 5 percent adjusted taxable income test and the 2 percent gross income test are modified as follows. First, the partnership, S corporation, or personal service corporation shall calculate the percentage of its adjusted taxable income or gross income that is attributable to deferral entities, excluding newly formed deferral entities. Second, the partnership, S corporation, or personal service corporation shall calculate (on the date specified in paragraph (d) of this section) the percentage of the tax basis of its assets that are attributable to its tax basis with respect to its ownership interests in all newly formed deferral entities. If the sum of the two percentages is 5 percent or less, the deferral entities are considered de minimis and are disregarded for purposes of paragraph (b)(1)(i) of this section. If the sum of the two percentages is greater than 5 percent, the deferral entities do not qualify for the de minimis rule provided in paragraph (c)(2) of this section and thus the partnership, S corporation, or personal service corporation is considered to be a member of a tiered structure for purposes of this section.

(*2*) *Newly formed partnership, S corporation, or personal service corporation* *desiring to make a section 444 election.* If a partnership, S corporation, or personal service corporation desires to make a section 444 election for the first taxable year of its existence, the 5 percent adjusted taxable income test and the 2 percent gross income test are replaced by a 5 percent of assets test. Thus, if on the date specified in paragraph (d) of this section, 5 percent or less of the assets (measured by reference to the tax basis of the assets) of the newly formed partnership, S corporation, or personal service corporation are attributable to the tax basis with respect to its ownership interests in the deferral entities, the deferral entities will be considered de minimis and will be disregarded for purposes of paragraph (b)(1)(i) of this section.

(*3*) *Upstream de minimis rule.* If a partnership, S corporation, or personal service corporation is directly owned by one or more deferral entities as of the date specified in paragraph (d) of this section, such ownership is disregarded for purposes of paragraph (b)(1)(ii) of this section if on the date specified in paragraph (d) of this section the deferral entities directly own, in the aggregate, 5 percent or less of—

(*i*) An interest in the current profits of the partnership, or

(*ii*) The stock (measured by value) of the S corporation or personal service corporation.

See examples (6) and (7) in paragraph (f) of this section.

(d) *Date for determining the existence of a tiered structure*—(1) *General rule.* For purposes of paragraph (a) of this section, a partnership, S corporation, or personal service corporation will be considered a member of a tiered structure for a particular taxable year if the partnership, S corporation, or personal service corporation is a member of a tiered structure on the last day of the required taxable year (as defined in section 444 (e) of the Code) ending within such year. If a particular taxable year does not include the last day of the required taxable year for such year, the partnership, S corporation, or personal service corporation will not be considered a member of a tiered structure for such year. The following examples illustrate the application of this paragraph (d)(1).

Example 1. Assume that a newly formed partnership whose first taxable year begins November 1, 1988, desires to adopt a September 30 taxable year by making a section 444 election. Furthermore, assume that for its taxable year beginning November 1, 1988, the partnership's required taxable year is December 31. If the partnership is a member of a tiered structure on December 31, 1988, it will not be eligible to make a section 444 election for a taxable year beginning November 1, 1988, and ending September 30, 1989.

Example 2. Assume an S corporation that historically used a June 30 taxable year desires to make a section 444 election to change to a year ending September 30 for its taxable year beginning July 1, 1987. If the S corporation can make the section 444 election, it will have a short taxable year beginning July 1, 1987, and ending September 30, 1987. Given these facts, the short taxable year beginning July 1, 1987, does not include the last day of the S corporation's required taxable year for such year (*i.e.*, December 31, 1987). Thus, pursuant to paragraph (d)(1) of this section, the S corporation will not be considered a member of a tiered structure for its taxable year beginning July 1, 1987, and ending September 30, 1987.

(2) *Special rule for taxable years beginning in 1987.* For purposes of paragraph (a) of this section, a partnership, S corporation, or personal service corporation will not be considered a member of a tiered structure for a taxable year beginning in 1987 if the partnership, S corporation, or personal service corporation is not a member of a tiered structure on the day the partnership, S corporation, or personal service corporation timely files its section 444 election for such year. The following examples illustrate the application of this paragraph (d)(2).

Example 1. Assume that a partnership desires to retain a June 30 taxable year by making a section 444 election for its taxable year beginning July 1, 1987. Furthermore, assume that the partnership's required taxable year for such year is December 31 and that the partnership was a member of a tiered structure on such date. Also assume that the partnership was not a member of a tiered structure as of the date it timely filed its section 444 election for its taxable year beginning July 1, 1987. Based upon the special rule provided in this paragraph (d)(2), the partnership will not be considered a member of a tiered structure for its taxable year beginning July 1, 1987.

Example 2. Assume the same facts as in Example 1, except that the partnership was a member of a tiered structure on the date it filed its section 444 election for its taxable year beginning July 1, 1987, but was not a member of a tiered structure on December 31, 1987. Paragraph (d)(1) of this section would still apply and thus the partnership would not be considered part of a tiered structure for its taxable year beginning July 1, 1987. However, the partnership would be considered a member of a tiered structure for its taxable year beginning July 1, 1988, if the partnership was a member of a tiered structure on December 31, 1988.

(e) *Same taxable year exception*—(1) *In general.* Although a partnership or S corporation is a member of a tiered structure as of the date specified in paragraph (d) of this section, the partnership, S corporation may make or continue a section 444 election if the tiered structure (as defined in paragraph (e)(2) of this section) consists entirely of partnerships or S corporations (or both), all of which have the same taxable year as determined under paragraph (e)(3) of this section. However, see paragraph (e)(5) of this section for the interaction of the de minimis rules provided in paragraph (c) of this section with the same taxable year exception. For purposes of this paragraph (e), two or more entities are considered to have the same taxable year if their taxable years end on the same day, even though they begin on different days. See examples (8) through (14) in paragraph (f) of this section.

(2) *Definition of tiered structure*—(i) *General rule.* For purposes of the same taxable year exception, the members of a tiered structure are defined to include the following entities—

(A) The partnership or S corporation that desires to qualify for the same taxable year exception,

(B) A deferral entity (or entities) directly owned (in whole or in part) by the partnership or S corporation that desires to qualify for the same taxable year exception,

(C) A deferral entity (or entities) directly owning any portion of the partnership or S corporation that desires to qualify for the same taxable year exception, and

(D) A deferral entity (or entities) directly owned (in whole or in part) by a "downstream controlled partnership," as defined in paragraph (e)(2)(ii) of this section.

(ii) *Special flow-through rule for downstream controlled partnerships.* If more than 50 percent of a partnership's profits and capital are owned by a partnership or S corporation that desires to qualify for the same taxable year exception, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (e)(2)(i) of this section. Furthermore, if more than 50 percent of a partnership's profits and capital are owned by a downstream controlled partnership, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (e)(2)(i) of this section.

(3) *Determining the taxable year of a partnership or S corporation.* The taxable year of a partnership or S corporation to be taken into account for purposes of paragraph (e)(1) of this section is the taxable year ending with or prior to the date specified in paragraph (d) of this section. Furthermore, the determination of such taxable year will take into consideration any section 444 elections made by the partnership or S corporation. See examples (10) and (11) in paragraph (f) of this section.

(4) *Special rule for 52–53-week taxable years.* For purposes of this paragraph (e), a 52–53-week taxable year with reference to the end of a particular month will be considered to be the same as a taxable year ending with reference to the last day of such month.

(5) *Interaction with de minimis rules*—(i) *Downstream de minimis rule*—(A) *In general.* If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (e)(2) of this section) and directly owns any member (or members) of the tiered structure with a taxable year different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable year exception of paragraph (e)(1) of this section provided that, in the aggregate, the de minimis rule of paragraph (c)(2) of this section is satisfied with respect to such owned member (or members). The following example illustrates the application of this paragraph (e)(5)(i)(A).

Example. P, a partnership with a June 30 taxable year, owns 60 percent of P1, another partnership with a June 30 taxable year. P also owns 1 percent of P2 and P3, calendar year partnerships. If, in the aggregate, P's ownership interests in P2 and P3 are considered de minimis under paragraph (c)(2) of this section, P meets the same taxable year exception and may make a section 444 election to retain its June 30 taxable year.

(B) *Special rule for members of a tiered structure directly owned by a downstream controlled partnership.* For purposes of paragraph (e)(5)(i)(A) of this section, a partnership or S corporation desiring to make or continue a section 444 election is considered to directly own any member of the tiered structure (as defined in paragraph (e)(2) of this section) directly owned by a downstream controlled partnership (as defined in paragraph (e)(2)(ii) of this section). The adjusted taxable income or gross income of the partnership or S corporation that is attributable to a member of a tiered structure directly owned by a downstream controlled partnership equals the adjusted taxable income or gross income of such member multiplied by the partnership's or S corporation's indirect ownership percentage of such member. The following example illustrates the application of this paragraph (e)(5)(i)(B).

Example. P, a partnership, desires to retain its June 30 taxable year by making a section 444 election. However, as of the date specified in paragraph (d) of this section, P owns 75 percent of P1, a June 30 partnership, and P1 owns 40 percent of P2, a calendar year partnership. P also owns 25 percent of P3, a calendar year partnership. Pursuant to paragraphs (e)(5)(i) (A) and (B) of this section, P may only qualify to use the same taxable year exception if, in the aggregate, P2 and P3 are de minimis with respect to P. Pursuant to paragraph (e)(5)(i)(B) of this section, P's adjusted taxable income or gross income attributable to P2 equals 30 percent (75 percent times 40 percent) of P2's adjusted taxable income or gross income.

(ii) *Upstream de minimis rule.* If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (e)(2) of this section) and is owned directly by a member (or members) of the tiered structure with taxable years different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable year exception of paragraph (e)(1) of this section provided that, in the aggregate, the de minimis rule of paragraph (c)(3) of this section is satisfied with respect to such owning member (or members). See Example 12 of paragraph (f) of this section.

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

Example 1. A, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (d) of this section, A is owned by a combination of individuals and S corporations. The S corporations are deferral entities, as defined in paragraph (b)(2) of this section. Thus, pursuant to paragraph (b)(1)(ii) of this section, A will be a member of a tiered structure unless under paragraph (c)(3) of this section, the S corporations, in the aggregate, own a de minimis portion of A. If the S corporations' ownership in A is not considered de minimis under paragraph (c)(3) of this section, A is a member of a tiered structure and will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (e) of this section.

Example 2. B, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (d) of this section, B is a partner in two partnerships, B1 and B2. B1 and B2 are deferral entities, as defined in paragraph (b)(2) of this section. Thus, under paragraph (b)(1)(i) of this section, B will be a member of a tiered structure unless B's aggregate ownership interests in B1 and B2 are considered de minimis under paragraph (c)(2) of this section. If B is a member of a tiered structure on the date specified in paragraph (d) of this section, B will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (e) of this section.

Example 3. C, a partnership with a September 30 taxable year, is 100 percent owned by calendar year individuals. C desires to make a section 444 election for its taxable year beginning October 1, 1987. However, on the date specified in paragraph (d) of this section, C owns a 1 percent interest in C1, a partnership. C does not own any other interest in a deferral entity. For the taxable year ended September 30, 1987, 10 percent of C's adjusted taxable income (as defined in paragraph (c)(2)(iii) of this section) was attributable to C's partnership interest in C1. Furthermore, 4 percent of C's gross income for the taxable year ended September 30, 1987, was attributable to C's partnership interest in C1. Under paragraph (c)(2) of this section, C's partnership interest in C1 is not de minimis because during the testing period more than 5 percent of C's adjusted taxable income is attributable to C1 and more than 2 percent of C's gross income is attributable to C1. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

Example 4. The facts are the same as Example 3, except that for the taxable year ended September 30, 1987, only 2 percent of C's adjusted taxable income was attributable to C1. Under paragraph (c)(2) of this section, C's partnership interest in C1 is considered de minimis for purposes of determining whether C is a member of a tiered structure because not more than 5 percent of C's adjusted taxable income during the testing period is attributable to C1. Thus, C is not a member of a tiered structure for its taxable year beginning October 1, 1987.

Example 5. The facts are the same as Example 4, except that in addition to owning C1, C also owns 15 percent of C2, another partnership. For the taxable year ended September 30, 1987, 2 percent of C's adjusted taxable income is attributable to C1 and an additional 4 percent is attributable to C2. Furthermore, for the taxable year ended September 30, 1987, 4 percent of C's gross income is attributable to C1 while 3 percent is attributable to C2. Under paragraph (c)(2) of this section, C1 and C2 must be aggregated for purposes of determining whether C meets either the 5 percent adjusted taxable income test or the 2 percent gross income test. Since C's adjusted taxable income attributable to C1 and C2 is 6 percent (2 percent + 4 percent) and C's gross income attributable to C1 and C2 is 7 percent (4 percent + 3 percent), C does not meet the downstream de minimis rule provided in paragraph (c)(2) of this section. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

Example 6. The facts are the same as Example 3, except that instead of determining whether C is part of a tiered structure, the issue is whether C1 is part of a tiered structure. In addition, assume that on the date specified in paragraph (d) of this section, the remaining 99 percent of C1 is owned by calendar year individuals and C1 does not own an interest in any deferral entity. Although C in Example 3 was considered to be a part of a tiered structure by virtue of its ownership interest in C1, C1 must be tested separately to determine whether it is part of a tiered structure. Since C's interest in C1 is 5 percent or less, C's interest in C1 is de minimis with respect to C1. See paragraph (c)(3) of this section. Thus, based upon these facts, C1 is not part of a tiered structure.

Example 7. The facts are the same as Example 6, except that the remaining 99 percent of C1 is owned 94 percent by calendar year individuals and 5 percent by C3, another partnership. Thus, deferral entities own 6 percent of C1 (1 percent owned by C and 5 percent owned by C3). Under paragraph (c)(3) of this section, deferral entities own more than a de minimis interest (*i.e.*, 5 percent) of C1, and thus C1 is part of a tiered structure.

Example 8. D, a partnership with a September 30 taxable year, desires to make a section 444 election for its taxable year beginning October 1, 1987. On December 31, 1987, and the date D plans to file its section 444 election, D is 10 percent owned by D1, a personal service corporation with a September 30 taxable year, and 90 percent owned by calendar year individuals. Furthermore, D1 will retain its September 30 taxable year because it previously established a business purpose for such year. Since D is owned in part by D1, a personal service corporation, and the ownership interest is not de minimis under paragraph (c)(3) of this section, D is considered a member of a tiered structure for its taxable year beginning October 1, 1987. Furthermore, although D and D1 have the same taxable year, D does not qualify for the same taxable year exception provided in paragraph (e) of this section because D1 is a personal service corporation rather than a partnership or S corporation. Thus, pursuant to paragraph (a) of this section, D may not make a section 444 election for its taxable year beginning October 1, 1987.

Example 9. The facts are the same as Example 8, except that D1 is a partnership rather than a personal service corporation. Based upon these facts, D qualifies for the same taxable year exception provided in paragraph (e) of this section. Thus, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example 10. The facts are the same as Example 9, except that D1 has not established a business purpose for a September 30 taxable year. In addition, D1 does not desire to make a section 444 election and, under section 706(b), D1 will be required to change to a calendar year for its taxable year beginning October 1, 1987. Pursuant to paragraph (e)(3) of this section, D and D1 do not have the same taxable year for purposes of the same taxable year exception provided in paragraph (e) of this section. Thus, D may not make a section 444 election for its taxable year beginning October 1, 1987.

Example 11. The facts are the same as Example 8, except that D1 is a partnership with a March 31 taxable year. Furthermore, for its taxable year beginning April 1, 1987, D1 will change to a September 30 taxable year by making a section 444 election. Pursuant to paragraph (e)(3) of this section, D1 is considered to have a September 30 taxable year for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (e) of this section. Since both D and D1 will have the same taxable year as of the date specified in paragraph (d) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example 12. The facts are the same as Example 11, except that instead of the remaining 90 percent of D being owned by calendar year individuals, it is owned 86 percent by individuals and 4 percent by D2, a calendar year partnership. Thus, D, a September 30 partnership, is 10 percent owned by D1, a September 30 partnership, 86 percent owned by calendar year individuals, and 4 percent owned by D2, a calendar year partnership. Under paragraph (e)(5)(ii) of this section, D2's ownership interest in D is considered de minimis for purposes of the same taxable year exception. Since D2's ownership interest in D is considered de minimis, it is disregarded for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (e) of this section. Thus, since both D and D1 will have the same taxable year as of the date specified in paragraph (d) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example 13. E, a partnership with a June 30 taxable year, desires to make a section 444 election for its taxable year beginning July 1, 1987. On the date specified in paragraph (d) of this section, E is 100 percent owned by calendar year individuals; E owns 99 percent of the profits and capital of E1, a partnership with a June 30 taxable year; and E1 owns 30 percent of the profits and capital of E2, a partnership with a September 30 taxable year. E owns no other deferral entities. Pursuant to paragraph (b)(1)(i) of this section, E is considered to be a member of a tiered structure. Furthermore, pursuant to paragraph (e) of this section, E does not qualify for the same taxable year exception because E2 does not have the same taxable year as E and E1.

Example 14. The facts are the same as Example 13, except that E owns only 49 percent (rather than 99 percent) of the profits and capital of E1. Pursuant to paragraph (e) of this section, E qualifies for the same taxable year exception because E and E1 have the same taxable year. Pursuant to paragraph (e) of this section, E1's ownership interest in E2 is disregarded since E does not own more than 50 percent of E1's profits and capital.

Example 15. Prior to consideration of the anti-abuse rule provided in paragraph (b)(3) of this section, H, a partnership that commenced operations on October 1, 1987, is eligible to make a section 444 election for its taxable year beginning October 1, 1987. Although H may obtain a significant deferral of income substantially all of which is not eliminated by a required payment under section 7519 (since there will be no required payment for H's first taxable year), the anti-abuse rule of paragraph (b)(3) will not apply unless the principal purpose of organizing H was the attainment of a significant deferral of income that would result from making a section 444 election.

Example 16. F, a partnership with a January 31 taxable year, desires to make a section 444 election to retain its January 31 taxable year for the taxable year beginning February 1, 1987. F is 100 percent owned by calendar year individuals. Prior to the date specified in paragraph (d) of this section, F contributes substantially all of its assets to F1, a partnership, in exchange for a 51 percent interest in F1. The remaining 49 percent of F1 is owned by the calendar year individuals owning 100 percent of F. If F is allowed to make a section 444 election to retain its January 31 taxable year, F1's required taxable year will be January 31 since a majority of F1's partners use a January 31 taxable year (see §1.706–3T). F's principal purpose for creating F1 and contributing its assets to F1 is to obtain an 11-month deferral on 49 percent of the income previously earned by F and now earned by F1. Pursuant to paragraph (b)(3) of this section, F is not allowed to make a section 444 election for its taxable year beginning February 1, 1987.

Example 17. The facts are the same as in Example 16, except that F does not create F1 and contribute its assets to F1 until immediately after F makes its section 444 election for the taxable year beginning February 1, 1987. Thus, F is allowed to make a section 444 election for its taxable year beginning February 1, 1987. However, pursuant to paragraph (b)(3) of this section, F will have its section 444 election terminated for subsequent years unless the tax deferral inherent in the structure is eliminated (*e.g.*, F1 is liquidated or the individual owners of F contribute their interests in F1 to F) prior to the date specified in paragraph (d) of this section for subsequent taxable years beginning on or after February 1, 1988.

Example 18. The facts are the same as in Example 16, except that F1 is 99 percent owned by F and none of the individual owners of F own any portion of F1. Furthermore, F obtained no tax benefit from creating and contributing assets to F1. Given these facts paragraph (b)(3) of this section does not apply and thus, F may make a section 444 election for its taxable year beginning February 1, 1987.

Example 19. G, a partnership with an October 31 taxable year, desires to retain its October 31 taxable year for its taxable year beginning November 1, 1987. However, as of December 31, 1987, G owns a 30 percent interest in G1, a calendar year partnership. G owns no other deferral entity, and G is 100 percent owned by calendar year individuals. Furthermore, G's interest in G1 does not meet the de minimis rule provided in paragraph (c)(3) of this section. Thus, in order to avoid being a tiered structure, G sells its interest in G1 to an unrelated third party prior to the date G timely makes it section 444 election for its taxable year beginning November 1, 1987. Although the sale of G1 allows G to qualify to make a section 444 election, and therefore to obtain a significant tax benefit, such benefit is not unintended. Thus, paragraph (b)(3) of this section does not apply, and G may make a section 444 election for its taxable year beginning November 1, 1987.

(g) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19698, May 27, 1988, as amended by T.D. 8996, 67 FR 35012, May 17, 2002]

§ 1.444–3T Manner and time of making section 444 election (temporary).

(a) *In general.* A section 444 election shall be made in the manner and at the time provided in this section.

(b) *Manner and time of making election*—(1) *General rule.* A section 444 election shall be made by filing a properly prepared Form 8716, ''Election to Have a Tax Year Other Than a Required Tax Year,'' with the Service Center indicated by the instructions to Form 8716. Except as provided in paragraphs (b) (2) and (4) of this section, Form 8716 must be filed by the earlier of—

(i) The 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective, or

(ii) The due date (without regard to extensions) of the income tax return resulting from the section 444 election.

In addition, a copy of Form 8716 must be attached to Form 1065 or Form 1120 series form, whichever is applicable, for the first taxable year for which the section 444 election is made. Form 8716 shall be signed by any person who is authorized to sign Form 1065 or Form 1120 series form, whichever is applicable. (See sections 6062 and 6063, relating to the signing of returns.) The provisions of this paragraph (b)(1) may be illustrated by the following examples.

Example 1. A, a partnership that began operations on September 10, 1988, is qualified to make a section 444 election to use a September 30 taxable year for its taxable year beginning September 10, 1988. Pursuant to paragraph (b)(1) of this section, A must file Form 8716 by the earlier of the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective (*i.e.*, February 15, 1989) or the due date (without regard to extensions) of the partnership's tax return for the period September 10, 1988 to September 30, 1988 (*i.e.*, January 15, 1989). Thus, A must file Form 8716 by January 15, 1989.

Example 2. The facts are the same as in Example 1, except that A began operations on October 20, 1988. Based upon these facts, A must file Form 8716 by March 15, 1989, the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective.

Example 3. B is a corporation that first becomes a personal service corporation for its taxable year beginning September 1, 1988. B qualifies to make a section 444 election to use a September 30 taxable year for its taxable year beginning September 1, 1988. Pursuant to this paragraph (b)(1), B must file Form 8716 by December 15, 1988, the due date of the income tax return for the short period September 1 to September 30, 1988.

(2) *Special extension of time for making an election.* If, pursuant to paragraph (b)(1) of this section, the due date for filing Form 8716 is prior to July 26, 1988, such date is extended to July 26, 1988. The provisions of this paragraph (b)(2) may be illustrated by the following examples.

Example 1. B, a partnership that historically used a June 30 taxable year, is qualified to make a section 444 election to retain a June 30 taxable year for its taxable year beginning July 1, 1987. Absent paragraph (b)(2) of this section, B would be required to file Form 8716 by December 15, 1987. However, pursuant to paragraph (b)(2) of this section, B's due date for filing Form 8716 is extended to July 26, 1988.

Example 2. C, a partnership that began operations on January 20, 1988, is qualified to make a section 444 election to use a year ending September 30 for its taxable year beginning January 20, 1988. Absent paragraph (b)(2) of this section, C is required to file Form 8716 by June 15, 1988 (the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective). However, pursuant to paragraph (b)(2) of this section, the due date for filing Form 8716 is July 26, 1988.

(3) *Corporation electing to be an S corporation*—(i) *In general.* A corporation electing to be an S corporation is subject to the same time and manner rules for filing Form 8716 as any other taxpayer making a section 444 election. Thus, a corporation electing to be an S corporation that desires to make a section 444 election is not required to file Form 8716 with its Form 2553, ''Election by a Small Business Corporation.'' However, a corporation electing to be an S corporation after September 26,

1988, is required to state on Form 2553 its intention to—

(A) Make a section 444 election, if qualified, or

(B) Make a "back-up section 444 election" as described in paragraph (b)(4) of this section.

If a corporation electing to be an S corporation fails to state either of the above intentions, the District Director may, at his discretion, disregard any section 444 election for such taxpayer.

(ii) *Examples.* The provisions of this paragraph (b)(3) may be illustrated by the following examples.

Example 1. D is a corporation that commences operations on October 1, 1988, and elects to be an S corporation for its taxable year beginning October 1, 1988. All of D's shareholders use the calendar year as their taxable year. D desires to adopt a September 30 taxable year. D does not believe it has a business purpose for a September 30 taxable year and thus it must make a section 444 election to use such year. Based on these facts, D must, pursuant to the instructions to Form 2553, state on Form 2553 that, if qualified, it will make a section 444 election to adopt a year ending September 30 for its taxable year beginning October 1, 1988. If D is qualified (*i.e.*, D is not a member of a tiered structure on December 31, 1988) to make a section 444 election for its taxable year beginning October 1, 1988, D must file Form 8716 by March 15, 1989. If D ultimately is not qualified to make a section 444 election for its taxable year beginning October 1, 1988, D's election to be an S corporation will not be effective unless, pursuant to the instructions to Form 2553, D made a back-up calendar year election (*i.e.*, an election to adopt the calendar year in the event D ultimately is not qualified to make a section 444 election for such year).

Example 2. The facts are the same as in Example 1, except that D believes it can establish, to the satisfaction of the Commissioner, a business purpose for adopting a September 30 taxable year. However, D desires to make a "back-up section 444 election" (see paragraph (b)(4) of this section) in the event that the Commissioner does not grant permission to adopt a September 30 taxable year based upon business purpose. Based on these facts, D must, pursuant to the instructions to Form 2553, state on Form 2553 its intention, if qualified, to make a back-up section 444 election to adopt a September 30 taxable year. If, by March 15, 1989, D has not received permission to adopt a September 30 taxable year and D is qualified to make a section 444 election, D must make a back-up election in accordance with paragraph (b)(4) of this section.

(4) *Back-up section 444 election*—(i) *General rule.* A taxpayer that has requested (or is planning to request) permission to use a particular taxable year based upon business purpose, may, if otherwise qualified, file a section 444 election (referred to as a "back-up section 444 election"). If the Commissioner subsequently denies the business purpose request, the taxpayer will, if otherwise qualified, be required to activate the back-up section 444 election. See examples (1) and (2) in paragraph (b)(4)(iv) of this section.

(ii) *Procedures for making a back-up section 444 election.* In addition to following the general rules provided in this section, a taxpayer making a back-up section 444 election should, in order to allow the Service to process the affected returns in an efficient manner, type or legibly print the words "BACK-UP ELECTION" at the top of Form 8716, "Election to Have a Tax Year Other Than a Required Tax Year." However, if such Form 8716 is filed on or after the date a Form 1128, Application for Change in Accounting Period, is filed with respect to a period that begins on the same date, the words "FORM 1128 BACK-UP ELECTION" should be typed or legibly printed at the top of Form 8716.

(iii) *Procedures for activating a back-up section 444 election*—(A) *Partnerships and S corporations*—(*1*) *In general.* A back-up section 444 election made by a partnership or S corporation is activated by filing the return required in §1.7519–2T (a)(2)(i) and making the payment required in §1.7519–1T. The due date for filing such return and payment will be the later of—

(*i*) The due dates provided in §1.7519–2T, or

(*ii*) 60 days from the date the Commissioner denies the business purpose request.

However, interest will be assessed (at the rate provided in section 6621 (a)(2)) on any required payment made after the due date (without regard to any extension for a back-up election) provided in §1.7519–2T (a)(4)(i) or (a)(4)(ii), whichever is applicable, for such payment. Interest will be calculated from such due date to the date such amount is actually paid. Interest assessed under this paragraph will be separate from any required payments. Thus, interest will not be subject to refund under § 1.7519–2T.

(*2*) *Special rule if Form 720 used to satisfy return requirement.* If, pursuant to § 1.7519–2T (a)(3), a partnership or S corporation must use Form 720, ''Quarterly Federal Excise Tax Return,'' to satisfy the return requirement of § 1.7519–2T (a)(2), then in addition to following the general rules provided in § 1.7519–2T, the partnership or S corporation must type or legibly print the words ''ACTIVATING BACK-UP ELECTION'' on the top of Form 720. A partnership or S corporation that would otherwise file a Form 720 on or before the date specified in paragraph (b)(4)(iii)(A)(*1*) of this section may satisfy the return requirement by including the necessary information on such Form 720. Alternatively, such partnership or S corporation may file an additional Form 720 (*i.e.,* a Form 720 separate from the Form 720 it would otherwise file). Thus, for example, if the due date for activating an S corporation's back-up election is November 15, 1988, and the S corporation must file a Form 720 by October 31, 1988, to report manufacturers excise tax for the third quarter of 1988, the S corporation may use that Form 720 to activate its back-up election. Alternatively, the S corporation may file its regular Form 720 that is due October 31, 1988, and file an additional Form 720 by November 15, 1988, activating its back-up election.

(B) *Personal service corporations.* A back-up section 444 election made by a personal service corporation is activated by filing Form 8716 with the personal service corporation's original or amended income tax return for the taxable year in which the election is first effective, and typing or legibly printing the words—''ACTIVATING BACK-UP ELECTION'' on the top of such income tax return.

(iv) *Examples.* The provisions of this paragraph (b)(4) may be illustrated by the following examples. Also see Example 2 in paragraph (b)(3) of this section.

Example 1. E, a partnership that historically used a June 30 taxable year, requested (pursuant to section 6 of Rev. Proc. 87–32, 1987–28 I.R.B. 14) permission from the Commissioner to retain a June 30 taxable year for its taxable year beginning July 1, 1987. Furthermore, E is qualified to make a section 444 election to retain a June 30 taxable year for its taxable year beginning July 1, 1987. However, as of the date specified in paragraph (b)(2) of this section, the Commissioner has not determined whether E has a valid business purpose for retaining its June 30 taxable year. Based on these facts, E may, by the date specified in paragraph (b)(2) of this section, make a back-up section 444 election to retain its June 30 taxable year.

Example 2. The facts are the same as in Example 1. In addition, on August 12, 1988, the Internal Revenue Service notifies E that its business purpose request is denied. E asks for reconsideration of the Service's decision, and the Service sustains the original denial on September 30, 1988. Based on these facts, E must activate its back-up section 444 election within 60 days after September 30, 1988.

Example 3. The facts are the same as in Example 1, except that E desires to make a section 444 election to use a year ending September 30 for its taxable year beginning July 1, 1987. Although E qualifies to make a section 444 election to retain its June 30 taxable year, E may make a back-up section 444 election for a September 30 taxable year.

(c) *Administrative relief*—(1) *Extension of time to file income tax returns*—(i) *Automatic extension.* If a partnership, S corporation, or personal service corporation makes a section 444 election (or does not make a section 444 election, either because it is ineligible or because it decides not to make the election, and therefore changes to its required taxable year) for its first taxable year beginning after December 31, 1986, the due date for filing its income tax return for such year shall be the later of—

(A) The due date established under—

(*1*) Section 6072, in the case of Form 1065,

(*2*) § 1.6037–1 (b), in the case of Form 1120S,

(*3*) Section 6072 (b), in the case of other Form 1120 series form; or

(B) August 15, 1988.

The words ''SECTION 444 RETURN'' should, in order to allow the Service to process the affected returns in an efficient manner, be typed or legibly printed at the top of the Form 1065 or Form 1120 series form, whichever is applicable, filed under this paragraph (c)(1)(i).

(ii) *Additional extensions.* If the due date of the income tax return for the first taxable year beginning after December 31, 1986, extended as provided in paragraph (c)(1)(i)(B) of this section, occurs before the date that is 6 months after the date specified in paragraph (c)(1)(i)(A) of this section, the partnership, S corporation, or personal service corporation may request an additional extension or extensions of time (up to 6 months after the date specified in paragraph (c)(1)(i)(A) of this section) to file its income tax return for such first taxable year. The request must be made by the later of the date specified in paragraph (c)(1)(i)(A) or (c)(1)(i)(B) of this section and must be made on Form 7004, ''Application for Automatic Extension of Time To File Corporation Income Tax Return'', or Form 2758, ''Application for Extension of Time to File U.S. Partnership, Fiduciary, and Certain Other Returns,'' whichever is applicable, in accordance with the form and its instructions. In addition, the following words should be typed or legibly printed at the top of the form—''SECTION 444 REQUEST FOR ADDITIONAL EXTENSION.''

(iii) *Examples.* The provisions of paragraph (c)(1) of this section may be illustrated by the following examples.

Example 1. G, a partnership that historically used a January 31 taxable year, makes a section 444 election to retain such year for its taxable year beginning February 1, 1987. Absent paragraph (c)(1)(i) of this section, G's Form 1065 for the taxable year ending January 31, 1988, is due on or before May 15, 1988. However, if G types or legibly prints ''SECTION 444 RETURN'' at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988.

Example 2. The facts are the same as in Example 1, except that G desires to extend the due date of its income tax return for the year ending January 31, 1988, to a date beyond August 15, 1988. Pursuant to paragraph (c)(1)(ii) of this section, G may extend such return to November 15, 1988 (*i.e.*, the date that is up to 6 months after May 15, 1988, the normal due date of the return). However, in order to obtain this additional extension, G must file Form 2758 pursuant to paragraph (c)(1)(i) of this section on or before August 15, 1988.

Example 3. H, a partnership that historically used a May 31 taxable year, makes a section 444 election to use a year ending September 30 for its taxable year beginning on June 1, 1987. Absent paragraph (c)(1)(i) of this section, H's Form 1065 for the taxable year beginning June 1, 1987, and ending September 30, 1987, is due on or before January 15, 1988. However, if H types or legibly prints ''SECTION 444 RETURN'' at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988.

Example 4. The facts are the same as in Example 3, except H desires to further extend (*i.e.*, extend beyond August 15, 1988) the due date of its income tax return for its taxable year beginning June 1, 1987, and ending September 30, 1987. Since August 15, 1988, is 6 months or more after the due date (without extensions) of such return, paragraph (c)(1)(ii) of this section prevents H from further extending the time for filing such return.

Example 5. I, a partnership that historically used a June 30 taxable year, considered making a section 44 election to retain such taxable year, but eventually decided to change to a December 31, taxable year (I's required taxable year). Absent paragraph (c)(1)(i) of this section, I's Form 1065 for the taxable year beginning July 1, 1987, and ending December 31, 1987, is due on or before April 15, 1988. Pursuant to paragraph (c)(1)(i) of this section, if I types or legibly prints ''SECTION 444 RETURN'' at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988. In addition, I may further extend such return pursuant to paragraph (c)(1)(ii) of this section.

(2) *No penalty for certain late payments*—(i) *In general.* In the case of a personal service corporation or S corporation described in paragraph (c)(1)(i) of this section, no penalty under section 6651 (a)(2) will be imposed for failure to pay income tax (if any) for the first taxable year beginning after December 31, 1986, but only for the period beginning with the last date for payment and ending with the later of the date specified in paragraph (c)(1)(i) or paragraph (c)(1)(ii) of this section.

(ii) *Example.* The provisions of paragraph (c)(2)(i) of this section may be illustrated by the following example.

Example. J, a personal service corporation that historically used a January 31 taxable year, makes a section 444 election to retain such year for its taxable year beginning February 1, 1987. The last date (without extension) for payment of J's income tax (if any) for its taxable year beginning February 1, 1987, is April 15, 1988. However, under paragraph (c)(2)(i) of this section, no penalty under section 6651(a)(2) will be imposed on any underpayment of income tax for the period beginning April 15, 1988 and ending August 15, 1988.

(d) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19703, May 27, 1988]

§ 1.444–4 Tiered structure.

(a) *Electing small business trusts.* For purposes of §1.444–2T, solely with respect to an S corporation shareholder, the term *deferral entity* does not include a trust that is treated as an electing small business trust under section 1361(e). An S corporation with an electing small business trust as a shareholder may make an election under section 444. This paragraph is applicable to taxable years beginning on and after December 29, 2000; however, taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1996.

(b) *Certain tax-exempt trusts.* For purposes of §1.444–2T, solely with respect to an S corporation shareholder, the term *deferral entity* does not include a trust that is described in section 401(a) or 501(c)(3), and is exempt from taxation under section 501(a). An S corporation with a trust as a shareholder that is described in section 401(a) or section 501(c)(3), and is exempt from taxation under section 501(a) may make an election under section 444. This paragraph is applicable to taxable years beginning on and after December 29, 2000; however taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1997.

(c) *Certain terminations disregarded*—(1) *In general.* An S corporation that is described in this paragraph (c)(1) may request that a termination of its election under section 444 be disregarded, and that the S corporation be permitted to resume use of the year it previously elected under section 444, by following the procedures of paragraph (c)(2) of this section. An S corporation is described in this paragraph if the S corporation is otherwise qualified to make a section 444 election, and its previous election was terminated under §1.444–2T(a) solely because—

(i) In the case of a taxable year beginning after December 31, 1996, a trust that is treated as an electing small business trust became a shareholder of such S corporation; or

(ii) In the case of a taxable year beginning after December 31, 1997, a trust that is described in section 401(a) or 501(c)(3), and is exempt from taxation under section 501(a) became a shareholder of such S corporation.

(2) *Procedure*—(i) *In general.* An S corporation described in paragraph (c)(1) of this section that wishes to make the request described in paragraph (c)(1) of this section must do so by filing Form 8716, ''Election To Have a Tax Year Other Than a Required Tax Year,'' and typing or printing legibly at the top of such form—''CONTINUATION OF SECTION 444 ELECTION UNDER §1.444–4.'' In order to assist the Internal Revenue Service in updating the S corporation's account, on Line 5 the Box ''Changing to'' should be checked. Additionally, the election month indicated must be the last month of the S corporation's previously elected section 444 election year, and the effective year indicated must end in 2002.

(ii) *Time and place for filing Form 8716.* Such form must be filed on or before October 15, 2002, with the service center where the S corporation's returns of tax (Forms 1120S) are filed. In addition, a copy of the Form 8716 should be attached to the S corporation's short period Federal income tax return for the first election year beginning on or after January 1, 2002.

(3) *Effect of request*—(i) *Taxable years beginning on or after January 1, 2002.* An S corporation described in paragraph (c)(1) of this section that requests, in accordance with this paragraph, that a termination of its election under section 444 be disregarded will be permitted to resume use of the year it previously elected under section 444, commencing with its first taxable year beginning on or after January 1, 2002. Such S corporation will be required to file a return under §1.7519–2T for each taxable year beginning on or after January 1, 2002. No payment under section 7519 will be due with respect to the first taxable year beginning on or after January 1, 2002. However, a required payment will be due on or before May 15, 2003, with respect to such S corporation's second continued section 444 election year that begins in calendar year 2002.

(ii) *Taxable years beginning prior to January 1, 2002.* An S corporation described in paragraph (c)(1) of this section that requests, in accordance with this paragraph, that a termination of its election under section 444 be disregarded will not be required to amend any prior Federal income tax returns, make any required payments under section 7519, or file any returns under §1.7519–2T, with respect to taxable years beginning on or after the date the termination of its section 444 election was effective and prior to January 1, 2002.

(iii) *Section 7519: required payments and returns.* The Internal Revenue Service waives any requirement for an S corporation described in paragraph (c)(1) of this section to file the federal tax returns and make any required payments under section 7519 for years prior to the taxable year of continuation as described in paragraph (c)(3)(i) of this section, if for such years the S corporation filed its federal income tax returns on the basis of its required taxable year.

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

METHODS OF ACCOUNTING

METHODS OF ACCOUNTING IN GENERAL

§ 1.446–1 General rule for methods of accounting.

(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term ''method of accounting'' includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see section 263A, 471, and 472 and the regulations thereunder.)

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

(iii) In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

(b) *Exceptions*. (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(2) A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

(c) *Permissible methods*—(1) In general. Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method*. Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see §1.451–2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and paragraph (a)(1) of §1.461–1.

(ii) *Accrual method*. (A) Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of §1.461–1 for examples of liabilities that may not be taken into account until after the taxable year incurred, and see §§1.461–4 through 1.461–6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that a deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of §1.263A–1(c)(3)) and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and related guidance.

(B) The term ''liability'' includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. Thus, for example, an amount that a taxpayer expends or will expend for capital improvements to property must be incurred before the taxpayer may take the amount into account in computing its basis in the property. The term ''liability'' is not limited to items for which a legal obligation to pay exists at the time of payment. Thus, for example, amounts prepaid for goods or services and amounts paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred.

(C) No method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. For example, a taxpayer engaged in a manufacturing business may account for sales of the taxpayer's product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customers, whether or not billed, depending on the method regularly employed in keeping the taxpayer's books.

(iii) *Other permissible methods.* Special methods of accounting are described elsewhere in chapter 1 of the Code and the regulations thereunder. For example, see the following sections and the regulations thereunder: Sections 61 and 162, relating to the crop method of accounting; section 453, relating to the installment method; section 460, relating to the long-term contract methods. In addition, special methods of accounting for particular items of income and expense are provided under other sections of chapter 1. For example, see section 174, relating to research and experimental expenditures, and section 175, relating to soil and water conservation expenditures.

(iv) *Combinations of the foregoing methods.* (*a*) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

(*b*) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

(2) *Special rules.* (i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the regulations in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. See section 446(a) and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books, and section 446(e) and paragraph (e) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

(iii) The timing rules of §1.1502–13 are a method of accounting for intercompany transactions (as defined in §1.1502–13(b)(1)(i)), to be applied by each member of a consolidated group in addition to the member's other methods of accounting. *See* §1.1502–13(a)(3)(i). This paragraph (c)(2)(iii) is applicable to consolidated return years beginning on or after November 7, 2001.

(d) *Taxpayer engaged in more than one business.* (1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

(e) *Requirement respecting the adoption or change of accounting method.* (1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this section. See also section 446(a) and paragraph (a) of this section.

(2)(i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

(ii) (*a*) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations under sections 471 and 472), a change from the cash or accrual method to a long-term contract method, or vice versa (see §1.460–4), certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(*d*) of this section), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations under the Internal Revenue Code specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(*b*) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and of items that are deducted as business expenses, but that are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts. Although such adjustment may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustment in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve (for example, for banks under section 585 of the Internal Revenue Code), see the regulations under section 166 of the Internal Revenue Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. For further guidance on changes involving depreciable or amortizable assets, see paragraph (e)(2)(ii)(*d*) of this section and §1.1016–3(h).

(*c*) A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting.

(*d*) *Changes involving depreciable or amortizable assets*—(*1*) *Scope*. This paragraph (e)(2)(ii)(*d*) applies to property subject to section 167, 168, 197, 1400I, 1400L(c), to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168), or to an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)).

(*2*) *Changes in depreciation or amortization that are a change in method of accounting*. Except as provided in paragraph (e)(2)(ii)(*d*)(*3*) of this section, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in method of accounting. Additionally, a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting. Further, except as provided in paragraph (e)(2)(ii)(*d*)(*3*) of this section, the following changes in computing depreciation or amortization are a change in method of accounting:

(*i*) A change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset.

(*ii*) A change from not claiming to claiming the additional first year depreciation deduction provided by, for example, section 168(k), 1400L(b), or 1400N(d), for, and the resulting change to the amount otherwise allowable as a depreciation deduction for the remaining adjusted depreciable basis (or similar basis) of, depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property), provided the taxpayer did not make the election out of the additional first year depreciation deduction (or did not make a deemed election out of the additional first year depreciation deduction; for further guidance, for example, see Rev. Proc. 2002–33 (2002–1 C.B. 963), Rev. Proc. 2003–50 (2003–2 C.B. 119), Notice 2006–77 (2006–40 I.R.B. 590), and

§ 601.601(d)(2)(ii)(*b*) of this chapter) for the class of property in which the depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property) is included.

(*iii*) A change from claiming the 30-percent additional first year depreciation deduction to claiming the 50-percent additional first year depreciation deduction for depreciable property that qualifies for the 50-percent additional first year depreciation deduction, provided the property is not included in any class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction (for example, 50-percent bonus depreciation property or qualified Gulf Opportunity Zone property), or a change from claiming the 50-percent additional first year depreciation deduction to claiming the 30-percent additional first year depreciation deduction for depreciable property that qualifies for the 30-percent additional first year depreciation deduction, including property that is included in a class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction (for example, qualified property or qualified New York Liberty Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's remaining adjusted depreciable basis (or similar basis). This paragraph (e)(2)(ii)(*d*)(*2*)(*iii*) does not apply if a taxpayer is making a late election or revoking a timely valid election under the applicable additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)) (see paragraph (e)(2)(ii)(*d*)(*3*)(*iii*) of this section).

(*iv*) A change from claiming to not claiming the additional first year depreciation deduction for an asset that does not qualify for the additional first year depreciation deduction, including an asset that is included in a class of property for which the taxpayer elected not to claim any additional first year depreciation deduction (for example, an asset that is not qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's depreciable basis.

(*v*) A change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Internal Revenue Code (for example, section 168(b)(4)), the regulations under the Internal Revenue Code (for example, § 1.197–2(f)(1)(ii)), or other guidance published in the Internal Revenue Bulletin.

(*vi*) A change in the accounting for depreciable or amortizable assets from a single asset account to a multiple asset account (pooling), or vice versa, or from one type of multiple asset account (pooling) to a different type of multiple asset account (pooling).

(*vii*) For depreciable or amortizable assets that are mass assets accounted for in multiple asset accounts or pools, a change in the method of identifying which assets have been disposed. For purposes of this paragraph (e)(2)(ii)(*d*)(*2*)(*vii*), the term *mass assets* means a mass or group of individual items of depreciable or amortizable assets that are not necessarily homogeneous, each of which is minor in value relative to the total value of the mass or group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, with respect to which separate identification is impracticable, and placed in service in the same taxable year.

(*viii*) Any other change in depreciation or amortization as the Secretary may designate by publication in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(*3*) *Changes in depreciation or amortization that are not a change in method of accounting.* Section 1.446–1(e)(2)(ii)(*b*) applies to determine whether a change in depreciation or amortization is not a change in method of accounting. Further, the following changes in depreciation or amortization are not a change in method of accounting:

(*i*) *Useful life.* An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) is not a change in method of accounting. This paragraph (e)(2)(ii)(*d*)(*3*)(*i*) does not apply if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Internal Revenue Code (for example, section 167(f)(1), section 168(c), section 168(g)(2) or (3), section 197), the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin and, therefore, such change is a change in method of accounting (unless paragraph (e)(2)(ii)(*d*)(*3*)(*v*) of this section applies). See paragraph (e)(2)(ii)(*d*)(*5*)(*iv*) of this section for determining the taxable year in which to correct an adjustment in useful life that is not a change in method of accounting.

(*ii*) *Change in use.* A change in computing depreciation or amortization allowances in the taxable year in which the use of an asset changes in the hands of the same taxpayer is not a change in method of accounting.

(*iii*) *Elections.* Generally, the making of a late depreciation or amortization election or the revocation of a timely valid depreciation or amortization election is not a change in method of accounting, except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin. This paragraph (e)(2)(ii)(*d*)(*3*)(*iii*) also applies to making a late election or revoking a timely valid election made under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (107 Stat. 312, 540) (relating to amortizable section 197 intangibles). A taxpayer may request consent to make a late election or revoke a timely valid election by submitting a request for a private letter ruling. For making or revoking an election under section 179 of the Internal Revenue Code, see section 179(c) and §1.179–5.

(*iv*) *Salvage value.* Except as provided under paragraph (e)(2)(ii)(*d*)(*2*)(*v*) of this section, a change in salvage value of a depreciable or amortizable asset is not treated as a change in method of accounting.

(*v*) *Placed-in-service date.* Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting. For example, if a taxpayer changes the placed-in-service date of a depreciable or amortizable asset because the taxpayer incorrectly determined the date on which the asset was placed in service, such a change is a change in the placed-in-service date of the asset and, therefore, is not a change in method of accounting. However, if a taxpayer incorrectly determines that a depreciable or amortizable asset is nondepreciable property and later changes the treatment of the asset to depreciable property, such a change is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(*d*)(*2*) of this section. Further, a change in the convention of a depreciable or amortizable asset is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(*d*)(*2*)(*i*) of this section. See paragraph (e)(2)(ii)(*d*)(*5*)(*v*) of this section for determining the taxable year in which to make a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting.

(*vi*) Any other change in depreciation or amortization as the Secretary may designate by publication in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(*4*) *Item being changed.* For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(*d*) applies, the item being changed generally is the depreciation treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to a depreciable asset for which depreciation is determined under §1.167(a)–11 (class life asset depreciation range (CLADR) property). Similarly, the item is the depreciable treatment of each general asset account with respect to a depreciable asset for which general asset account treatment has been elected under section 168(i)(4) or the item is the depreciation treatment of each mass asset account with respect to a depreciable asset for which mass asset account treatment has been elected under former section 168(d)(2)(A). Further, a change in computing depreciation or amortization under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) is permitted only with respect to all assets in a particular account (as defined in §1.167(a)–7) or vintage account.

(*5*) *Special rules.* For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(*d*) applies—

(*i*) *Declining balance method to the straight line method for MACRS property.* For tangible, depreciable property subject to section 168 (MACRS property) that is depreciated using the 200-percent or 150-percent declining balance method of depreciation under section 168(b)(1) or (2), a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight line method of depreciation in the first taxable year in which the use of the straight line method with respect to the adjusted depreciable basis of the MACRS property as of the beginning of that year will yield a depreciation allowance that is greater than the depreciation allowance yielded by the use of the declining balance method. When the change is made, the adjusted depreciable basis of the MACRS property as of the beginning of the taxable year is recovered through annual depreciation allowances over the remaining recovery period (for further guidance, see section 6.06 of Rev. Proc. 87–57 (1987–2 C.B. 687) and §601.601(d)(2)(ii)(*b*) of this chapter).

(*ii*) *Depreciation method changes for section 167 property.* For a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))), see §1.167(e)–1(b), (c), and (d) for the changes in depreciation method that are permitted to be made without the consent of the Commissioner. For CLADR property, see §1.167(a)–11(c)(1)(iii) for the changes in depreciation method for CLADR property that are permitted to be made without the consent of the Commissioner. Further, see §1.167(a)–11(b)(4)(iii)(*c*) for how to correct an incorrect classification or characterization of CLADR property.

(*iii*) *Section 481 adjustment.* Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, no section 481 adjustment is required or permitted for a change from one permissible method of computing depreciation or amortization to another permissible method of computing depreciation or amortization for an asset because this change is implemented by either a cut-off method (for further guidance, for example, see section 2.06 of Rev. Proc. 97–27 (1997–1 C.B. 680), section 2.06 of Rev. Proc. 2002–9 (2002–1 C.B. 327), and §601.601(d)(2)(ii)(*b*) of this chapter) or a modified cut-off method (under which the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method of accounting), as appropriate. However, a change from an impermissible method of computing depreciation or amortization to a permissible method of computing depreciation or amortization for an asset results in a section 481 adjustment. Similarly, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable (or vice versa) or a change in the treatment of an asset from expensing to depreciating (or vice versa) results in a section 481 adjustment.

(*iv*) *Change in useful life*. This paragraph (e)(2)(ii)(*d*)(*5*)(*iv*) applies to an adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) and that is not a change in method of accounting under paragraph (e)(2)(ii)(*d*) of this section. For this adjustment in useful life, no section 481 adjustment is required or permitted. The adjustment in useful life, whether initiated by the Internal Revenue Service (IRS) or a taxpayer, is corrected by adjustments in the taxable year in which the conditions known to exist at the end of that taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)–1(b) (or if the period of limitation for assessment under section 6501(a) has expired for that taxable year, in the first succeeding taxable year open under the period of limitation for assessment), and in subsequent taxable years. In other situations (for example, the useful life is incorrectly determined in the placed-in-service year), the adjustment in the useful life, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the correction in useful life, in lieu of filing amended Federal tax returns (for example, because the conditions known to exist at the end of a prior taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)–1(b)), the taxpayer may correct the adjustment in useful life by adjustments in the current and subsequent taxable years.

(*v*) *Change in placed-in-service date*. This paragraph (e)(2)(ii)(*d*)(*5*)(*v*) applies to a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting under paragraph (e)(2)(ii)(*d*) of this section. For this change in placed-in-service date, no section 481 adjustment is required or permitted. The change in placed-in-service date, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the change in placed-in-service date, in lieu of filing amended Federal tax returns, the taxpayer may correct the placed-in-service date by adjustments in the current and subsequent taxable years.

(iii) *Examples*. The rules of this paragraph (e) are illustrated by the following examples:

Example 1. Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example 2. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example 3. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example 4. From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example 5. A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change in method of accounting for inventories.

Example 6. A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations under the Internal Revenue Code. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example 7. A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a ''reserve for price changes.'' Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations under the Internal Revenue Code, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example 8. A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

Example 9. In 2003, A1, a calendar year taxpayer engaged in the trade or business of manufacturing knitted goods, purchased and placed in service a building and its components at a total cost of $10,000,000 for use in its manufacturing operations. A1 classified the $10,000,000 as nonresidential real property under section 168(e). A1 elected not to deduct the additional first year depreciation provided by section 168(k) on its 2003 Federal tax return. As a result, on its 2003, 2004, and 2005 Federal tax returns, A1 depreciated the $10,000,000 under the general depreciation system of section 168(a), using the straight line method of depreciation, a 39-year recovery period, and the mid-month convention. In 2006, A1 completes a cost segregation study on the building and its components and identifies items that cost a total of $1,500,000 as section 1245 property. As a result, the $1,500,000 should have been classified in 2003 as 5-year property under section 168(e) and depreciated on A1's 2003, 2004, and 2005 Federal tax returns under the general depreciation system, using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*i*) of this section, A1's change to this depreciation method, recovery period, and convention is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section does not apply because the assets are depreciated under section 168.

Example 10. In 2003, B, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $1,000,000 for use in its plant located outside the United States. The equipment is 15-year property under section 168(e) with a class life of 20 years. The equipment is required to be depreciated under the alternative depreciation system of section 168(g). However, B incorrectly depreciated the equipment under the general depreciation system of section 168(a), using the 150-percent declining balance method, a 15-year recovery period, and the half-year convention. In 2010, the IRS examines B's 2007 Federal income tax return and changes the depreciation of the equipment to the alternative depreciation system, using the straight line method of depreciation, a 20-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*i*) of this section, this change in depreciation method and recovery period made by the IRS is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section does not apply because the assets are depreciated under section 168.

Example 11. In May 2003, C, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. C never held this equipment for sale. However, C incorrectly treated the equipment as inventory on its 2003 and 2004 Federal tax returns. In 2005, C realizes that the equipment should have been treated as a depreciable asset. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*) of this section, C's change in the treatment of the equipment from inventory to a depreciable asset is a change in method of accounting. This method change results in a section 481 adjustment.

Example 12. Since 2003, D, a calendar year taxpayer, has used the distribution fee period method to amortize distributor commissions and, under that method, established pools to account for the distributor commissions (for further guidance, see Rev. Proc. 2000–38 (2000–2 C.B. 310) and §601.601(d)(2)(ii)(*b*) of this chapter). A change in the accounting of distributor commissions under the distribution fee period method from pooling to single asset accounting is a change in method of accounting pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*vi*) of this section. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 13. Since 2003, E, a calendar year taxpayer, has accounted for items of MACRS property that are mass assets in pools. Each pool includes only the mass assets that are placed in service by E in the same taxable year. E is able to identify the cost basis of each asset in each pool. None of the pools are general asset accounts under section 168(i)(4) and the regulations under section 168(i)(4). E identified any dispositions of these mass assets by specific identification. Because of changes in E's recordkeeping in 2006, it is impracticable for E to continue to identify disposed mass assets using specific identification. As a result, E wants to change to a first-in, first-out method under which the mass assets disposed of in a taxable year are deemed to be from the pool with the earliest placed-in-service year in existence as of the beginning of the taxable year of each disposition. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*vii*) of this section, this change is a change in method of accounting. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 14. In August 2003, F, a calendar year taxpayer, purchased and placed in service a copier for use in its trade or business. F incorrectly classified the copier as 7-year property under section 168(e). F elected not to deduct the additional first year depreciation provided by section 168(k) on its 2003 Federal tax return. As a result, on its 2003 and 2004 Federal tax returns, F depreciated the copier under the general depreciation system of section 168(a), using the 200-percent declining balance method of depreciation, a 7-year recovery period, and the half-year convention. In 2005, F realizes that the copier is 5-year property and should have been depreciated on its 2003 and 2004 Federal tax returns under the general depreciation system using a 5-year recovery period rather than a 7-year recovery period. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*i*) of this section, F's change in recovery period from 7 to 5 years is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section does not apply because the copier is depreciated under section 168.

Example 15. In 2004, G, a calendar year taxpayer, purchased and placed in service an intangible asset that is not an amortizable section 197 intangible and that is not described in section 167(f). G amortized the cost of the intangible asset under section 167(a) using the straight line method of depreciation and a determinable useful life of 13 years. The safe harbor useful life of 15 or 25 years under §1.167(a)–3(b) does not apply to the intangible asset. In 2008, because of changing conditions, G changes the remaining useful life of the intangible asset to 2 years. Pursuant to paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section, G's change in useful life is not a change in method of accounting because the intangible asset is depreciated under section 167 and G is not changing to or from a useful life that is specifically assigned by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin.

Example 16. In July 2003, H, a calendar year taxpayer, purchased and placed in service ''off-the-shelf'' computer software and a new computer. The cost of the new computer and computer software are separately stated. H incorrectly included the cost of this software as part of the cost of the computer, which is 5-year property under section 168(e). On its 2003 Federal tax return, H elected to depreciate its 5-year property placed in service in 2003 under the alternative depreciation system of section 168(g) and H elected not to deduct the additional first year depreciation provided by section 168(k). The class life for a computer is 5 years. As a result, because H included the cost of the computer software as part of the cost of the computer hardware, H depreciated the cost of the software under the alternative depreciation system, using the straight line method of depreciation, a 5-year recovery period, and the half-year convention. In 2005, H realizes that the cost of the software should have been amortized under section 167(f)(1), using the straight line method of depreciation, a 36-month useful life, and a monthly convention. H's change from 5-years to 36-months is a change in method of accounting because H is changing to a useful life that is specifically assigned by section 167(f)(1). The change in convention from the half-year to the monthly convention also is a change in method of accounting. Both changes result in a section 481 adjustment.

Example 17. On May 1, 2003, I2, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $500,000 for use in its business. The equipment is 5-year property under section 168(e) with a class life of 9 years and is qualified property under section 168(k)(2). I2 did not place in service any other depreciable property in 2003. Section 168(g)(1)(A) through (D) do not apply to the equipment. I2 intended to elect the alternative depreciation system under section 168(g) for 5-year property placed in service in 2003. However, I2 did not make the election. Instead, I2 deducted on its 2003 Federal tax return the 30-percent additional first year depreciation attributable to the equipment and, on its 2003 and 2004 Federal tax returns, depreciated the remaining adjusted depreciable basis of the equipment under the general depreciation system under 168(a), using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. In 2005, I2 realizes its failure to make the alternative depreciation system election in 2003 and files a Form 3115, ''Application for Change in Accounting Method,'' to change its method of depreciating the remaining adjusted depreciable basis of the 2003 equipment to the alternative depreciation system. Because this equipment is not required to be depreciated under the alternative depreciation system, I2 is attempting to make an election under section 168(g)(7). However, this election must be made in the taxable year in which the equipment is placed in service (2003) and, consequently, I2 is attempting to make a late election under section 168(g)(7). Accordingly, I2's change to the alternative depreciation system is not a change in accounting method pursuant to paragraph (e)(2)(ii)(*d*)(*3*)(*iii*) of this section. Instead, I2 must submit a request for a private letter ruling under §301.9100–3 of this chapter, requesting an extension of time to make the alternative depreciation system election on its 2003 Federal tax return.

Example 18. On December 1, 2004, J, a calendar year taxpayer, purchased and placed in service 20 previously-owned adding machines. For the 2004 taxable year, J incorrectly classified the adding machines as items in its ''suspense'' account for financial and tax accounting purposes. Assets in this suspense account are not depreciated until reclassified to a depreciable fixed asset account. In January 2006, J realizes that the cost of the adding machines is still in the suspense account and reclassifies such cost to the appropriate depreciable fixed asset account. As a result, on its 2004 and 2005 Federal tax returns, J did not depreciate the cost of the adding machines. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*) of this section, J's change in the treatment of the adding machines from nondepreciable assets to depreciable assets is a change in method of accounting. The placed-in-service date exception under paragraph (e)(2)(ii)(*d*)(*3*)(*v*) of this section does not apply because the adding machines were incorrectly classified in a nondepreciable suspense account. This method change results in a section 481 adjustment.

Example 19. In December 2003, K, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. However, K did not receive the invoice for this equipment until January 2004. As a result, K classified the equipment on its fixed asset records as being placed in service in January 2004. On its 2004 and 2005 Federal tax returns, K depreciated the cost of the equipment. In 2006, K realizes that the equipment was actually placed in service during the 2003 taxable year and, therefore, depreciation should have began in the 2003 taxable year instead of the 2004 taxable year. Pursuant to paragraph (e)(2)(ii)(*d*)(*3*)(*v*) of this section, K's change in the placed-in-service date of the equipment is not a change in method of accounting.

(3)(i) Except as otherwise provided under the authority of paragraph (e)(3)(ii) of this section, to secure the Commissioner's consent to a taxpayer's change in method of accounting the taxpayer generally must file an application on Form 3115, ''Application for Change in Accounting Method,'' with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. See §§1.381(c)(4)–1(d)(2) and 1.381(c)(5)–1(d)(2) for rules allowing additional time, in some circumstances, for the filing of an application on Form 3115 with respect to a transaction to which section 381(a) applies. To the extent applicable, the taxpayer must furnish all information requested on the Form 3115. This information includes all classes of items that will be treated differently under the new method of accounting, any amounts that will be duplicated or omitted as a result of the proposed change, and the taxpayer's computation of any adjustments necessary to prevent such duplications or omissions. The Commissioner may require such other information as may be necessary to determine whether the proposed change will be permitted.

Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer agrees to the Commissioner's prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is to be taken into account. See section 481 and the regulations thereunder, relating to certain adjustments resulting from accounting method changes, and section 472 and the regulations thereunder, relating to adjustments for changes to and from the last-in, first-out inventory method. For any Form 3115 filed on or after May 15, 1997, see §1.446–1T(e)(3)(i)(B).

(ii) Notwithstanding the provisions of paragraph (e)(3)(i) of this section, the Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted. The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or by an adjustment under section 481(a) to be taken into account in the taxable year or years prescribed by the Commissioner.

(iii) This paragraph (e)(3) applies to Forms 3115 filed on or after December 31, 1997. For other Forms 3115, see §1.446–1(e)(3) in effect prior to December 31, 1997 (§1.446–1(e)(3) as contained in the 26 CFR part 1 edition revised as of April 1, 1997).

(4) *Effective date*—(i) *In general*. Except as provided in paragraphs (e)(3)(iii), (e)(4)(ii), and (e)(4)(iii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.446–1(e) in effect prior to December 30, 2003 (§1.446–1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(ii) *Changes involving depreciable or amortizable assets*. With respect to paragraph (e)(2)(ii)(*d*) of this section, paragraph (e)(2)(iii) *Examples 9* through *19* of this section, and the language ''certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(*d*) of this section)'' in the last sentence of paragraph (e)(2)(ii)(*a*) of this section—

(A) For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003; and

(B) For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003.

(iii) *Effective/applicability date for paragraph (e)(3)(i)*. The rules of paragraph (e)(3)(i) of this section apply to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after August 31, 2011.

[T.D. 6500, 25 FR 11708, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.446–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§1.446–2 Method of accounting for interest.

(a) *Applicability*—(1) *In general*. This section provides rules for determining the amount of interest that accrues during an accrual period (other than interest described in paragraph (a)(2) of this section) and for determining the portion of a payment that consists of accrued interest. For purposes of this section, interest includes original issue discount and amounts treated as interest (whether stated or unstated) in any lending or deferred payment transaction. Accrued interest determined under this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method). Application of an exception described in paragraph (a)(2) of this section to one party to a transaction does not affect the application of this section to any other party to the transaction.

(2) *Exceptions*—(i) *Interest included or deducted under certain other provisions.* This section does not apply to interest that is taken into account under—

(A) Sections 1272(a), 1275, and 163(e) (income and deductions relating to original issue discount);

(B) Section 467(a)(2) (certain payments for the use of property or services);

(C) Sections 1276 through 1278 (market discount);

(D) Sections 1281 through 1283 (discount on certain short-term obligations);

(E) Section 7872(a) (certain loans with below-market interest rates); or

(F) Section 1.1272–3 (an election by a holder to treat all interest on a debt instrument as original issue discount).

(ii) *De minimis original issue discount.* This section does not apply to de minimis original issue discount (other than de minimis original issue discount treated as qualified stated interest) as determined under §1.1273–1(d). See §1.163–7 for the treatment of de minimis original issue discount by the issuer and §§1.1273–1(d) and 1.1272–3 for the treatment of de minimis original issue discount by the holder.

(b) *Accrual of qualified stated interest.* Qualified stated interest (as defined in §1.1273–1(c)) accrues ratably over the accrual period (or periods) to which it is attributable and accrues at the stated rate for the period (or periods).

(c) *Accrual of interest other than qualified stated interest.* Subject to the modifications in paragraph (d) of this section, the amount of interest (other than qualified stated interest) that accrues for any accrual period is determined under rules similar to those in the regulations under sections 1272 and 1275 for the accrual of original issue discount. The preceding sentence applies regardless of any contrary formula agreed to by the parties.

(d) *Modifications*—(1) *Issue price.* The issue price of the loan or contract is equal to—

(i) In the case of a contract for the sale or exchange of property to which section 483 applies, the amount described in §1.483–2(a)(1)(i) or (ii), whichever is applicable;

(ii) In the case of a contract for the sale or exchange of property to which section 483 does not apply, the stated principal amount; or

(iii) In any other case, the amount loaned.

(2) *Principal payments that are not deferred payments.* In the case of a contract to which section 483 applies, principal payments that are not deferred payments are ignored for purposes of determining yield and adjusted issue price.

(e) *Allocation of interest to payments*—(1) *In general.* Except as provided in paragraphs (e)(2), (e)(3), and (e)(4) of this section, each payment under a loan (other than payments of additional interest or similar charges provided with respect to amounts that are not paid when due) is treated as a payment of interest to the extent of the accrued and unpaid interest determined under paragraphs (b) and (c) of this section as of the date the payment becomes due.

(2) *Special rule for points deductible under section 461(g)(2).* If a payment of points is deductible by the borrower under section 461(g)(2), the payment is treated by the borrower as a payment of interest.

(3) *Allocation respected in certain small transactions.* [Reserved]

(4) *Pro rata prepayments.* Accrued but unpaid interest is allocated to a pro rata prepayment under rules similar to those for allocating accrued but unpaid original issue discount to a pro rata prepayment under §1.1275–2(f). For purposes of the preceding sentence, a pro rata prepayment is a payment that is made prior to maturity that—

(i) Is not made pursuant to the contract's payment schedule; and

(ii) Results in a substantially pro rata reduction of each payment remaining to be paid on the contract.

(f) *Aggregation rule.* For purposes of this section, all contracts calling for deferred payments arising from the same transaction (or a series of related transactions) are treated as a single contract. This rule, however, generally only applies to contracts involving a single borrower and a single lender.

(g) *Debt instruments denominated in a currency other than the U.S. dollar.* This section applies to a debt instrument that provides for all payments denominated in, or determined by reference to, the functional currency of the taxpayer or qualified business unit of the taxpayer (even if that currency is other than the U.S. dollar). See § 1.988–2(b) to determine interest income or expense for debt instruments that provide for payments denominated in, or determined by reference to, a nonfunctional currency.

(h) *Example.* The following example illustrates the rules of this section.

Example. Allocation of unstated interest to deferred payments. (i) *Facts.* On July 1, 1996, A sells his personal residence to B for a stated purchase price of $1,297,143.66. The property is not personal use property (within the meaning of section 1275(b)(3)) in the hands of B. Under the loan agreement, B is required to make two installment payments of $648,571.83 each, the first due on June 30, 1998, and the second due on June 30, 2000. Both A and B use the cash receipts and disbursements method of accounting and use a calendar year for their taxable year.

(ii) *Amount of unstated interest.* Under section 483, the agreement does not provide for adequate stated interest. Thus, the loan's yield is the test rate of interest determined under § 1.483–3. Assume that both A and B use annual accrual periods and that the test rate of interest is 9.2 percent, compounded annually. Under § 1.483–2, the present value of the deferred payments is $1,000,000. Thus, the agreement has unstated interest of $297,143.66.

(iii) *First two accrual periods.* Under paragraph (d)(1) of this section, the issue price at the beginning of the first accrual period is $1,000,000 (the amount described in § 1.483–2(a)(1)(i)). Under paragraph (c) of this section, the amount of interest that accrues for the first accrual period is $92,000 ($1,000,000 × .092) and the amount of interest that accrues for the second accrual period is $100,464 ($1,092,000 × .092). Thus, $192,464 of interest has accrued as of the end of the second accrual period. Under paragraph (e)(1) of this section, the $648,571.83 payment made on June 30, 1998, is treated first as a payment of interest to the extent of $192,464. The remainder of the payment ($456,107.83) is treated as a payment of principal. Both A and B take the payment of interest ($192,464) into account in 1998.

(iv) *Second two accrual periods.* The adjusted issue price at the beginning of the third accrual period is $543,892.17 ($1,092,000 + $100,464–$648,571.83). The amount of interest that accrues for the third accrual period is $50,038.08 ($543,892.17 × .092) and the amount of interest that accrues for the final accrual period is $54,641.58, the excess of the amount payable at maturity ($648,571.83), over the adjusted issue price at the beginning of the accrual period ($593,930.25). As of the date the second payment becomes due, $104,679.66 of interest has accrued. Thus, of the $648,571.83 payment made on June 30, 2000, $104,679.66 is treated as interest and $543,892.17 is treated as principal. Both A and B take the payment of interest ($104,679.66) into account in 2000.

(i) [Reserved]

(j) *Effective date.* This section applies to debt instruments issued on or after April 4, 1994, and to lending transactions, sales, and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for debt instruments issued after December 21, 1992, and before April 4, 1994, and for lending transactions, sales, and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4804, Feb. 2, 1994]

§ 1.446–3 Notional principal contracts.

(a) *Table of contents.* This paragraph (a) lists captioned paragraphs contained in § 1.446–3.

§ 1.446–3 Notional principal contracts.

(b) *Purpose*. The purpose of this section is to enable the clear reflection of the income and deductions from notional principal contracts by prescribing accounting methods that reflect the economic substance of such contracts.

(c) *Definitions and scope*—(1) *Notional principal contract*—(i) *In general*. A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract because a taxpayer cannot enter into a contract with itself. Notional principal contracts governed by this section include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar agreements. A collar is not itself a notional principal contract, but certain caps and floors that comprise a collar may be treated as a single notional principal contract under paragraph (f)(2)(v)(C) of this section. A contract may be a notional principal contract governed by this section even though the term of the contract is subject to termination or extension. Each confirmation under a master agreement to enter into agreements governed by this section is treated as a separate notional principal contract.

(ii) *Excluded contracts*. A contract described in section 1256(b), a futures contract, a forward contract, and an option are not notional principal contracts. An instrument or contract that constitutes indebtedness under general principles of Federal income tax law is not a notional principal contract. An option or forward contract that entitles or obligates a person to enter into a notional principal contract is not a notional principal contract, but payments made under such an option or forward contract may be governed by paragraph (g)(3) of this section.

(iii) *Transactions within section 475*. To the extent that the rules provided in paragraphs (e) and (f) of this section are inconsistent with the rules that apply to any notional principal contract that is governed by section 475 and regulations thereunder, the rules of section 475 and the regulations thereunder govern.

(iv) *Transactions within section 988*. To the extent that the rules provided in this section are inconsistent with the rules that apply to any notional principal contract that is also a section 988 transaction or that is integrated with other property or debt pursuant to section 988(d), the rules of section 988 and the regulations thereunder govern.

(2) *Specified index*. A specified index is—

(i) A fixed rate, price, or amount;

(ii) A fixed rate, price, or amount applicable in one or more specified periods followed by one or more different fixed rates, prices, or amounts applicable in other periods;

(iii) An index that is based on objective financial information (as defined in paragraph (c)(4)(ii) of this section); and

(iv) An interest rate index that is regularly used in normal lending transactions between a party to the contract and unrelated persons.

(3) *Notional principal amount.* For purposes of this section, a notional principal amount is any specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract, but is not borrowed or loaned between the parties as part of the contract. The notional principal amount may vary over the term of the contract, provided that it is set in advance or varies based on objective financial information (as defined in paragraph (c)(4)(ii) of this section).

(4) *Special definitions*—(i) *Related person and party to the contract.* A related person is a person related (within the meaning of section 267(b) or 707(b)(1)) to one of the parties to the notional principal contract or a member of the same consolidated group (as defined in §1.1502–1(h)) as one of the parties to the contract. For purposes of this paragraph (c), a related person is considered to be a party to the contract.

(ii) *Objective financial information.* For purposes of this paragraph (c), objective financial information is any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances (such as one party's dividends, profits, or the value of its stock). Thus, for example, a notional principal amount may be based on a broadly-based equity index or the outstanding balance of a pool of mortgages, but not on the value of a party's stock.

(iii) *Dealer in notional principal contracts.* A dealer in notional principal contracts is a person who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in notional principal contracts with customers in the ordinary course of a trade or business.

(d) *Taxable year of inclusion and deduction.* For all purposes of the Code, the net income or net deduction from a notional principal contract for a taxable year is included in or deducted from gross income for that taxable year. The net income or net deduction from a notional principal contract for a taxable year equals the total of all of the periodic payments that are recognized from that contract for the taxable year under paragraph (e) of this section and all of the nonperiodic payments that are recognized from that contract for the taxable year under paragraph (f) of this section.

(e) *Periodic payments*—(1) *Definition.* Periodic payments are payments made or received pursuant to a notional principal contract that are payable at intervals of one year or less during the entire term of the contract (including any extension periods provided for in the contract), that are based on a specified index described in paragraph (c)(2)(i), (iii), or (iv) of this section (appropriately adjusted for the length of the interval), and that are based on either a single notional principal amount or a notional principal amount that varies over the term of the contract in the same proportion as the notional principal amount that measures the other party's payments. Payments to purchase or sell a cap or a floor, however, are not periodic payments.

(2) *Recognition rules*—(i) *In general.* All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates.

(ii) *Rate set in arrears.* If the amount of a periodic payment is not determinable at the end of a taxable year because the value of the specified index is not fixed until a date that occurs after the end of the taxable year, the ratable daily portion of a periodic payment that relates to that taxable year is generally based on the specified index that would have applied if the specified index were fixed as of the last day of the taxable year. If a taxpayer determines that the value of the specified index as of the last day of the taxable year does not provide a reasonable estimate of the specified index that will apply when the payment is fixed, the taxpayer may use a reasonable estimate of the specified index each year, provided that the taxpayer (and any related person that is a party to the contract) uses the same method to make the estimate consistently from year to year and uses the same estimate for purposes of all financial reports to equity holders and creditors. The taxpayer's treatment of notional principal contracts with substantially similar specified indices will be considered in determining whether the taxpayer's estimate of the specified index is reasonable. Any difference between the amount that is recognized under this paragraph (e)(2)(ii) and the corresponding portion of the actual payment that becomes fixed under the contract is taken into account as an adjustment to the net income or net deduction from the notional principal contract for the taxable year during which the payment becomes fixed.

(iii) *Notional principal amount set in arrears.* Rules similar to the rules of paragraph (e)(2)(ii) of this section apply if the amount of a periodic payment is not determinable at the end of a taxable year because the notional principal amount is not fixed until a date that occurs after the end of the taxable year.

(3) *Examples.* The following examples illustrate the application of paragraph (e) of this section.

Example 1. Accrual of periodic swap payments. (a) On April 1, 1995, *A* enters into a contract with unrelated counterparty *B* under which, for a term of five years, *A* is obligated to make a payment to *B* each April 1, beginning April 1, 1996, in an amount equal to the London Interbank Offered Rate (LIBOR), as determined on the immediately preceding April 1, multiplied by a notional principal amount of $100 million. Under the contract, *B* is obligated to make a payment to *A* each April 1, beginning April 1, 1996, in an amount equal to 8% multiplied by the same notional principal amount. *A* and *B* are calendar year taxpayers that use the accrual method of accounting. On April 1, 1995, LIBOR is 7.80%.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and both LIBOR and a fixed interest rate of 8% are specified indices under paragraph (c)(2) of this section. All of the payments to be made by *A* and *B* are periodic payments under paragraph (e)(1) of this section because each party's payments are based on a specified index described in paragraphs (c)(2)(iii) and (c)(2)(i) of this section, respectively, are payable at periodic intervals of one year or less throughout the term of the contract, and are based on a single notional principal amount.

(c) Under the terms of the swap agreement, on April 1, 1996, *B* is obligated to make a payment to *A* of $8,000,000 (8% × $100,000,000) and *A* is obligated to make a payment to *B* of $7,800,000 (7.80% × $100,000,000). Under paragraph (e)(2)(i) of this section, the ratable daily portions for 1995 are the amounts of these periodic payments that are attributable to *A*'s and *B*'s taxable year ending December 31, 1995. The ratable daily portion of the 8% fixed leg is $6,010,929 (275 days/366 days × $8,000,000), and the ratable daily portion of the floating leg is $5,860,656 (275 days/366 days × $7,800,000). The net amount for the taxable year is the difference between the ratable daily portions of the two periodic payments, or $150,273 ($6,010,929—$5,860,656). Accordingly, *A* has net income of $150,273 from this swap for 1995, and *B* has a corresponding net deduction of $150,273.

(d) The $49,727 unrecognized balance of the $200,000 net periodic payment that is made on April 1, 1996, is included in *A*'s and *B*'s net income or net deduction from the contract for 1996.

(e) If the parties had entered into the contract on February 1, 1995, the result would not change because no portion of either party's obligation to make a payment under the swap relates to the period prior to April 1, 1995. Consequently, under paragraph (e)(2) of this section, neither party would accrue any income or deduction from the swap for the period from February 1, 1995, through March 31, 1995.

Example 2. Accrual of periodic swap payments by cash method taxpayer. (a) On April 1, 1995, *C* enters into a contract with unrelated counterparty *D* under which, for a period of five years, *C* is obligated to make a fixed payment to *D* each April 1, beginning April 1, 1996, in an amount equal to 8% multiplied by a notional principal amount of $100 million. *D* is obligated to make semi-annual payments to *C* each April 1 and October 1, beginning October 1, 1995, in an amount equal to one-half of the LIBOR amount as of the first day of the preceding 6-month period multiplied by the notional principal amount. The payments are to be calculated using a 30/360 day convention. *C* is a calendar year taxpayer that uses the accrual method of accounting. *D* is a calendar year taxpayer that uses the cash receipts and disbursements method of accounting. LIBOR is 7.80% on April 1, 1995, and 7.46% on October 1, 1995.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and LIBOR and the fixed interest rate of 8% are each specified indices under paragraph (c)(2) of this section. All of the payments to be made by *C* and *D* are periodic payments under paragraph (e)(1) of this section because they are each based on appropriate specified indices, are payable at periodic intervals of one year or less throughout the term of the contract, and are based on a single notional principal amount.

(c) Under the terms of the swap agreement, *D* pays *C* \$3,900,000 (0.5 × 7.8% × \$100,000,000) on October 1, 1995. In addition, *D* is obligated to pay *C* \$3,730,000 (0.5 × 7.46% × \$100,000,000) on April 1, 1996. *C* is obligated to pay *D* \$8,000,000 on April 1, 1996. Under paragraph (e)(2)(i) of this section, *C*'s and *D*'s ratable daily portions for 1995 are the amounts of the periodic payments that are attributable to their taxable year ending December 31, 1995. The ratable daily portion of the 8% fixed leg is \$6,000,000 (270 days/360 days × \$8,000,000), and the ratable daily portion of the floating leg is \$5,765,000 (\$3,900,000 + (90 days/180 days × \$3,730,000)). Thus, *C*'s net deduction from the contract for 1995 is \$235,000 (\$6,000,000—\$5,765,000) and *D* reports \$235,000 of net income from the contract for 1995.

(d) The net unrecognized balance of \$135,000 (\$2,000,000 balance of the fixed leg—\$1,865,000 balance of the floating leg) is included in *C*'s and *D*'s net income or net deduction from the contract for 1996.

Example 3. Accrual of swap payments on index set in arrears. (a) The facts are the same as in *Example 1*, except that *A*'s obligation to make payments based upon LIBOR is determined by reference to LIBOR on the day each payment is due. LIBOR is 8.25% on December 31, 1995, and 8.16% on April 1, 1996.

(b) On December 31, 1995, the amount that *A* is obligated to pay *B* is not known because it will not become fixed until April 1, 1996. Under paragraph (e)(2)(ii) of this section, the ratable daily portion of the periodic payment from *A* to *B* for 1995 is based on the value of LIBOR on December 31, 1995 (unless *A* or *B* determines that the value of LIBOR on that day does not reasonably estimate the value of the specified index). Thus, the ratable daily portion of the floating leg is \$6,198,770 (275 days/366 days × 8.25% × \$100,000,000), while the ratable daily portion of the fixed leg is \$6,010,929 (275 days/366 days × \$8,000,000). The net amount for 1995 on this swap is \$187,841 (\$6,198,770—\$6,010,929). Accordingly, *B* has \$187,841 of net income from the swap in 1995, and *A* has a net deduction of \$187,841.

(c) On April 1, 1996, *A* makes a net payment to *B* of \$160,000 (\$8,160,000 payment on the floating leg—\$8,000,000 payment on the fixed leg). For purposes of determining their net income or net deduction from this contract for the year ended December 31, 1996, *B* and *A* must adjust the net income and net deduction they recognized in 1995 by \$67,623 (275 days/366 days × (\$8,250,000 presumed payment on the floating leg—\$8,160,000 actual payment on the floating leg)).

(f) *Nonperiodic payments*—(1) *Definition.* A nonperiodic payment is any payment made or received with respect to a notional principal contract that is not a periodic payment (as defined in paragraph (e)(1) of this section) or a termination payment (as defined in paragraph (h) of this section). Examples of nonperiodic payments are the premium for a cap or floor agreement (even if it is paid in installments), the payment for an off-market swap agreement, the prepayment of part or all of one leg of a swap, and the premium for an option to enter into a swap if and when the option is exercised.

(2) *Recognition rules*—(i) *In general.* All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates. Generally, a nonperiodic payment must be recognized over the term of a notional principal contract in a manner that reflects the economic substance of the contract.

(ii) *General rule for swaps.* A nonperiodic payment that relates to a swap must be recognized over the term of the contract by allocating it in accordance with the forward rates (or, in the case of a commodity, the forward prices) of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount. For purposes of this allocation, the forward rates or prices used to determine the amount of the nonperiodic payment will be respected, if reasonable. See paragraph (f)(4) *Example 7* of this section.

(iii) *Alternative methods for swaps.* Solely for purposes of determining the timing of income and deductions, a nonperiodic payment made or received with respect to a swap may be allocated to each period of the swap contract using one of the methods described in this paragraph (f)(2)(iii). The alternative methods may not be used by a dealer in notional principal contracts (as defined in paragraph (c)(4)(iii) of this section) for swaps entered into or acquired in its capacity as a dealer.

(A) *Prepaid swaps.* An upfront payment on a swap may be amortized by assuming that the nonperiodic payment represents the present value of a series of equal payments made throughout the term of the swap contract (the level payment method), adjusted as appropriate to take account of increases or decreases in the notional principal amount. The discount rate used in this calculation must be the rate (or rates) used by the parties to determine the amount of the nonperiodic payment. If that rate is not readily ascertainable, the discount rate used must be a rate that is reasonable under the circumstances. Under this method, an upfront payment is allocated by dividing each equal payment into its principal recovery and time value components. The principal recovery components of the equal payments are treated as periodic payments that are deemed to be made on each of the dates that the swap contract provides for periodic payments by the payor of the nonperiodic payment or, if none, on each of the dates that the swap contract provides for periodic payments by the recipient of the nonperiodic payment. The time value component is needed to compute the amortization of the nonperiodic payment, but is otherwise disregarded. See paragraph (f)(4) *Example 5* of this section.

(B) *Other nonperiodic swap payments.* Nonperiodic payments on a swap other than an upfront payment may be amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties. The discount rate (or rates) used in determining the deemed upfront payment and the time value component of the deemed loan is the same as the rate (or rates) used in the level payment method. The single upfront payment is then amortized under the level payment method described in paragraph (f)(2)(iii)(A) of this section. The time value component of the loan is not treated as interest, but, together with the amortized amount of the deemed upfront payment, is recognized as a periodic payment. See paragraph (f)(4) *Example 6* of this section. If both parties make nonperiodic payments, this calculation is done separately for the nonperiodic payments made by each party.

(iv) *General rule for caps and floors.* A payment to purchase or sell a cap or floor must be recognized over the term of the agreement by allocating it in accordance with the prices of a series of cash-settled option contracts that reflect the specified index and the notional principal amount. For purposes of this allocation, the option pricing used by the parties to determine the total amount paid for the cap or floor will be respected, if reasonable. Only the portion of the purchase price that is allocable to the option contract or contracts that expire during a particular period is recognized for that period. Thus, under this paragraph (f)(2)(iv), straight-line or accelerated amortization of a cap premium is generally not permitted. See paragraph (f)(4) *Examples 1* and *2* of this section.

(v) *Alternative methods for caps and floors that hedge debt instruments.* Solely for purposes of determining the timing of income and deductions, if a cap or floor is entered into primarily to reduce risk with respect to a specific debt instrument or group of debt instruments held or issued by the taxpayer, the taxpayer may amortize a payment to purchase or sell the cap or floor using the methods described in this paragraph (f)(2)(v), adjusted as appropriate to take account of increases or decreases in the notional principal amount. The alternative methods may not be used by a dealer in notional principal contracts (as defined in paragraph (c)(4)(iii) of this section) for caps or floors entered into or acquired in its capacity as a dealer.

(A) *Prepaid caps and floors.* A premium paid upfront for a cap or a floor may be amortized using the ''level payment method'' described in paragraph (f)(2)(iii)(A) of this section. See paragraph (f)(4) *Example 3* of this section.

(B) *Other caps and floors.* Nonperiodic payments on a cap or floor other than an upfront payment are amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties as described in paragraph (f)(2)(iii)(B) of this section. Under the level payment method, a cap or floor premium paid in level annual installments over the term of the contract is effectively included or deducted from income ratably, in accordance with the level payments. See paragraph (f)(4) *Example 4* of this section.

(C) *Special method for collars.* A taxpayer may also treat a cap and a floor that comprise a collar as a single notional principal contract and may amortize the net nonperiodic payment to enter into the cap and floor over the term of the collar in accordance with the methods prescribed in this paragraph (f)(2)(v).

(vi) *Additional methods.* The Commissioner may, by a revenue ruling or a revenue procedure published in the Internal Revenue Bulletin, provide alternative methods for allocating nonperiodic payments that relate to a notional principal contract to each year of the contract. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(3) *Term of extendible or terminable contracts.* For purposes of this paragraph (f), the term of a notional principal contract that is subject to extension or termination is the reasonably expected term of the contract.

(4) *Examples.* The following examples illustrate the application of paragraph (f) of this section.

Example 1.Cap premium amortized using general rule. (a) On January 1, 1995, when LIBOR is 8%, *F* pays unrelated party *E* $600,000 for a contract that obligates *E* to make a payment to *F* each quarter equal to one-quarter of the excess, if any, of three-month LIBOR over 9% with respect to a notional principal amount of $25 million. Both *E* and *F* are calendar year taxpayers. *E* provides *F* with a schedule of allocable premium amounts indicating that the cap was priced according to a reasonable variation of the Black-Scholes option pricing formula and that the total premium is allocable to the following periods:

	Pricing allocation
1995	$55,000
1996	225,000
1997	320,000
	$600,000

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and LIBOR is a specified index under paragraph (c)(2)(iii) of this section. Any payments made by *E* to *F* are periodic payments under paragraph (e)(1) of this section because they are payable at periodic intervals of one year or less throughout the term of the contract, are based on an appropriate specified index, and are based on a single notional principal amount. The $600,000 cap premium paid by *F* to *E* is a nonperiodic payment as defined in paragraph (f)(1) of this section.

(c) The Black-Scholes model is recognized in the financial industry as a standard technique for pricing interest rate cap agreements. Therefore, because *E* has used a reasonable option pricing model, the schedule generated by *E* is consistent with the economic substance of the cap, and may be used by both *E* and *F* for calculating their ratable daily portions of the cap premium. Under paragraph (f)(2)(iv) of this section, *E* recognizes the ratable daily portion of the cap premium as income, and *F* recognizes the ratable daily portion of the cap premium as a deduction based on the pricing schedule. Thus, *E* and *F* account for the contract as follows:

	Ratable daily portion
1995	$55,000
1996	225,000
1997	320,000
	$600,000

(d) Any periodic payments under the cap agreement (that is, payments that *E* makes to *F* because LIBOR exceeds 9%) are included in the parties' net income or net deduction from the contract in accordance with paragraph (e)(2) of this section.

Example 2. Cap premium allocated to proper period. (a) The facts are the same as in *Example 1,* except that the cap is purchased by *F* on November 1, 1994. The first determination date under the cap agreement is January 31, 1995 (the last day of the first quarter to which the contract relates). LIBOR is 9.1% on December 31, 1994, and is 9.15% on January 31, 1995.

(b) *E* and *F* recognize $9,192 (61 days/365 days × $55,000) as the ratable daily portion of the nonperiodic payment for 1994, and include that amount in their net income or net deduction from the contract for 1994. If *E*'s pricing model allocated the cap premium to each quarter covered by the contract, the ratable daily portion would be 61 days/92 days times the premium allocated to the first quarter.

(c) Under paragraph (e)(2)(ii) of this section, *E* and *F* calculate the payments using LIBOR as of December 31, 1994. *F* recognizes as income the ratable daily portion of the presumed payment, or $4,144 (61 days/92 days × .25 × .001 × $25,000,000). Thus, *E* reports $5,048 of net income from the contract for 1994 ($9,192–$4,144), and *F* reports a net deduction from the contract of $5,048.

(d) On January 31, 1995, *E* pays *F* $9,375 (.25 × .0015 × $25,000,000) under the terms of the cap agreement. For purposes of determining their net income or net deduction from this contract for the year ended December 31, 1995, *E* and *F* must adjust their respective net income and net deduction from the cap by $2,072 (61 days/92 days × ($9,375 actual payment under the cap on January 31, 1995—$6,250 presumed payment under the cap on December 31, 1994)).

Example 3. Cap premium amortized using alternative method. (a) The facts are the same as in *Example 1*, except that the cap provides for annual payments by *E* and is entered into by F primarily to reduce risk with respect to a debt instrument issued by *F*. *F* elects to amortize the cap premium using the alternative level payment method provided under paragraph (f)(2)(v)(A) of this section. Under that method, *F* amortizes the cap premium by assuming that the $600,000 is repaid in 3 equal annual payments of $241,269, assuming a discount rate of 10%. Each payment is divided into a time value component and a principal component, which are set out below.

	Level payment	Time value component	Principal component
1995	$241,269	$60,000	$181,269
1996	241,269	41,873	199,396
1997	241,269	21,934	219,335
	$723,807	$123,807	$600,000

(b) The net of the ratable daily portions of the principal component and the payments, if any, received from *E* comprise *F*'s annual net income or net deduction from the cap. The time value components are needed only to compute the ratable daily portions of the cap premium, and are otherwise disregarded.

Example 4. Cap premium paid in level installments and amortized using alternative method. (a) The facts are the same as in *Example 3*, except that *F* agrees to pay for the cap in three level installments of $241,269 (a total of $723,807) on December 31, 1995, 1996, and 1997. The present value of three payments of $241,269, discounted at 10%, is $600,000. For purposes of amortizing the cap premium under the alternative method provided in paragraph (f)(2)(v)(B) of this section, *F* is treated as paying $600,000 for the cap on January 1, 1995, and borrowing $600,000 from *E* that will be repaid in three annual installments of $241,269. The time value component of the loan is computed as follows:

	Loan balance	Time value component	Principal component
1995	$600,000	$60,000	$181,269
1996	418,731	41,873	199,396
1997	219,335	21,934	219,335
		$123,807	$600,000

(b) *F* is treated as making periodic payments equal to the amortized principal components from a $600,000 cap paid in advance (as described in *Example 3*), increased by the time value components of the $600,000 loan, which totals $241,269 each year. The time value components of the $600,000 loan are included in the periodic payments made by *F*, but are not characterized as interest income or expense. The effect of the alternative method in this situation is to allow *F* to amortize the cap premium in level installments, the same way it is paid. The net of the ratable daily portions of *F*'s deemed periodic payments and the payments, if any, received from *E* comprise *F*'s annual net income or net deduction from the cap.

Example 5. Upfront interest rate swap payment amortized using alternative method. (a) On January 1, 1995, *G* enters into an interest rate swap agreement with unrelated counterparty *H* under which, for a term of five years, *G* is obligated to make annual payments at 11% and H is obligated to make annual payments at LIBOR on a notional principal amount of $100 million. At the time *G* and *H* enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, on January 1, 1995, *H* pays *G* a yield adjustment fee of $3,790,786. *G* provides *H* with information that indicates that the amount of the yield adjustment fee was determined as the present value, at 10% compounded annually, of five annual payments of $1,000,000 (1% × $100,000,000). *G* and *H* are calendar year taxpayers.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section. The yield adjustment fee is a nonperiodic payment as defined in paragraph (f)(1) of this section.

(c) Under the alternative method described in paragraph (f)(2)(iii)(A) of this section, the yield adjustment fee is recognized over the life of the agreement by assuming that the

$3,790,786 is repaid in five level payments. Assuming a constant yield to maturity and annual compounding at 10%, the ratable daily portions are computed as follows:

	Level payment	Time value component	Principal component
1995	$1,000,000	$379,079	$620,921
1996	1,000,000	316,987	683,013
1997	1,000,000	248,685	751,315
1998	1,000,000	173,554	826,446
1999	1,000,000	90,909	909,091
	$5,000,000	$1,209,214	$3,790,786

(d) *G* also makes swap payments to *H* at 11%, while *H* makes swap payments to *G* based on LIBOR. The net of the ratable daily portions of the 11% payments by *G*, the LIBOR payments by *H*, and the principal component of the yield adjustment fee paid by *H* determines the annual net income or net deduction from the contract for both *G* and *H*. The time value components are needed only to compute the ratable daily portions of the yield adjustment fee paid by *H*, and are otherwise disregarded.

Example 6. Backloaded interest rate swap payment amortized using alternative method. (a) The facts are the same as in *Example 5*, but *H* agrees to pay *G* a yield adjustment fee of $6,105,100 on December 31, 1999. Under the alternative method in paragraph (f)(2)(iii)(B) of this section, *H* is treated as paying a yield adjustment fee of $3,790,786 (the present value of $6,105,100, discounted at a 10% rate with annual compounding) on January 1, 1995. Solely for timing purposes, *H* is treated as borrowing $3,790,786 from *G*. Assuming annual compounding at 10%, the time value component is computed as follows:

	Loan balance	Time value component	Principal component
1995	$3,790,786	$379,079	0
1996	4,169,865	416,987	0
1997	4,586,852	458,685	0
1998	5,045,537	504,554	0
1999	5,550,091	555,009	6,105,100

(b) The amortization of *H*'s yield adjustment fee is equal to the amortization of a yield adjustment fee of $3,790,786 paid in advance (as described in *Example 5*), increased by the time value component of the $3,790,786 deemed loan from *G* to *H*. Thus, the amount of *H*'s yield adjustment fee that is allocated to 1995 is $1,000,000 ($620,921 + $379,079). The time value components of the $3,790,786 loan are included in the periodic payments paid by *H*, but are not characterized as interest income or expense. The net of the ratable daily portions of the 11% swap payments by *G*, and the LIBOR payments by H, added to the principal components from *Example 5* and the time value components from this *Example 6*, determines the annual net income or net deduction from the contract for both *G* and *H*.

Example 7. Nonperiodic payment on a commodity swap amortized under general rule. (a) On January 1, 1995, *I* enters into a commodity swap agreement with unrelated counterparty *J* under which, for a term of three years, *I* is obligated to make annual payments based on a fixed price of $2.35 per bushel times a notional amount of 100,000 bushels of corn and *J* is obligated to make annual payments equal to the spot price times the same notional amount. Assume that on January 1, 1995, the price of a one year forward for corn is $2.40 per bushel, of a two year forward $2.55 per bushel, and of a 3 year forward $2.75 per bushel. To compensate for the below-market fixed price provided in the swap agreement, *I* pays *J* $53,530 for entering into the swap. *I* and *J* are calendar year taxpayers.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and $2.35 and the spot price of corn are specified indices under paragraphs (c)(2)(i) and (iii) of this section, respectively. The $53,530 payment is a nonperiodic payment as defined by paragraph (f)(1) of this section.

(c) Assuming that *I* does not use the alternative methods provided under paragraph (f)(2)(iii) of this section, paragraph (f)(2)(ii) of this section requires that *I* recognize the nonperiodic payment over the term of the agreement by allocating the payment to each forward contract in accordance with the forward price of corn. Solely for timing purposes, *I* treats the $53,530 nonperiodic payment as a loan that *J* will repay in three installments of $5,000, $20,000, and $40,000, the expected payouts on the in-the-money forward contracts. With annual compounding at 8%, the ratable daily portions are computed as follows:

	Expected forward payment	Time value component	Principal component
1995	$5,000	$4,282	$718
1996	20,000	4,225	15,775
1997	40,000	2,963	37,037
	$65,000	$11,470	$53,530

(d) The ratable daily portion of the principal component is added to *I*'s periodic payments in computing its net income or net deduction from the notional principal contract for each taxable year. The time value components are needed only to compute the principal components, and are otherwise disregarded.

(g) *Special rules*—(1) *Disguised notional principal contracts.* The Commissioner may recharacterize all or part of a transaction (or series of transactions) if the effect of the transaction (or series of transactions) is to avoid the application of this section.

(2) *Hedged notional principal contracts.* If a taxpayer, either directly or through a related person (as defined in paragraph (c)(4)(i) of this section), reduces risk with respect to a notional principal contract by purchasing, selling, or otherwise entering into other notional principal contracts, futures, forwards, options, or other financial contracts (other than debt instruments), the taxpayer may not use the alternative methods provided in paragraphs (f)(2)(iii) and (v) of this section. Moreover, where such positions are entered into to avoid the appropriate timing or character of income from the contracts taken together, the Commissioner may require that amounts paid to or received by the taxpayer under the notional principal contract be treated in a manner that is consistent with the economic substance of the transaction as a whole.

(3) *Options and forwards to enter into notional principal contracts.* An option or forward contract that entitles or obligates a person to enter into a notional principal contract is subject to the general rules of taxation for options or forward contracts. Any payment with respect to the option or forward contract is treated as a nonperiodic payment for the underlying notional principal contract under the rules of paragraphs (f) and (g)(4) or (g)(5) of this section if and when the underlying notional principal contract is entered into.

(4) [Reserved]. For further guidance, see §1.446–3T(g)(4).

(5) *Caps and floors that are significantly in-the-money.* [Reserved]

(6) *Examples.* The following examples illustrate the application of paragraph (g) of this section.

Example 1. Cap hedged with options. (a) On January 1, 1995, *K* sells to unrelated counterparty *L* three cash settlement European-style put options on Eurodollar time deposits with a strike rate of 9%. The options have exercise dates of January 1, 1996, January 1, 1997, and January 1, 1998, respectively. If LIBOR exceeds 9% on any of the exercise dates, *L* will be entitled, by exercising the relevant option, to receive from *K* an amount that corresponds to the excess of LIBOR over 9% times $25 million. *L* pays *K* $650,000 for the three options. Furthermore, *K* is related to *F*, the cap purchaser in paragraph (f)(4) *Example 1* of this section.

(b) *K*'s option agreements with *L* reduce risk with respect to *F*'s cap agreement with *E*. Accordingly, under paragraph (g)(2) of this section, *F* cannot use the alternative methods provided in paragraph (f)(2)(v) of this section to amortize the premium paid under the cap agreement. *F* must amortize the cap premium it paid in accordance with paragraph (f)(2)(iv) of this section.

(c) The method that *E* may use to account for its agreement with *F* is not affected by the application of paragraph (g)(2) of this section to *F*.

Example 2. [Reserved]. For further guidance, see §1.446–3T(g)(6), *Example 2.*

Example 3. [Reserved]. For further guidance, see §1.446–3T(g)(6), *Example 3.*

Example 4. [Reserved]. For further guidance, see §1.446–3T(g)(6), *Example 4.*

(h) *Termination payments*—(1) *Definition.* A payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract is a termination payment to the party making the termination payment and the party receiving the payment. A termination payment includes a payment made between the original parties to the contract (an extinguishment), a payment made between one party to the contract and a third party (an assignment), and any gain or loss realized on the exchange of one notional principal contract for another. Where one party assigns its remaining rights and obligations to a third party, the original nonassigning counterparty realizes gain or loss if the assignment results in a deemed exchange of contracts and a realization event under section 1001.

(2) *Taxable year of inclusion and deduction by original parties.* Except as otherwise provided (for example, in section 453, section 1092, or §1.446–4), a party to a notional principal contract recognizes a termination payment in the year the contract is extinguished, assigned, or exchanged. When the termination payment is recognized, the party also recognizes any other payments that have been made or received pursuant to the notional principal contract, but that have not been recognized under paragraph (d) of this section. If only a proportionate part of a party's rights and obligations is extinguished, assigned, or exchanged, then only that proportion of the unrecognized payments is recognized under the previous sentence.

(3) *Taxable year of inclusion and deduction by assignees.* A termination payment made or received by an assignee pursuant to an assignment of a notional principal contract is recognized by the assignee under the rules of paragraphs (f) and (g)(4) or (g)(5) of this section as a nonperiodic payment for the notional principal contract that is in effect after the assignment.

(4) *Special rules*—(i) *Assignment of one leg of a contract.* A payment is not a termination payment if it is made or received by a party in exchange for assigning all or a portion of one leg of a notional principal contract at a time when a substantially proportionate amount of the other leg remains unperformed and unassigned. The payment is either an amount loaned, an amount borrowed, or a nonperiodic payment, depending on the economic substance of the transaction to each party. This paragraph (h)(4)(i) applies whether or not the original notional principal contract is terminated as a result of the assignment.

(ii) *Substance over form.* Any economic benefit that is given or received by a taxpayer in lieu of a termination payment is a termination payment.

(5) *Examples.* The following examples illustrate the application of this paragraph (h). The contracts in the examples are not hedging transactions as defined in §1.1221–2(b), and all of the examples assume that no loss-deferral rules apply.

Example 1. Termination by extinguishment. (a) On January 1, 1995, *P* enters into an interest rate swap agreement with unrelated counterparty *Q* under which, for a term of seven years, *P* is obligated to make annual payments based on 10% and *Q* is obligated to make semi-annual payments based on LIBOR and a notional principal amount of $100 million. *P* and *Q* are both calendar year taxpayers. On January 1, 1997, when the fixed rate on a comparable LIBOR swap has fallen to 9.5%, *P* pays *Q* $1,895,393 to terminate the swap.

(b) The payment from *P* to *Q* extinguishes the swap contract and is a termination payment, as defined in paragraph (h)(1) of this section, for both parties. Accordingly, under paragraph (h)(2) of this section, *P* recognizes a loss of $1,895,393 in 1997 and *Q* recognizes $1,895,393 of gain in 1997.

Example 2. Termination by assignment. (a) The facts are the same as in *Example 1*, except that on January 1, 1997, *P* pays unrelated party *R* $1,895,393 to assume all of *P*'s rights and obligations under the swap with *Q*. In return for this payment, *R* agrees to pay 10% of $100 million annually to *Q* and to receive LIBOR payments from *Q* for the remaining five years of the swap.

(b) The payment from *P* to *R* terminates *P*'s interest in the swap contract with *Q* and is a termination payment, as defined in paragraph (h)(1) of this section, for *P*. Under paragraph (h)(2) of this section, *P* recognizes a loss of $1,895,393 in 1997. Whether *Q* also has a termination payment with respect to the payment from *P* to *R* is determined under section 1001.

(c) Under paragraph (h)(3) of this section, the assignment payment that *R* receives from *P* is a nonperiodic payment for an interest rate swap. Because the assignment payment is not a significant nonperiodic payment within the meaning of paragraph (g)(1) of this section, *R* amortizes the $1,895,393 over the five year term of the swap agreement under paragraph (f)(2) of this section.

Example 3. Assignment of swap with yield adjustment fee. (a) The facts are the same as in *Example 2*, except that on January 1, 1995, *Q* paid *P* a yield adjustment fee to enter into the seven year interest rate swap. In accordance with paragraph (f)(2) of this section, *P* and *Q* included the ratable daily portions of that nonperiodic payment in their net income or net deduction from the contract for 1995 and 1996. On January 1, 1997, $300,000 of the nonperiodic payment has not yet been recognized by *P* and *Q*.

(b) Under paragraph (h)(2) of this section, *P* recognizes a loss of $1,595,393 ($1,895,393–$300,000) in 1997. *R* accounts for the termination payment in the same way it did in *Example 2*; the existence of an unamortized payment with respect to the original swap has no effect on *R*.

Example 4. Assignment of one leg of a swap. (a) On January 1, 1995, *S* enters into an interest rate swap agreement with unrelated counterparty *T* under which, for a term of five years, *S* will make annual payments at 10% and *T* will make annual payments at LIBOR on a notional principal amount of $50 million. On January 1, 1996, unrelated party U pays *T* $15,849,327 for the right to receive the four remaining $5,000,000 payments from *S*. Under the terms of the agreement between *S* and *T*, *S* is notified of this assignment, and *S* is contractually bound thereafter to make its payments to *U* on the appropriate payment dates. *S*'s obligation to pay *U* is conditioned on *T* making its LIBOR payment to *S* on the appropriate payment dates.

(b) Because *T* has assigned to *U* its rights to the fixed rate payments, but not its floating rate obligations under the notional principal contract, *U*'s payment to *T* is not a termination payment as defined in paragraph (h)(1) of this section, but is covered by paragraph (h)(4)(i) of this section. The economic substance of the transaction between *T* and *U* is a loan that does not affect the way that *S* and *T* account for the notional principal contract under this section.

(i) *Anti-abuse rule.* If a taxpayer enters into a transaction with a principal purpose of applying the rules of this section to produce a material distortion of income, the Commissioner may depart from the rules of this section as necessary to reflect the appropriate timing of income and deductions from the transaction.

(j)(1) *Effective/applicability date.* These regulations are effective for notional principal contracts entered into on or after December 13, 1993.

(2) [Reserved]. For further guidance, see §1.446–3T(j)(2).

[T.D. 8491, 58 FR 53128, Oct. 14, 1993; 59 FR 9411, Feb. 28, 1994, as amended by T.D. 8554, 59 FR 36358, July 18, 1994; T.D. 9719, 80 FR 26440, May 8, 2015; 80 FR 34051, June 15, 2015]

§ 1.446–3T Notional principal contracts (temporary).

(a) through (g)(3) [Reserved]. For further guidance, see §1.446–3(a) through (g)(3).

(4) *Notional principal contracts with nonperiodic payments*—(i) *General rule.* Except as provided in paragraph (g)(4)(ii) of this section, a notional principal contract with one or more nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and one or more loans. The loan(s) must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan(s) is not included in the net income or net deduction from the swap under §1.446–3(d), but it is recognized as interest for all purposes of the Internal Revenue Code. See paragraph (g)(6) *Example 2* of this section.

(ii) *Exceptions*—(A) *Notional principal contract with a term of one year or less*—(*1*) *General rule.* Except for purposes of sections 514 and 956, paragraph (g)(4)(i) of this section does not apply to a notional principal contract if the term of the contract is one year or less. For purposes of this paragraph (g)(4)(ii)(A), the term of a notional principal contract is the stated term of the contract, inclusive of any extensions (optional or otherwise) provided for in the terms of the contract, without regard to whether any extension is unilateral, is subject to approval by one or both parties to the contract, or is based on the occurrence or non-occurrence of a specified event.

(*2*) *Anti-abuse rule.* For purposes of determining the term of a contract under paragraph (g)(4)(ii)(A)(*1*) of this section, the Commissioner may treat two or more contracts as a single contract if a principal purpose of entering into separate contracts is to qualify for the exception set forth in paragraph (g)(4)(ii)(A)(*1*) of this section. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(B) *Notional principal contract subject to margin or collateral requirements.* Subject to the requirements in paragraph (g)(4)(ii)(C) of this section, paragraph (g)(4)(i) of this section does not apply to a notional principal contract if the contract is described in paragraph (g)(4)(ii)(B)(*1*) or (*2*) of this section. See §1.956–2T(b)(1)(xi) for a related exception under section 956.

(*1*) The contract is cleared by a derivatives clearing organization (as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a)) or by a clearing agency (as such term in defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)) that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively, and the derivatives clearing organization or clearing agency requires the parties to the contract to post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract. The mark-to-market exposure on a contract will be fully collateralized only if the contract is subject to both initial variation margin in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin in an amount equal to the daily change in the fair market value of the contract. See paragraph (g)(6) *Example 3* of this section.

(*2*) The parties to the contract are required, pursuant to the terms of the contract or the requirements of a federal regulator, to post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract. The mark-to-market exposure on a contract will be fully collateralized only if the contract is subject to both initial variation margin or collateral in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin or collateral in an amount equal to the daily change in the fair market value of the contract. For purposes of this paragraph (g)(4)(ii)(B)(*2*), the term ''federal regulator'' means the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), or a prudential regulator, as defined in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a), as amended by section 721 of the Dodd-Frank Act. See paragraph (g)(6) *Example 4* of this section.

(C) *Limitations and special rules*—(*1*) *Cash requirement.* A notional principal contract is described in paragraph (g)(4)(ii)(B) of this section only to the extent the parties post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) by paying and receiving the required margin or collateral in cash. The term ''cash'' includes U.S. dollars or cash in any currency in which payment obligations under the notional principal contract are denominated.

(*2*) *Excess margin or collateral.* For purposes of paragraph (g)(4)(ii)(B)(*2*) of this section, if the amount of cash margin or collateral posted and collected is in excess of the amount necessary to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract, any excess is subject to the rule in paragraph (g)(4)(i) of this section.

(*3*) *Margin or collateral paid and received in cash and other property.* If the parties to the contract post and collect both cash and other property to satisfy margin or collateral requirements to collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment), any excess of the nonperiodic payment over the cash margin or collateral posted and collected is subject to the rule in paragraph (g)(4)(i) of this section.

(5) [Reserved]. For further guidance, see §1.446–3(g)(5).

(6) *Examples* through *Example 1.* [Reserved]. For further guidance, see

§ 1.446–3(g)(6), *Examples* through *Example 1*.

Example 2. Nonperiodic payment. (i) On January 1, 2016, unrelated parties M and N enter into an interest rate swap contract. Under the terms of the contract, N agrees to make five annual payments to M equal to LIBOR times a notional principal amount of $100 million. In return, M agrees to pay N 6% of $100 million annually, plus an upfront payment of $15,163,147 on January 1, 2016. At the time M and N enter into the contract, the rate for similar on-market swaps is LIBOR to 10%, and N provides M with information that the amount of the upfront payment was determined as the present value, at 10% compounded annually, of five annual payments from M to N of $4,000,000 (4% of $100,000,000). The contract does not require the parties to post and collect margin or collateral to collateralize the mark-to-market exposure on the contract on a daily basis for the entire term of the contract.

(ii) The exceptions in paragraphs (g)(4)(ii)(A) and (B) of this section do not apply. Under paragraph (g)(4)(i) of this section, the transaction is recharacterized as consisting of both a $15,163,147 loan from M to N that N repays in installments over the term of the contract and an interest rate swap between M and N in which M immediately pays the installment payments on the loan back to N as part of its fixed payments on the swap in exchange for the LIBOR payments by N.

(iii) The upfront payment is recognized over the life of the contract by treating the $15,163,147 as a loan that will be repaid with level payments over five years. Assuming a constant yield to maturity and annual compounding at 10%, M and N account for the principal and interest on the loan as follows:

	Level payment	Interest component	Principal component
2016	$4,000,000	$1,516,315	$2,483,685
2017	4,000,000	1,267,946	2,732,054
2018	4,000,000	994,741	3,005,259
2019	4,000,000	694,215	3,305,785
2020	4,000,000	363,636	3,636,364
	20,000,000	4,836,853	15,163,147

(iv) M recognizes interest income, and N claims an interest deduction, each taxable year equal to the interest component of the deemed installment payments on the loan. These interest amounts are not included in the parties' net income or net deduction from the swap contract under § 1.446–3(d). The principal components are needed only to compute the interest component of the level payment for the following period and do not otherwise affect the parties' net income or net deduction from this contract.

(v) N also makes swap payments to M based on LIBOR and receives swap payments from M at a fixed rate that is equal to the sum of the stated fixed rate and the rate calculated by dividing the deemed level annual payments on the loan by the notional principal amount. Thus, the fixed rate on this swap is 10%, which is the sum of the stated rate of 6% and the rate calculated by dividing the annual loan payment of $4,000,000 by the notional principal amount of $100,000,000, or 4%. Using the methods provided in § 1.446–3(e)(2), the fixed swap payments from M to N of $10,000,000 (10% of $100,000,000) and the LIBOR swap payments from N to M are included in the parties' net income or net deduction from the contract for each taxable year.

Example 3. Full margin—cleared contract. (i) A, a domestic corporation enters into an interest rate swap contract with unrelated counterparty B. The contract is required to be cleared and is accepted for clearing by a U.S.-registered derivatives clearing organization (DCO). The standardized terms of the contract provide that A, for a term of X years, will pay B a fixed coupon of 1% per year and receive a floating coupon on a notional principal amount of $Y. When A and B enter into the interest rate swap, the market coupon for similar interest rate swaps is 2% per year. The DCO requires A to make an upfront payment to compensate B for the below-market annual coupon payments that B will receive, and A makes the upfront payment in cash. The DCO also requires B to post initial variation margin in an amount equal to the upfront payment and requires each party to post and collect daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract. B posts the initial variation margin in U.S. dollars, and the parties post and collect daily variation margin in U.S. dollars.

(ii) Because the contract is subject to initial variation margin in an amount equal to the upfront payment and daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in paragraph (g)(4)(ii)(B)(*1*) of this section and paragraph (g)(4)(i) of this section does not apply to the contract.

Example 4. Full margin—uncleared contract. (i) On June 1, 2016, P, a domestic corporation, enters into an interest rate swap contract with an unrelated domestic counterparty, CP. Under the terms of the contract, CP agrees to make five annual payments to P equal to a specified contract rate of 3% times the notional amount of $10,000,000 plus an upfront payment of $1,878,030. In exchange, P agrees to make five annual payments to CP equal to the same notional amount times LIBOR. At the time the parties enter into the contract, the fixed rate for an on-market swap is 7.52%. The contract is not required to be cleared and is not accepted for clearing by a U.S.-registered derivatives clearing organization. However, pursuant to the terms of the contract, P is obligated to post $1,878,030 as collateral with CP, and P and CP are obligated to post and collect collateral each business day in an amount equal to the daily change in the fair market value of the contract for the entire term of the contract. All collateral on the contract is required to be in U.S. dollars.

(ii) Because the contract is required to be collateralized in an amount equal to the upfront payment and changes in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in paragraph (g)(4)(ii)(B)(*2*) of this section and paragraph (g)(4)(i) of this section does not apply to the contract.

(h) through (j)(1) [Reserved]. For further guidance, see §1.446–3(h) through (j)(1).

(2) *Application of §1.446–3T(g)(4).* Paragraph (g)(4)(i) of this section and paragraph (g)(6) *Example 2* of this section apply to notional principal contracts entered into on or after the later of January 1, 2017, or 180 days after the date of publication of the Treasury decision adopting these rules as final regulations in the FEDERAL REGISTER. Paragraph (g)(4)(ii) of this section applies to notional principal contracts entered into on or after May 8, 2015. However, before the later of January 1, 2017, or 180 days after the date of publication of the Treasury decision adopting paragraph (g)(4)(i) of this section as final regulations in the FEDERAL REGISTER, taxpayers may rely on the provision in §1.446–3(g)(4), as contained in 26 CFR part 1, revised April 1, 2015, which (except for purposes of section 956) limits the application of the embedded loan rule to nonperiodic payments that are significant, even if the requirements for the exceptions in paragraph (g)(4)(ii) of this section are not met. Taxpayers may apply paragraph (g)(4)(i) of this section, paragraph (g)(4)(ii) of this section, or both to notional principal contracts entered into before the dates set forth in this paragraph (j)(2).

(k) *Expiration date.* The applicability of paragraph (g)(4) of this section and paragraph (g)(6) *Examples 2, 3* and *4* of this section expires May 7, 2018.

[T.D. 9719, 80 FR 26440, May 8, 2015, as amended by 80 FR 61308, Oct. 13, 2015]

§1.446–4 Hedging transactions.

(a) *In general.* Except as provided in this paragraph (a), a hedging transaction as defined in §1.1221–2(b) (whether or not the character of gain or loss from the transaction is determined under §1.1221–2) must be accounted for under the rules of this section. To the extent that provisions of any other regulations governing the timing of income, deductions, gain, or loss are inconsistent with the rules of this section, the rules of this section control.

(1) *Trades or businesses excepted.* A taxpayer is not required to account for hedging transactions under the rules of this section for any trade or business in which the cash receipts and disbursements method of accounting is used or in which §1.471–6 is used for inventory valuations if, for all prior taxable years ending on or after September 30, 1993, the taxpayer met the $5,000,000 gross receipts test of section 448(c) (or would have met that test if the taxpayer were a corporation or partnership). A taxpayer not required to use the rules of this section may nonetheless use a method of accounting that is consistent with these rules.

(2) *Coordination with other sections.* This section does not apply to—

(i) Any position to which section 475(a) applies;

(ii) An integrated transaction subject to §1.1275–6;

(iii) Any section 988 hedging transaction if the transaction is integrated under §1.988–5 or if other regulations issued under section 988(d) (or an advance ruling described in 1.988–5(e)) govern when gain or loss from the transaction is taken into account; or

(iv) The determination of the issuer's yield on an issue of tax-exempt bonds for purposes of the arbitrage restrictions to which § 1.148–4(h) applies.

(b) *Clear reflection of income.* The method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. Taking gains and losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions. For example, where a hedge and the item being hedged are disposed of in the same taxable year, taking realized gain or loss into account on both items in that taxable year may clearly reflect income. In the case of many hedging transactions, however, taking gains and losses into account as they are realized does not result in the matching required by this section.

(c) *Choice of method and consistency.* For any given type of hedging transaction, there may be more than one method of accounting that satisfies the clear reflection requirement of paragraph (b) of this section. A taxpayer is generally permitted to adopt a method of accounting for a particular type of hedging transaction that clearly reflects the taxpayer's income from that type of transaction. See paragraph (e) of this section for requirements and limitations on the taxpayer's choice of method. Different methods of accounting may be used for different types of hedging transactions and for transactions that hedge different types of items. Once a taxpayer adopts a method of accounting, however, that method must be applied consistently and can only be changed with the consent of the Commissioner, as provided by section 446(e) and the regulations and procedures thereunder.

(d) *Recordkeeping requirements*—(1) *In general.* The books and records maintained by a taxpayer must contain a description of the accounting method used for each type of hedging transaction. The description of the method or methods used must be sufficient to show how the clear reflection requirement of paragraph (b) of this section is satisfied.

(2) *Additional identification.* In addition to the identification required by § 1.1221–2(f), the books and records maintained by a taxpayer must contain whatever more specific identification with respect to a transaction is necessary to verify the application of the method of accounting used by the taxpayer for the transaction. This additional identification may relate to the hedging transaction or to the item, items, or aggregate risk being hedged. The additional identification must be made at the time specified in § 1.1221–2(f)(2) and must be made on, and retained as part of, the taxpayer's books and records.

(3) *Transactions in which character of gain or loss is not determined under § 1.1221–2.* A section 988 transaction, as defined in section 988(c)(1), or a qualified fund, as defined in section 988(c)(1)(E)(iii), is subject to the identification and recordkeeping requirements of § 1.1221–2(f). See § 1.1221–2(a)(4).

(e) *Requirements and limitations with respect to hedges of certain assets and liabilities.* In the case of certain hedging transactions, this paragraph (e) provides guidance in determining whether a taxpayer's method of accounting satisfies the clear reflection requirement of paragraph (b) of this section. Even if these rules are satisfied, however, the taxpayer's method, as actually applied to the taxpayer's hedging transactions, must clearly reflect income by meeting the matching requirement of paragraph (b) of this section.

(1) *Hedges of aggregate risk*—(i) *In general.* The method of accounting used for hedges of aggregate risk must comply with the matching requirements of paragraph (b) of this section. Even though a taxpayer may not be able to associate the hedging transaction with any particular item being hedged, the timing of income, deduction, gain, or loss from the hedging transaction must be matched with the timing of the aggregate income, deduction, gain, or loss from the items being hedged. For example, if a notional principal contract hedges a taxpayer's aggregate

risk, taking into account income, deduction, gain, or loss under the provisions of §1.446–3 may clearly reflect income. See paragraph (e)(5) of this section.

(ii) *Mark-and-spread method.* The following method may be appropriate for taking into account income, deduction, gain, or loss from hedges of aggregate risk:

(A) The hedging transactions are marked to market at regular intervals for which the taxpayer has the necessary data, but no less frequently than quarterly; and

(B) The income, deduction, gain, or loss attributable to the realization or periodic marking to market of hedging transactions is taken into account over the period for which the hedging transactions are intended to reduce risk. Although the period over which the hedging transactions are intended to reduce risk may change, the period must be reasonable and consistent with the taxpayer's hedging policies and strategies.

(2) *Hedges of items marked to market.* In the case of a transaction that hedges an item that is marked to market under the taxpayer's method of accounting, marking the hedge to market clearly reflects income.

(3) *Hedges of inventory*—(i) *In general.* If a hedging transaction hedges purchases of inventory, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of the cost of inventory. Similarly, if a hedging transaction hedges sales of inventory, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of sales proceeds. If a hedge is associated with a particular purchase or sales transaction, the gain or loss on the hedge may be taken into account when it would be taken into account if it were an element of cost incurred in, or sales proceeds from, that transaction. As with hedges of aggregate risk, however, a taxpayer may not be able to associate hedges of inventory purchases or sales with particular purchase or sales transactions. In order to match the timing of income, deduction, gain, or loss from the hedge with the timing of aggregate income, deduction, gain, or loss from the hedged purchases or sales, it may be appropriate for a taxpayer to account for its hedging transactions in the manner described in paragraph (e)(1)(ii) of this section, except that the gain or loss that is spread to each period is taken into account when it would be if it were an element of cost incurred (purchase hedges), or an element of proceeds from sales made (sales hedges), during that period.

(ii) *Alternative methods for certain inventory hedges.* In lieu of the method described in paragraph (e)(3)(i) of this section, other simpler, less precise methods may be used in appropriate cases where the clear reflection requirement of paragraph (b) of this section is satisfied. For example:

(A) Taking into account realized gains and losses on both hedges of inventory purchases and hedges of inventory sales when they would be taken into account if the gains and losses were elements of inventory cost in the period realized may clearly reflect income in some situations, but does not clearly reflect income for a taxpayer that uses the last-in, first-out method of accounting for the inventory; and

(B) Marking hedging transactions to market with resulting gain or loss taken into account immediately may clearly reflect income even though the inventory that is being hedged is not marked to market, but only if the inventory is not accounted for under either the last-in, first-out method or the lower-of-cost-or-market method and only if items are held in inventory for short periods of time.

(4) *Hedges of debt instruments.* Gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer, or a debt instrument held or to be held by a taxpayer, must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. A hedge of an instrument that provides for interest to be paid at a fixed rate or a qualified floating rate, for example, generally is accounted for using constant yield principles. Thus, assuming that a fixed rate or qualified floating rate instrument remains outstanding, hedging gain or loss is taken

into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates. For example, gain or loss realized on a transaction that hedged an anticipated fixed rate borrowing for its entire term is accounted for, solely for purposes of this section, as if it decreased or increased the issue price of the debt instrument. Similarly, gain or loss realized on a transaction that hedges a contingent payment on a debt instrument subject to §1.1275–4(c) (a contingent payment debt instrument issued for nonpublicly traded property) is taken into account when the contingent payment is taken into account under §1.1275–4(c).

(5) *Notional principal contracts.* The rules of §1.446–3 govern the timing of income and deductions with respect to a notional principal contract unless, because the notional principal contract is part of a hedging transaction, the application of those rules would not result in the matching that is needed to satisfy the clear reflection requirement of paragraph (b) and, as applicable, (e)(4) of this section. For example, if a notional principal contract hedges a debt instrument, the method of accounting for periodic payments described in §1.446–3(e) and the methods of accounting for nonperiodic payments described in §1.446–3(f)(2)(iii) and (v) generally clearly reflect the taxpayer's income. The methods described in §1.446–3(f)(2)(ii) and (iv), however, generally do not clearly reflect the taxpayer's income in that situation.

(6) *Disposition of hedged asset or liability.* If a taxpayer hedges an item and disposes of, or terminates its interest in, the item but does not dispose of or terminate the hedging transaction, the taxpayer must appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item. To meet this requirement, the taxpayer may mark the hedge to market on the date it disposes of the hedged item. If the taxpayer intends to dispose of the hedging transaction within a reasonable period, however, it may be appropriate to match the realized gain or loss on the hedging transaction with the gain or loss on the disposed item. If the taxpayer intends to dispose of the hedging transaction within a reasonable period and the hedging transaction is not actually disposed of within that period, the taxpayer must match the gain or loss on the hedge at the end of the reasonable period with the gain or loss on the disposed item. For purposes of this paragraph (e)(6), a reasonable period is generally 7 days.

(7) *Recycled hedges.* If a taxpayer enters into a hedging transaction by recycling a hedge of a particular hedged item to serve as a hedge of a different item, as described in §1.1221–2(d)(4), the taxpayer must match the built-in gain or loss at the time of the recycling to the gain or loss on the original hedged item, items, or aggregate risk. Income, deduction, gain, or loss attributable to the period after the recycling must be matched to the new hedged item, items, or aggregate risk under the principles of paragraph (b) of this section.

(8) *Unfulfilled anticipatory transactions*—(i) *In general.* If a taxpayer enters into a hedging transaction to reduce risk with respect to an anticipated asset acquisition, debt issuance, or obligation, and the anticipated transaction is not consummated, any income, deduction, gain, or loss from the hedging transaction is taken into account when realized.

(ii) *Consummation of anticipated transaction.* A taxpayer consummates a transaction for purposes of paragraph (e)(8)(i) of this section upon the occurrence (within a reasonable interval around the expected time of the anticipated transaction) of either the anticipated transaction or a different but similar transaction for which the hedge serves to reasonably reduce risk.

(9) *Hedging by members of a consolidated group*—(i) *General rule: single-entity approach.* In general, a member of a consolidated group must account for its hedging transactions as if all of the members were separate divisions of a single corporation. Thus, the timing of the income, deduction, gain, or loss on a hedging transaction must match the timing of income, deduction, gain, or loss from the item or items being hedged. Because all of the members are treated as if they were divisions of a single corporation, intercompany

transactions are neither hedging transactions nor hedged items for these purposes.

(ii) *Separate-entity election.* If a consolidated group makes an election under § 1.1221–2(e)(2), then paragraph (e)(9)(i) of this section does not apply. Thus, in that case, each member of the consolidated group must account for its hedging transactions in a manner that meets the requirements of paragraph (b) of this section. For example, the income, deduction, gain, or loss from intercompany hedging transactions (as defined in § 1.1221–2(e)(2)(ii)) is taken into account under the timing rules of § 1.446–4 rather than under the timing rules of § 1.1502–13.

(iii) *Definitions.* For definitions of consolidated group, divisions of a single corporation, intercompany transaction, and member, see section 1502 and the regulations thereunder.

(iv) *Effective date.* This paragraph (e)(9) applies to transactions entered into on or after March 8, 1996.

(f) *Type or character of income and deduction.* The rules of this section govern the timing of income, deduction, gain, or loss on hedging transactions but do not affect the type or character of income, deduction, gain, or loss produced by the transaction. Thus, for example, the rules of paragraph (e)(3) of this section do not affect the computation of cost of goods sold or sales proceeds for a taxpayer that hedges inventory purchases or sales. Similarly, the rules of paragraph (e)(4) of this section do not increase or decrease the interest income or expense of a taxpayer that hedges a debt instrument or a liability.

(g) *Effective date.* This section applies to hedging transactions entered into on or after October 1, 1994.

(h) *Consent to change methods of accounting.* The Commissioner grants consent for a taxpayer to change its methods of accounting for transactions that are entered into on or after October 1, 1994, and that are described in paragraph (a) of this section. This consent is granted only for changes for the taxable year containing October 1, 1994. The taxpayer must describe its new methods of accounting in a statement that is included in its Federal income tax return for that taxable year.

[T.D. 8554, 59 FR 36358, July 18, 1994, as amended by T.D. 8653, 61 FR 519, Jan. 8, 1996; T.D. 8674, 61 FR 30138, June 14, 1996; T.D. 8985, 67 FR 12865, Mar. 20, 2002; 67 FR 31955, May 13, 2002]

§ 1.446–5 Debt issuance costs.

(a) *In general.* This section provides rules for allocating debt issuance costs over the term of the debt. For purposes of this section, the term *debt issuance costs* means those transaction costs incurred by an issuer of debt (that is, a borrower) that are required to be capitalized under § 1.263(a)–5. If these costs are otherwise deductible, they are deductible by the issuer over the term of the debt as determined under paragraph (b) of this section.

(b) *Method of allocating debt issuance costs*—(1) *In general.* Solely for purposes of determining the amount of debt issuance costs that may be deducted in any period, these costs are treated as if they adjusted the yield on the debt. To effect this, the issuer treats the costs as if they decreased the issue price of the debt. See § 1.1273–2 to determine issue price. Thus, debt issuance costs increase or create original issue discount and decrease or eliminate bond issuance premium.

(2) *Original issue discount.* Any resulting original issue discount is taken into account by the issuer under the rules in § 1.163–7, which generally require the use of a constant yield method (as described in § 1.1272–1) to compute how much original issue discount is deductible for a period. However, see § 1.163–7(b) for special rules that apply if the total original issue discount on the debt is *de minimis.*

(3) *Bond issuance premium.* Any remaining bond issuance premium is taken into account by the issuer under the rules of § 1.163–13, which generally require the use of a constant yield method for purposes of allocating bond issuance premium to accrual periods.

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

Example 1. (i) On January 1, 2004, X borrows $10,000,000. The principal amount of the loan ($10,000,000) is repayable on December 31, 2008, and payments of interest in the amount of $500,000 are due on December 31 of each year the loan is outstanding. X incurs debt issuance costs of $130,000 to facilitate the borrowing.

(ii) Under § 1.1273–2, the issue price of the loan is $10,000,000. However, under paragraph (b) of this section, X reduces the issue price of the loan by the debt issuance costs of $130,000, resulting in an issue price of $9,870,000. As a result, X treats the loan as having original issue discount in the amount of $130,000 (stated redemption price at maturity of $10,000,000 minus the issue price of $9,870,000). Because this amount of original issue discount is more than the *de minimis* amount of original issue discount for the loan determined under § 1.1273–1(d) ($125,000 ($10,000,000 × .0025 × 5)), X must allocate the original issue discount to each year based on the constant yield method described in § 1.1272–1(b). See § 1.163–7(a). Based on this method and a yield of 5.30%, compounded annually, the original issue discount is allocable to each year as follows: $23,385 for 2004, $24,625 for 2005, $25,931 for 2006, $27,306 for 2007, and $28,753 for 2008.

Example 2. (i) Assume the same facts as in *Example 1*, except that X incurs debt issuance costs of $120,000 rather than $130,000.

(ii) Under § 1.1273–2, the issue price of the loan is $10,000,000. However, under paragraph (b) of this section, X reduces the issue price of the loan by the debt issuance costs of $120,000, resulting in an issue price of $9,880,000. As a result, X treats the loan as having original issue discount in the amount of $120,000 (stated redemption price at maturity of $10,000,000 minus the issue price of $9,880,000). Because this amount of original issue discount is less than the *de minimis* amount of original issue discount for the loan determined under § 1.1273–1(d) ($125,000), X does not have to use the constant yield method described in § 1.1272–1(b) to allocate the original issue discount to each year. Instead, under § 1.163–7(b)(2), X can choose to allocate the original issue discount to each year on a straight-line basis over the term of the loan or in proportion to the stated interest payments ($24,000 each year). X also could choose to deduct the original issue discount at maturity of the loan. X makes its choice by reporting the original issue discount in a manner consistent with the method chosen on X's timely filed federal income tax return for 2004. If X wanted to use the constant yield method, based on a yield of 5.279%, compounded annually, the original issue discount is allocable to each year as follows: $21,596 for 2004, $22,736 for 2005, $23,937 for 2006, $25,200 for 2007, and $26,531 for 2008.

(d) *Effective date.* This section applies to debt issuance costs paid or incurred for debt instruments issued on or after December 31, 2003.

(e) *Accounting method changes*—(1) *Consent to change.* An issuer required to change its method of accounting for debt issuance costs to comply with this section must secure the consent of the Commissioner in accordance with the requirements of § 1.446–1(e). Paragraph (e)(2) of this section provides the Commissioner's automatic consent for certain changes.

(2) *Automatic consent.* The Commissioner grants consent for an issuer to change its method of accounting for debt issuance costs incurred for debt instruments issued on or after December 31, 2003. Because this change is made on a cut-off basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (e)(2) applies provided—

(i) The change is made to comply with this section;

(ii) The change is made for the first taxable year for which the issuer must account for debt issuance costs under this section; and

(iii) The issuer attaches to its federal income tax return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

[T.D. 9107, 69 FR 464, Jan. 5, 2004]

§ 1.446–6 REMIC inducement fees.

(a) *Purpose.* This section provides specific timing rules for the clear reflection of income from an inducement fee received in connection with becoming the holder of a noneconomic REMIC residual interest. An inducement fee must be included in income over a period reasonably related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest.

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

(1) *Applicable REMIC.* The applicable REMIC is the REMIC that issued the noneconomic residual interest with respect to which the inducement fee is paid.

(2) *Inducement fee.* An inducement fee is the amount paid to induce a person to become the holder of a noneconomic

residual interest in an applicable REMIC.

(3) *Noneconomic residual interest.* A REMIC residual interest is a noneconomic residual interest if it is a noneconomic residual interest within the meaning of §1.860E–1(c)(2).

(4) *Remaining anticipated weighted average life.* The remaining anticipated weighted average life is the anticipated weighted average life determined using the methodology set forth in §1.860E–1(a)(3)(iv) applied as of the date of acquisition of the noneconomic residual interest.

(5) *REMIC.* The term REMIC has the same meaning in this section as given in §1.860D–1.

(c) *General rule.* All taxpayers, regardless of their overall method of accounting, must recognize an inducement fee over the remaining expected life of the applicable REMIC in a manner that reasonably reflects, without regard to this paragraph, the after-tax costs and benefits of holding that noneconomic residual interest.

(d) *Special rule on disposition of a residual interest.* If any portion of an inducement fee received with respect to becoming the holder of a noneconomic residual interest in an applicable REMIC has not been recognized in full by the holder as of the time the holder transfers, or otherwise ceases to be the holder for Federal tax purposes of, that residual interest in the applicable REMIC, then the holder must include the unrecognized portion of the inducement fee in income at that time. This rule does not apply to a transaction to which section 381(c)(4) applies.

(e) *Safe harbors.* If inducement fees are recognized in accordance with a method described in this paragraph (e), that method complies with the requirements of paragraph (c) of this section.

(1) *The book method.* Under the book method, an inducement fee is recognized in accordance with the method of accounting, and over the same period, used by the taxpayer for financial reporting purposes (including consolidated financial statements to shareholders, partners, beneficiaries, and other proprietors and for credit purposes), provided that the inducement fee is included in income for financial reporting purposes over a period that is not shorter than the period during which the applicable REMIC is expected to generate taxable income.

(2) *The modified REMIC regulatory method.* Under the modified REMIC regulatory method, the inducement fee is recognized ratably over the remaining anticipated weighted average life of the applicable REMIC as if the inducement fee were unrecognized gain being included in gross income under §1.860F–2(b)(4)(iii).

(3) *Additional safe harbor methods.* The Commissioner, by revenue ruling or revenue procedure (*see* §1.601(d)(2) of this chapter), may provide additional safe harbor methods for recognizing inducement fees relating to noneconomic REMIC residual interests.

(f) *Method of accounting.* The treatment of inducement fees is a method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. A taxpayer is generally permitted to adopt a method of accounting for inducement fees that satisfies the requirements of paragraph (c) of this section. Once a taxpayer adopts a method of accounting for inducement fees, that method must be applied consistently to all inducement fees received in connection with noneconomic REMIC residual interests and may be changed only with the consent of the Commissioner, as provided by section 446(e) and the regulations and procedures thereunder.

(g) *Effective date.* This section is applicable for taxable years ending on or after May 11, 2004.

[T.D. 9128, 69 FR 26041, May 11, 2004]

§1.448–1 Limitation on the use of the cash receipts and disbursements method of accounting.

(a)–(f) [Reserved]

(g) *Treatment of accounting method change and timing rules for section 481(a) adjustment*—(1) *Treatment of change in accounting method.* Notwithstanding any other procedure published prior to January 7, 1991, concerning changes from the cash method, any taxpayer to whom section 448 applies must change its method of accounting in accordance with the provisions of this paragraph (g) and paragraph (h) of this section. In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. The adjustments required under section 481(a) with respect to the change in method of accounting of such a taxpayer shall not be reduced by amounts attributable to taxable years preceding the Internal Revenue Code of 1954. Paragraph (h)(2) of this section provides procedures under which a taxpayer may change to an overall accrual method of accounting for the first taxable year the taxpayer is subject to this section (''first section 448 year''). If the taxpayer complies with the provisions of paragraph (h)(2) of this section for its first section 448 year, the change shall be treated as made with the consent of the Commissioner. Paragraph (h)(3) of this section provides procedures under which a taxpayer may change to other than an overall accrual method of accounting for its first section 448 year. Unless the taxpayer complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year, the taxpayer must comply with the provisions of paragraph (h)(4) of this section. See paragraph (h) of this section for rules to effect a change in method of accounting.

(2) *Timing rules for section 481(a) adjustment*—(i) *In general.* Except as otherwise provided in paragraphs (g)(2)(ii) and (g)(3) of this section, a taxpayer required by this section to change from the cash method must take the net section 481(a) adjustment into account over the section 481(a) adjustment period as determined under the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method (for example, see Rev. Proc. 2002–9 (2002–1 C.B. 327) and Rev. Proc. 97–27 (1997–1 C.B. 680) (also see §601.601(d)(2) of this chapter)), provided the taxpayer complies with the provisions of paragraph (h)(2) or (3) of this section for its first section 448 year.

(ii) *Hospital timing rules*—(A) *In general.* In the case of a hospital that is required by this section to change from the cash method, the section 481(a) adjustment shall be taken into account ratably (beginning with the year of change) over 10 years, provided the taxpayer complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year.

(B) *Definition of hospital.* For purposes of paragraph (g) of this section, a hospital is an institution—

(*1*) Accredited by the Joint Commission on Accreditation of Healthcare Organizations or its predecessor (the JCAHO) (or accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of the JCAHO);

(*2*) Used primarily to provide, by or under the supervision of physicians, to inpatients diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons;

(*3*) Requiring every patient to be under the care and supervision of a physician; and

(*4*) Providing 24-hour nursing services rendered or supervised by a registered professional nurse and having a licensed practical nurse or registered nurse on duty at all times.

For purposes of this section, an entity need not be owned by or on behalf of a governmental unit or by a section 501(c)(3) organization, or operated by a section 501(c)(3) organization, in order to be considered a hospital. In addition, for purposes of this section, a hospital does not include a rest or nursing home, continuing care facility, daycare center, medical school facility, research laboratory, or ambulatory care facility.

(C) *Dual function facilities.* With respect to any taxpayer whose operations consist both of a hospital, and other facilities not qualifying as a hospital, the portion of the adjustment required by section 481(a) that is attributable to the hospital shall be taken into account in accordance with the rules of paragraph (g)(2) of this section relating to hospitals. The portion of the adjustment required by section 481(a) that is not attributable to the hospital shall be taken into account in accordance with the rules of paragraph (g)(2) of this section not relating to hospitals.

(iii) *Untimely change in method of accounting to comply with this section.* Unless a taxpayer (including a hospital and a cooperative) required by this section to change from the cash method complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year within the time prescribed by those paragraphs, the taxpayer must take the section 481 (a) adjustment into account under the provisions of any applicable administrative procedure that is prescribed by the Commissioner after January 7, 1991, specifically for purposes of complying with this section. Absent such an administrative procedure, a taxpayer must request a change under §1.446–1(e)(3) and shall be subject to any terms and conditions (including the year of change) as may be imposed by the Commissioner.

(3) *Special timing rules for section 481(a) adjustment*—(i)*Cessation of trade or business.* If the taxpayer ceases to engage in the trade or business to which the section 481(a) adjustment relates, or if the taxpayer operating the trade or business terminates existence, and such cessation or termination occurs prior to the expiration of the adjustment period described in paragraph (g)(2)(i) or (ii) of this section, the taxpayer must take into account, in the taxable year of such cessation or termination, the balance of the adjustment not previously taken into account in computing taxable income. For purposes of this paragraph (g)(3)(i), the determination as to whether a taxpayer has ceased to engage in the trade or business to which the section 481(a) adjustment relates, or has terminated its existence, is to be made under the principles of §1.446–1(e)(3)(ii) and its underlying administrative procedures.

(ii) *De minimis rule for a taxpayer other than a cooperative.* Notwithstanding paragraph (g)(2)(i) and (ii) of this section, a taxpayer other than a cooperative (within the meaning of section 1381(a)) that is required to change from the cash method by this section may elect to use, in lieu of the adjustment period described in paragraph (g)(2)(i) and (ii) of this section, the adjustment period for *de minimis* section 481(a) adjustments provided in the applicable administrative procedure issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method. A taxpayer may make an election under this paragraph (g)(3)(ii) only if—

(A) The taxpayer's entire net section 481(a) adjustment (whether positive or negative) is a de minimis amount as determined under the applicable administrative procedure issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method,

(B) The taxpayer complies with the provisions of paragraph (h)(2) or (3) of this section for its first section 448 year,

(C) The return for such year is due (determined with regard to extensions) after December 27, 1993, and

(D) The taxpayer complies with any applicable instructions to Form 3115 that specify the manner of electing the adjustment period for de minimis section 481(a) adjustments.

(4) *Additional rules relating to section 481(a) adjustment.* In addition to the rules set forth in paragraph (g) (2) and (3) of this section, the following rules shall apply in taking the section 481(a) adjustment into account—

(i) Any net operating loss and tax credit carryforwards will be allowed to offset any positive section 481(a) adjustment,

(ii) Any net operating loss arising in the year of change or in any subsequent year that is attributable to a negative section 481(a) adjustment may be carried back to earlier taxable years in accordance with section 172, and

(iii) For purposes of determining estimated income tax payments under sections 6654 and 6655, the section 481(a) adjustment will be recognized in taxable income ratably throughout a taxable year.

(5) *Outstanding section 481(a) adjustment from previous change in method of accounting.* If a taxpayer changed its method of accounting to the cash method for a taxable year prior to the year the taxpayer was required by this section to change from the cash method (the section 448 year), any section 481(a) adjustment from such prior change in method of accounting that is

outstanding as of the section 448 year shall be taken into account in accordance with the provisions of this paragraph (g)(5). A taxpayer shall account for any remaining portion of the prior section 481(a) adjustment outstanding as of the section 448 year by continuing to take such remaining portion into account under the provisions and conditions of the prior change in method of accounting, or, at the taxpayer's option, combining or netting the remaining portion of the prior section 481(a) adjustment with the section 481(a) adjustment required under this section, and taking into account under the provisions of this section the resulting net amount of the adjustment. Any taxpayer choosing to combine or net the section 481(a) adjustments as described in the preceding sentence shall indicate such choice on the Form 3115 required to be filed by such taxpayer under the provisions of paragraph (h) of this section.

(h) *Procedures for change in method of accounting*—(1) *Applicability*. Paragraph (h) of this section applies to taxpayers who change from the cash method as required by this section. Paragraph (h) of this section does not apply to a change in accounting method required by any Code section (or regulations thereunder) other than this section.

(2) *Automatic rule for changes to an overall accrual method*—(i) *Timely changes in method of accounting*. Notwithstanding any other available procedures to change to the accrual method of accounting, a taxpayer to whom paragraph (h) of this section applies who desires to make a change to an overall accrual method for its first section 448 year must make that change under the provisions of this paragraph (h)(2). A taxpayer changing to an overall accrual method under this paragraph (h)(2) must file a current Form 3115 by the time prescribed in paragraph (h)(2)(ii). In addition, the taxpayer must set forth on a statement accompanying the Form 3115 the period over which the section 481(a) adjustment will be taken into account and the basis for such conclusion. Moreover, the taxpayer must type or legibly print the following statement at the top of page 1 of the Form 3115: "Automatic Change to Accrual Method—Section 448." The consent of the Commissioner to the change in method of accounting is granted to taxpayers who change to an overall accrual method under this paragraph (h)(2). See paragraph (g)(2)(i), (g)(2)(ii), or (g)(3) of this section, whichever is applicable, for rules to account for the section 481(a) adjustment.

(ii) *Time and manner for filing Form 3115*—(A) *In general*. Except as provided in paragraph (h)(2)(ii)(B) of this section, the Form 3115 required by paragraph (h)(2)(i) must be filed no later than the due date (determined with regard to extensions) of the taxpayer's federal income tax return for the first section 448 year and must be attached to that return.

(B) *Extension of filing deadline*. Notwithstanding paragraph (h)(2)(ii)(A) of this section, the filing of the Form 3115 required by paragraph (h)(2)(i) shall not be considered late if such Form 3115 is attached to a timely filed amended income tax return for the first section 448 year, provided that—

(*1*) The taxpayer's first section 448 year is a taxable year that begins (or, pursuant to §1.441–2(c), is deemed to begin) in 1987, 1988, 1989, or 1990,

(*2*) The taxpayer has not been contacted for examination, is not before appeals, and is not before a federal court with respect to an income tax issue (each as defined in applicable administrative pronouncements), unless the taxpayer also complies with any requirements for approval in those applicable administrative pronouncements, and

(*3*) Any amended return required by this paragraph (h)(2)(ii)(B) is filed on or before July 8, 1991.

Filing an amended return under this paragraph (h)(2)(ii)(B) does not extend the time for making any other election. Thus, for example, taxpayers that comply with this section by filing an amended return pursuant to this paragraph (h)(2)(ii)(B) may not elect out of section 448 pursuant to paragraph (i)(2) of this section.

(3) *Changes to a method other than overall accrual method*—(i) *In general*. A taxpayer to whom paragraph (h) of this section applies who desires to change to a special method of accounting must make that change under the provisions

of this paragraph (h)(3), except to the extent other special procedures have been promulgated regarding the special method of accounting. Such a taxpayer includes taxpayers who change to both an accrual method of accounting and a special method of accounting such as a long-term contract method. In order to change an accounting method under this paragraph (h)(3), a taxpayer must submit an application for change in accounting method under the applicable administrative procedures in effect at the time of change, including the applicable procedures regarding the time and place of filing the application for change in method. Moreover, a taxpayer who changes an accounting method under this paragraph (h)(3) must type or legibly print the following statement on the top of page 1 of Form 3115: ''Change to a Special Method of Accounting—Section 448.'' The filing of a Form 3115 by any taxpayer requesting a change of method of accounting under this paragraph (h)(3) for its taxable year beginning in 1987 will not be considered late if the form is filed with the appropriate office of the Internal Revenue Service on or before the later of: the date that is the 180th day of the taxable year of change; or September 14, 1987. If the Commissioner approves the taxpayer's application for change in method of accounting, the timing of the adjustment required under section 481 (a), if applicable, will be determined under the provisions of paragraph (g)(2)(i), (g)(2)(ii), or (g)(3) of this section, whichever is applicable. If the Commissioner denies the taxpayer's application for change in accounting method, or if the taxpayer's application is untimely, the taxpayer must change to an overall accrual method of accounting under the provisions of either paragraph (h)(2) or (h)(4) of this section, whichever is applicable.

(ii) *Extension of filing deadline.* Notwithstanding paragraph (h)(3)(i) of this section, if the events or circumstances which under section 448 disqualify a taxpayer from using the cash method occur after the time prescribed under applicable procedures for filing the Form 3115, the filing of such form shall not be considered late if such form is filed on or before 30 days after the close of the taxable year.

(4) *Untimely change in method of accounting to comply with this section.* Unless a taxpayer to whom paragraph (h) of this section applies complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year, the taxpayer must comply with the requirements of §1.446–1 (e)(3) (including any applicable administrative procedure that is prescribed thereunder after January 7, 1991 specifically for purposes of complying with this section) in order to secure the consent of the Commissioner to change to a method of accounting that is in compliance with the provisions of this section. The taxpayer shall be subject to any terms and conditions (including the year of change) as may be imposed by the Commissioner.

(i) *Effective date*—(1) *In general.* Except as provided in paragraph (i)(2), (3), (4), and (5) of this section, this section applies to any taxable year beginning after December 31, 1986.

(2) *Election out of section 448*—(i) *In general.* A taxpayer may elect not to have this section apply to any (A) transaction with a related party (within the meaning of section 267(b) of the Internal Revenue Code of 1954, as in effect on October 21, 1986), (B) loan, or (C) lease, if such transaction, loan, or lease was entered into on or before September 25, 1985. Any such election described in the preceding sentence may be made separately with respect to each transaction, loan, or lease. For rules relating to the making of such election, see §301.9100–7T (temporary regulations relating to elections under the Tax Reform Act of 1986). Notwithstanding the provisions of this paragraph (i)(2), the gross receipts attributable to a transaction, loan, or lease described in this paragraph (i)(2) shall be taken into account for purposes of the $5,000,000 gross receipts test described in paragraph (f) of this section.

(ii) *Special rules for loans.* If the taxpayer makes an election under paragraph (i)(2)(i) of this section with respect to a loan entered into on or before September 25, 1985, the election shall apply only with respect to amounts that are attributable to the loan balance outstanding on September

25, 1985. The election shall not apply to any amounts advanced or lent after September 25, 1985, regardless of whether the loan agreement was entered into on or before such date. Moreover, any payments made on outstanding loan balances after September 25, 1985, shall be deemed to first extinguish loan balances outstanding on September 25, 1985, regardless of any contrary treatment of such loan payments by the borrower and lender.

(3) *Certain contracts entered into before September 25, 1985.* This section does not apply to a contract for the acquisition or transfer of real property or a contract for services related to the acquisition or development of real property if—

(i) The contract was entered into before September 25, 1985; and

(ii) The sole element of the contract which was not performed as of September 25, 1985, was payment for such property or services.

(4) *Transitional rule for paragraphs (g) and (h) of this section.* To the extent the provisions of paragraphs (g) and (h) of this section were not reflected in paragraphs (g) and (h) of §1.448–1T (as set forth in 26 CFR part 1 as revised on April 1, 1993), paragraphs (g) and (h) of this section will not be adversely applied to a taxpayer with respect to transactions entered into before December 27, 1993.

(5) *Effective date of paragraph (g)(2)(i).* Paragraph (g)(2)(i) of this section applies to taxable years ending on or after June 16, 2004.

[T.D. 8514, 58 FR 68299, Dec. 27, 1993, as amended by T.D. 8996, 67 FR 35012, May 17, 2002; T.D. 9131, 69 FR 33572, June 16, 2004]

§ 1.448–1T Limitation on the use of the cash receipts and disbursements method of accounting (temporary).

(a) *Limitation on accounting method*—(1) *In general.* This section prescribes regulations under section 448 relating to the limitation on the use of the cash receipts and disbursements method of accounting (the cash method) by certain taxpayers.

(2) *Limitation rule.* Except as otherwise provided in this section, the computation of taxable income using the cash method is prohibited in the case of a—

(i) C corporation,

(ii) Partnership with a C corporation as a partner, or

(iii) Tax shelter.

A partnership is described in paragraph (a)(2)(ii) of this section, if the partnership has a C corporation as a partner at any time during the partnership's taxable year beginning after December 31, 1986.

(3) *Meaning of C corporation.* For purposes of this section, the term ''C corporation'' includes any corporation that is not an S corporation. For example, a regulated investment company (as defined in section 851) or a real estate investment trust (as defined in section 856) is a C corporation for purposes of this section. In addition, a trust subject to tax under section 511 (b) shall be treated, for purposes of this section, as a C corporation, but only with respect to the portion of its activities that constitute an unrelated trade or business. Similarly, for purposes of this section, a corporation that is exempt from federal income taxes under section 501 (a) shall be treated as a C corporation only with respect to the portion of its activities that constitute an unrelated trade or business. Moreover, for purposes of determining whether a partnership has a C corporation as a partner, any partnership described in paragraph (a)(2)(ii) of this section is treated as a C corporation. Thus, if partnership ABC has a partner that is a partnership with a C corporation, then, for purposes of this section, partnership ABC is treated as a partnership with a C corporation partner.

(4) *Treatment of a combination of methods.* For purposes of this section, the use of a method of accounting that records some, but not all, items on the cash method shall be considered the use of the cash method. Thus, a C corporation that uses a combination of accounting methods including the use of the cash method is subject to this section.

(b) *Tax shelter defined*—(1) *In general.* For purposes of this section, the term ''tax shelter'' means any—

(i) Enterprise (other than a C corporation) if at any time (including taxable years beginning before January 1, 1987) interests in such enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale,

(ii) Syndicate (within the meaning of paragraph (b)(3) of this section), or

(iii) Tax shelter within the meaning of section 6662(d)(2)(C).

(2) *Requirement of registration.* For purposes of paragraph (b)(1)(i) of this section, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to register the offering would result in a violation of the applicable federal or state law (regardless of whether the offering is in fact registered). In addition, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable federal or state law (regardless of whether the notice is in fact filed).

(3) *Meaning of syndicate.* For purposes of paragraph (b)(1)(ii) of this section, the term ''syndicate'' means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs. For purposes of this paragraph (b)(3), the term ''limited entrepreneur'' has the same meaning given such term in section 464 (e)(2). In addition, in determining whether an interest in a partnership is held by a limited partner, or an interest in an entity or enterprise is held by a limited entrepreneur, section 464 (c)(2) shall apply in the case of the trade or business of farming (as defined in paragraph (d)(2) of this section), and section 1256 (e)(3)(C) shall apply in any other case. Moreover, for purposes of this paragraph (b)(3), the losses of a partnership, entity, or enterprise (the enterprise) means the excess of the deductions allowable to the enterprise over the amount of income recognized by such enterprise under the enterprise's method of accounting used for federal income tax purposes (determined without regard to this section). For this purpose, gains or losses from the sale of capital assets or section 1221 (2) assets are not taken into account.

(4) *Presumed tax avoidance.* For purposes of paragraph (b)(1)(iii) of this section, marketed arrangements in which persons carrying on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons use borrowed funds to prepay a substantial portion of their farming expenses (*e.g.*, payment for farm supplies that will not be used or consumed until a taxable year subsequent to the taxable year of payment).

(5) *Taxable year tax shelter must change accounting method.* A partnership, entity, or enterprise that is a tax shelter must change from the cash method for the later of (i) the first taxable year beginning after December 31, 1986, or (ii) the taxable year that such partnership, entity, or enterprise becomes a tax shelter.

(c) *Effect of section 448 on other provisions.* Nothing in section 448 shall have any effect on the application of any other provision of law that would otherwise limit the use of the cash method, and no inference shall be drawn from section 448 with respect to the application of any such provision. For example, nothing in section 448 affects the requirement of section 447 that certain corporations must use an accrual method of accounting in computing taxable income from farming, or the requirement of §1.446–1(c)(2) that an accrual method be used with regard to purchases and sales of inventory. Similarly, nothing in section 448 affects the authority of the Commissioner under section 446(b) to require the use of an accounting method that clearly reflects income, or the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. For example, a taxpayer using the cash method may be required to change to an accrual method of accounting under section 446(b) because such method clearly reflects that taxpayer's income, even though the taxpayer is not prohibited by section 448 from using the cash method. Similarly, a taxpayer using an accrual method of accounting that is not prohibited by section 448 from using the cash method may not change to the cash method unless the taxpayer secures the consent of the Commissioner under section 446(e), and, in the opinion of the Commissioner, the use of the cash method clearly reflects that taxpayer's income under section 446(b).

(d) *Exception for farming business*—(1) *In general.* Except in the case of a tax shelter, this section shall not apply to any farming business. A taxpayer engaged in a farming business and a separate nonfarming business is not prohibited by this section from using the cash method with respect to the farming business, even though the taxpayer may be prohibited by this section from using the cash method with respect to the nonfarming business.

(2) *Meaning of farming business.* For purposes of paragraph (d) of this section, the term ''farming business'' means—

(i) The trade or business of farming as defined in section 263A(e)(4) (including the operation of a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees), or

(ii) The raising, harvesting , or growing of trees described in section 263A(c)(5) (relating to trees raised, harvested, or grown by the taxpayer other than trees described in paragraph (d)(2)(i) of this section).

Thus, for purposes of this section, the term ''farming business'' includes the raising of timber. For purposes of this section, the term ''farming business'' does not include the processing of commodities or products beyond those activities normally incident to the growing, raising or harvesting of such products. For example, assume that a C corporation taxpayer is in the business of growing and harvesting wheat and other grains. The taxpayer processes the harvested grains to produce breads, cereals, and similar food products which it sells to customers in the course of its business. Although the taxpayer is in the farming business with respect to the growing and harvesting of grain, the taxpayer is not in the farming business with respect to the processing of such grains to produce food products which the taxpayer sells to customers. Similarly, assume that a taxpayer is in the business of raising poultry or other livestock. The taxpayer uses the livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged or canned for sale to customers. Although the taxpayer is in the farming business with respect to the raising of livestock, the taxpayer is not in the farming business with respect to the meat processing operation. However, under this section the term ''farming business'' does include processing activities which are normally incident to the growing, raising or harvesting of agricultural products. For example, assume a taxpayer is in the business of growing fruits and vegetables. When the fruits and vegetables are ready to be harvested, the taxpayer picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the business of farming with respect to the growing of fruits and vegetables, and the processing activities incident to the harvest.

(e) *Exception for qualified personal service corporation*—(1) *In general.* Except in the case of a tax shelter, this section does not apply to a qualified personal service corporation.

(2) *Certain treatment for qualified personal service corporation.* For purposes of paragraph (a)(2)(ii) of this section (relating to whether a partnership has a C corporation as a partner), a qualified personal service corporation shall be treated as an individual.

(3) *Meaning of qualified personal service corporation.* For purposes of this section, the term ''qualified personal service corporation'' means any corporation that meets—

(i) The function test paragraph (e)(4) of this section, and

(ii) The ownership test of paragraph (e)(5) of this section.

(4) *Function test*—(i) *In general.* A corporation meets the function test if substantially all the corporation's activities for a taxable year involve the performance of services in one or more of the following fields—

(A) Health,

(B) Law,

(C) Engineering (including surveying and mapping),

(D) Architecture,

(E) Accounting,

(F) Actuarial science,

(G) Performing arts, or

(H) Consulting.

Substantially all of the activities of a corporation are involved in the performance of services in any field described in the preceding sentence (a qualifying field), only if 95 percent or more of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services in a qualifying field. For purposes of determining whether this 95 percent test is satisfied, the performance of any activity incident to the actual performance of services in a qualifying field is considered the performance of services in that field. Activities incident to the performance of services in a qualifying field include the supervision of employees engaged in directly providing services to clients, and the performance of administrative and support services incident to such activities.

(ii) *Meaning of services performed in the field of health.* For purposes of paragraph (e)(4)(i)(A) of this section, the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers.

(iii) *Meaning of services performed in the field of performing arts.* For purposes of paragraph (e)(4)(i)(G) of this section, the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performances of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers). Finally, the performance of services in the field of the performing arts does not include the provision of services by athletes.

(iv) *Meaning of services performed in the field of consulting*—(A) *In general.* For purposes of paragraph (e)(4)(i)(H) of this section, the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.*, whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect).

(B) *Examples.* The following examples illustrate the provisions of paragraph (e)(4)(iv)(A) of this section. The examples do not address all types of services that may or may not qualify as consulting. The determination of whether activities not specifically addressed in the examples qualify as consulting shall be made by comparing the service activities in question to the types of service activities discussed in the examples. With respect to a corporation which performs services which qualify as consulting under this section, and other services which do not qualify as consulting, see paragraph (e)(4)(i) of this section which requires that substantially all of the corporation's activities involve the performance of services in a qualifying field.

Example 1. A taxpayer is in the business of providing economic analyses and forecasts of business prospects for its clients. Based on these analyses and forecasts, the taxpayer advises its clients on their business activities. For example, the taxpayer may analyze the economic conditions and outlook for a particular industry which a client is considering entering. The taxpayer will then make recommendations and advise the client on the prospects of entering the industry, as well as on other matters regarding the client's activities in such industry. The taxpayer provides similar services to other clients, involving, for example, economic analyses and evaluations of business prospects in different areas of the United States or in other countries, or economic analyses of overall economic trends and the provision of advice based on these analyses and evaluations. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example 2. A taxpayer is in the business of providing services that consist of determining a client's electronic data processing needs. The taxpayer will study and examine the client's business, focusing on the types of data and information relevant to the client and the needs of the client's employees for access to this information. The taxpayer will then make recommendations regarding the design and implementation of data processing systems intended to meet the needs of the client. The taxpayer does not, however, provide the client with additional computer programming services distinct from the recommendations made by the taxpayer with respect to the design and implementation of the client's data processing systems. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example 3. A taxpayer is in the business of providing services that consist of determining a client's management and business structure needs. The taxpayer will study the client's organization, including, for example, the departments assigned to perform specific functions, lines of authority in the managerial hierarchy, personnel hiring, job responsibility, and personnel evaluations and compensation. Based on the study, the taxpayer will then advise the client on changes in the client's management and business structure, including, for example, the restructuring of the client's departmental systems or its lines of managerial authority. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example 4. A taxpayer is in the business of providing financial planning services. The taxpayer will study a particular client's financial situation, including, for example, the client's present income, savings and investments, and anticipated future economic and financial needs. Based on this study, the taxpayer will then assist the client in making decisions and plans regarding the client's financial activities. Such financial planning includes the design of a personal budget to assist the client in monitoring the client's financial situation, the adoption of investment strategies tailored to the client's needs, and other similar services. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example 5. A taxpayer is in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. The taxpayer provides its clients with economic analyses and forecasts of conditions in various industries and businesses. Based on these analyses, the taxpayer makes recommendations regarding transactions in securities and commodities. Clients place orders with the taxpayer to trade securities or commodities based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the trade orders. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the execution of trade orders for its clients).

Example 6. A taxpayer is in the business of studying a client's needs regarding its data processing facilities and making recommendations to the client regarding the design and implementation of data processing systems. The client will then order computers and other data processing equipment through the taxpayer based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the equipment orders made by the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of sales services. Relevant to this determination is the fact that the compensation of the taxpayer for its services it contingent upon the consummation of the transaction the services were intended to effect (i.e., the execution of equipment orders for its clients).

Example 7. A taxpayer is in the business of assisting businesses in meeting their personnel requirements by referring job applicants to employers with hiring needs in a particular area. The taxpayer may be informed by potential employers of their need for job applicants, or, alternatively, the taxpayer may become aware of the client's personnel requirements after the taxpayer studies and examines the client's management and business structure. The taxpayer's compensation for its services is typically based on the job applicants, referred by the taxpayer to the clients, who accept employment positions with the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is involved in the performance of services economically similar to brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the hiring of a job applicant by the client).

Example 8. The facts are the same as in Example 7, except that the taxpayer's clients are individuals who use the services of the taxpayer to obtain employment positions. The taxpayer is typically compensated by its clients who obtain employment as a result of the taxpayer's services. For the reasons set forth in Example 7, the taxpayer is not considered to be engaged in the performance of services in the field of consulting.

Example 9. A taxpayer is in the business of assisting clients in placing advertisements for their goods and services. The taxpayer analyzes the conditions and trends in the client's particular industry, and then makes recommendations to the client regarding the types of advertisements which should be placed by the client and the various types of advertising media (e.g., radio, television, magazines, etc.) which should be used by the client. The client will then purchase, through the taxpayer, advertisements in various media based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the particular orders for advertisements which the client makes. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of services economically similar to brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the placing of advertisements by clients).

Example 10. A taxpayer is in the business of selling insurance (including life and casualty insurance), annuities, and other similar insurance products to various individual and business clients. The taxpayer will study the particular client's financial situation, including, for example, the client's present income, savings and investments, business and personal insurance risks, and anticipated future economic and financial needs. Based on this study, the taxpayer will then make recommendations to the client regarding the desirability of various insurance products. The client will then purchase these various insurance products through the taxpayer. The taxpayer's compensation for its services is typically based on the purchases made by the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of brokerage or sales services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the purchase of insurance products by its clients).

(5) *Ownership test*—(i) *In general.* A corporation meets the ownership test, if at all times during the taxable year, substantially all the corporation's stock, by value, is held, directly or indirectly, by—

(A) Employees performing services for such corporation in connection with activities involving a field referred to in paragraph (e)(4) of this section,

(B) Retired employees who had performed such services for such corporation,

(C) The estate of any individual described in paragraph (e)(5)(i) (A) or (B) of this section, or

(D) Any other person who acquired such stock by reason of the death of an individual described in paragraph (e)(5)(i) (A) or (B) of this section, but only for the 2-year period beginning on the date of the death of such individual.

For purposes of this paragraph (e)(5) of this section, the term ''substantially all'' means an amount equal to or greater than 95 percent.

(ii) *Definition of employee.* For purposes of the ownership test of this paragraph (e)(5) of this section, a person shall not be considered an employee of a corporation unless the services performed by that person for such corporation, based on the facts and circumstances, are more than de minimis. In addition, a person who is an employee of a corporation shall not be treated as an employee of another corporation merely by reason of the employer corporation and the other corporation being members of the same affiliated group or otherwise related.

(iii) *Attribution rules.* For purposes of this paragraph (e)(5) of this section, a corporation's stock is considered held indirectly by a person if, and to the extent, such person owns a proportionate interest in a partnership, S corporation, or qualified personal service corporation that owns such stock. No other arrangement or type of ownership shall constitute indirect ownership of a corporation's stock for purposes of this paragraph (e)(5) of this section. Moreover, stock of a corporation held by a trust is considered held by a person if, and to the extent, such person is treated under subpart E, part I, subchapter J, chapter 1 of the Code as the owner of the portion of the trust that consists of such stock.

(iv) *Disregard of community property laws.* For purposes of this paragraph (e)(5) of this section, community property laws shall be disregarded. Thus, in determining the stock ownership of a corporation, stock owned by a spouse solely by reason of community property laws shall be treated as owned by the other spouse.

(v) *Treatment of certain stock plans.* For purposes of this paragraph (e)(5) of this section, stock held by a plan described in section 401 (a) that is exempt from tax under section 501 (a) shall be treated as held by an employee described in paragraph (e)(5)(i)(A) of this section.

(vi) *Special election for certain affiliated groups.* For purposes of determining whether the stock ownership test of this paragraph (e)(5) of this section has been met, at the election of the common parent of an affiliated group (within the meaning of section 1504 (a)), all members of such group shall be treated as one taxpayer if substantially all (within the meaning of paragraph (e)(4)(i) of this section) the activities of all such members (in the aggregate) are in the same field described in paragraph (e)(4)(i)(A)–(H) of this section. For rules relating to the making of the election, see 26 CFR 5h.5 (temporary regulations relating to elections under the Tax Reform Act of 1986).

(vii) *Examples.* The following examples illustrate the provisions of paragraph (e) of this section:

Example 1. (i) X, a Corporation, is engaged in the business of providing accounting services to its clients. These services consist of the preparation of audit and financial statements and the preparation of tax returns. For purposes of section 448, such services consist of the performance of services in the field of accounting. In addition, for purposes of section 448, the supervision of employees directly preparing the statements and returns, and the performance of all administrative and support services incident to such activities (including secretarial, janitorial, purchasing, personnel, security, and payroll services) are the performance of services in the field of accounting.

(ii) In addition, X owns and leases a portion of an office building. For purposes of this section, the following types of activities undertaken by the employees of X shall be considered as the performance of services in a field other than the field of accounting: (A) services directly relating to the leasing activities, e.g., time spent in leasing and maintaining the leased portion of the building; (B) supervision of employees engaged in directly providing services in the leasing activity; and (C) all administrative and support services incurred incident to services described in (A) and (B). The leasing activities of X are considered the performance of services in a field other than the field of accounting, regardless of whether such leasing activities constitute a trade or business under the Code. If the employees of X spend 95% or more of their time in the performance of services in the field of accounting, X satisfies the function test of paragraph (e)(4) of this section.

Example 2. Assume that Y, a C corporation, meets the function test of paragraph (e)(4) of this section. Assume further that all the employees of Y are performing services for Y in a qualifying field as defined in paragraph (e)(4) of this section. P, a partnership, owns 40%, by value, of the stock of Y. The remaining 60% of the stock of Y is owned directly by employees of Y. Employees of Y have an aggregate interest of 90% in the capital and profits of P. This, 96% of the stock of Y is held directly, or indirectly, by employees of Y performing services in a qualifying field. Accordingly, Y meets the ownership test of paragraph (e)(5) of this section and is a qualified personal service corporation.

Example 3. The facts are the same as in Example 2, except that 40% of the stock of Y is owned by Z, a C corporation. The remaining 60% of the stock is owned directly by the employees of Y. Employees of Y own 90% of the stock, by value, of Z. Assume that Z independently qualifies as a personal service corporation. The result is the same as in Example 2, i.e., 96% of the stock of Y is held, directly or indirectly, by employees of Y performing services in a qualifying field. Thus, Y is a qualified personal service corporation.

Example 4. The facts are the same as in Example 3, except that Z does not independently qualify as a personal service corporation. Because Z is not a qualified personal service corporation, the Y stock owned by Z is not treated as being held indirectly by the Z shareholders. Consequently, only 60% of the stock of Y is held, directly or indirectly, by employees of Y. Thus, Y does not meet the ownership test of paragraph (e)(5) of this section, and is not a qualified personal service corporation.

Example 5. Assume that W, a C corporation, meets the function test of paragraph (e)(4) of this section. In addition, assume that all the employees of W are performing services for W in a qualifying field. Nominal legal title to 100% of the stock of W is held by employees of W. However, due solely to the operation of community property laws, 20% of the stock of W is held by spouses of such employees who themselves are not employees of W. In determining the ownership of the stock, community property laws are disregarded. Thus, Y meets the ownership test of paragraph (e)(5) of this section, and is a qualified personal service corporation.

Example 6. Assume that 90% of the stock of T, a C corporation, is directly owned by the employees of T. Spouses of T's employees directly own 5% of the stock of T. The spouses are not employees of T, and their ownership does not occur solely by operation of community property laws. In addition, 5% of the stock of T is held by trusts (other than a trust described in section 401(a) that is exempt from tax under section 501(a)), the sole beneficiaries of which are employees of T. The employees are not treated as owners of the trusts under subpart E, part I, subchapter J, chapter 1 of the Code. Since a person is not treated as owning the stock of a corporation owned by that person's spouse, or by any portion of a trust that is not treated as owned by such person under subpart E, only 90% of the stock of T is treated as held, directly or indirectly, by employees of T. Thus, T does not meet the ownership test of paragraph (e)(5) of this section, and is not a qualified personal service corporation.

Example 7. Assume that Y, a C corporation, directly owns all the stock of three subsidiaries, F, G, and H. Y is a common parent of an affiliated group within the meaning of section 1504(a) consisting of Y, F, G, and H. Y is not engaged in the performance of services in a qualifying field. Instead, Y is a holding company whose activities consist of its ownership and investment in its operating subsidiaries. Substantially all the activities of F involve the performance of services in the field of engineering. In addition, a majority of (but not substantially all) the activities of G involve the performance of services in the field of engineering; the remainder of G's services involve the performance of services in a nonqualifying field. Moreover, a majority of (but not substantially all) the activities of H involve the performance of services in the field of engineering; the remainder of H's activities involve the performance of services in the field of architecture. Nevertheless, substantially all the activities of the group consisting of Y, F, G, and H, in the aggregate, involve the performance of services in the field of engineering. Accordingly, Y elects under paragraph (e)(5)(vi) of this section to be treated as one taxpayer for determining the ownership test of paragraph (e)(5) of this section. Assume that substantially all the stock of Y (by value) is held by employees of F, G, or H who perform services in connection with a qualifying field (engineering or architecture). Thus, for purposes of determining whether any member corporation is a qualified personal service corporation, the ownership test of paragraph (e)(5) of this section has been satisfied. Since F and H satisfy the function test of paragraph (e)(4) of this section, F and H are qualified personal service corporations. However, since Y and G each fail the function test of paragraph (e)(4) of this section, neither corporation is a qualified personal service corporation.

Example 8. The facts are the same as in Example 7, except that less than substantially all the activities of the group consisting of Y, F, G, and H, in the aggregate, are performed in the field of engineering. Substantially all the activities of the group consisting of Y, F, G, and H, are, in the aggregate, performed in two fields, the fields of engineering and architecture. Y may not elect to have the affiliated group treated as one taxpayer for purposes of determining whether group members meet the ownership test of paragraph (e)(5) of this section. The election is available only if substantially all the activities of the group, in the aggregate, involve the performance of services in only one qualifying field. Moreover, none of the group members are qualified personal service corporations. Y fails the function test of paragraph (e)(4) of this section because less than substantially all the activities of Y are performed in a qualifying field. In addition, F, G, and H fail the ownershp test of paragraph (e)(5) of this section because substantially all their stock is owned by Y and not by their employees. The owners of Y are not deemed to indirectly own the stock owned by Y because Y is not a qualified personal service corporation.

Example 9. (i) The facts are the same as in Example 8, except Y itself satisfies the function tests of paragraph (e)(4) of this section because substantially all the activities of Y involve the performance of services in the field of engineering. In addition, assume that all employees of Y are involved in the performance of services in the field of engineering, and that all such employees own 100% of Y's stock. Moreover, assume that one-third of all the employees of Y are separately employed by F. Similarly, another one-third of the employees of Y are separately employed by G and H, respectively. None of the employees of Y are employed by more than one of Y's subsidiaries. Also, no other persons except the employees of Y are employed by any of the subsidiaries.

(ii) Y is a personal service corporation under section 448 because Y satisfies both the function and the ownership test of paragraphs (e) (4) and (5) of this section. As in Example 8, Y is unable to make the election to have the affiliated group treated as one taxpayer for purposes of determining whether group members meet the ownership test of paragraph (e)(5) of this section because less than substantially all the activities, in the aggregate, of the group members are performed in one of the qualifying fields. However, because Y is a personal service corporation, the stock owned by Y is treated as indirectly owned, proportionately, by the owners of Y. Thus, the employees of F are collectively treated as owning one-third of the stock of F, G, and H. The employees of G and H are similarly treated as owning one-third of each subsidiary's stock.

(iii) F, G, and H each fail the ownership test of paragraph (e)(5) of this section because less than substantially all of each corporation's stock is owned by the employees of the respective corporation. Only one-third of each corporation's stock is owned by employees of that corporation. Thus, F, G, and H are not qualified personal service corporations.

Example 10. (i) Assume that Y, a C corporation, directly owns all the stock of three subsidiaries, F, G, and Z. Y is a common parent of an affiliated group within the meaning of section 1504(a) consisting of Y, F, and G. Z is a foreign corporation and is excluded from the affiliated group under section 1504. Assume that Y is a holding company whose activities consist of its ownership and investment in its operating subsidiaries. Substantially all the activities of F, G, and Z involve the performance of services in the field of engineering. Assume that employees of Z own one-third of the stock of Y and that none of these employees are also employees of Y, F, or G. In addition, assume that Y elects to be treated as one taxpayer for determining whether group members meet the ownership tests of paragraph (e)(5) of this section. Thus, Y, F, and G are treated as one taxpayer for purposes of the ownership test.

(ii) None of the members of the group are qualified personal service corporations. Y, F, and G fail the ownership test of paragraph (e)(5) of this section because less than substantially all the stock of Y is owned by employees of either Y, F, or G. Moreover, Z fails the ownership test of paragraph (e)(5) of this section because substantially all its stock is owned by Y and not by its employees.

(6) *Application of function and ownership tests*. A corporation that fails the function test of paragraph (e)(4) of this section for any taxable year, or that fails the ownership test of paragraph (e)(5) of this section at any time during any taxable year, shall change from the cash method effective for the year in which the corporation fails to meet the function test or the ownership test. For example, if a personal service corporation fails the function test for taxable year 1987, such corporation must change from the cash method effective for taxable year 1987. A corporation that fails the function or ownership test for a taxable year shall not be treated as a qualified personal service corporation for any part of that taxable year.

(f) *Exception for entities with gross receipts of not more than $5 million*—(1) *In general*. Except in the case of a tax shelter, this section shall not apply to any C corporation or partnership with a C corporation as a partner for any taxable year if, for all prior taxable years beginning after December 31, 1985, such corporation or partnership (or any predecessor thereof) meets the $5,000,000 gross receipts test of paragraph (f)(2) of this section.

(2) *The $5,000,000 gross receipts test*—(i) *In general*. A corporation meets the $5,000,000 gross receipts test of this paragraph (f)(2) for any prior taxable year if the average annual gross receipts of such corporation for the 3 taxable years (or, if shorter, the taxable years during which such corporation was in existence) ending with such prior taxable year does not exceed $5,000,000. In the case of a C corporation exempt from federal income taxes under section 501(a), or a trust subject to tax under section 511(b) that is treated as a C corporation under paragraph (a)(3) of this section, only gross receipts from the activities of such corporation or trust that constitute unrelated trades or businesses are taken into account in determining whether the $5,000,000 gross receipts test is satisfied. A partnership with a C corporation as a partner meets the $5,000,000 gross receipts test of this paragraph (f)(2) for any prior taxable year if the average annual gross receipts of such partnership for the 3 taxable years (or,

if shorter, the taxable years during which such partnership was in existence) ending with such prior year does not exceed $5,000,000. The gross receipts of the corporate partner are not taken into account in determining whether the partnership meets the $5,000,000 gross receipts test.

(ii) *Aggregation of gross receipts.* For purposes of determining whether the $5,000,000 gross receipts test has been satisfied, all persons treated as a single employer under section 52 (a) or (b), or section 414 (m) or (o) (or who would be treated as a single employer under such sections if they had employees) shall be treated as one person. Gross receipts attributable to transactions between persons who are treated as a common employer under this paragraph shall not be taken into account in determining whether the $5,000,000 gross receipts test is satisified.

(iii) *Treatment of short taxable year.* In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by (A) multiplying the gross receipts for the short period by 12 and (B) dividing the result by the number of months in the short period.

(iv) *Determination of gross receipts*—(A) *In general.* The term ''gross receipts'' means gross receipts of the taxable year in which such receipts are properly recognized under the taxpayer's accounting method used in that taxable year (determined without regard to this section) for federal income tax purposes. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade of business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221 (1), (3), (4) or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in 1221 (2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (*e.g.*, a repayment of the principal amount of a loan held by a commercial lender). Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts shall include the amounts received that are allocable to the payment of such tax.

(3) *Examples.* The following examples illustrate the provisions of paragraph (f) of this section:

Example 1. X, a calendar year C corporation, was formed on January 1, 1986. Assume that in 1986 X has gross receipts of $15 million. For taxable year 1987, this section applies to X because in 1986, the period during which X was in existence, X has average annual gross receipts of more than $5 million.

Example 2. Y, a calendar year C corporation that is not a qualified personal service corporation, has gross receipts of $10 million, $9 million, and $4 million for taxable years 1984, 1985, and 1986, respectively. In taxable year 1986, X has average annual gross receipts for the 3-taxable-year period ending with 1986 of $7.67 million ($10 million + 9 million + 4 million ÷ 3). Thus, for taxable year 1987, this section applies and Y must change from the cash method for such year.

Example 3. Z, a C corporation which is not a qualified personal service corporation, has a 5% partnership interest in ZAB partnership, a calendar year cash method taxpayer. All other partners of ZAB partnership are individuals. Z corporation has average annual gross receipts of $100,000 for the 3-taxable-year period ending with 1986 (*i.e.*, 1984, 1985 and 1986). The ZAB partnership has average annual gross receipts of $6 million for the same 3-taxable-year period. Since ZAB fails to meet the $5,000,000 gross receipts test for 1986, this section applies to ZAB for its taxable year beginning January 1, 1987. Accordingly, ZAB must change from the cash method for its 1987 taxable year. The gross receipts of Z corporation are not relevant in determining whether ZAB is subject to this section.

Example 4. The facts are the same as in Example 3, except that during the 1987 taxable year of ZAB, the Z corporation transfers its partnership interest in ZAB to an individual. Under paragraph (a)(1) of this section, ZAB is treated as a partnership with a C corporation as a partner. Thus, this section requires ZAB to change from the cash method effective for its taxable year 1987. If ZAB later desires to change its method of accounting to the cash method for its taxable year beginning January 1, 1988 (or later), ZAB must comply with all requirements of law, including sections 446(b), 446(e), and 481, to effect the change.

Example 5. X, a C corporation that is not a qualified personal service corporation, was formed on January 1, 1986, in a transaction described in section 351. In the transaction, A, an individual, contributed all of the assets and liabilities of B, a trade or business, to X, in return for the receipt of all the outstanding stock of X. Assume that in 1986 X has gross receipts of $4 million. In 1984 and 1985, the gross receipts of B, the trade or business, were $10 million and $7 million respectively. The gross receipts test is applied for the period during which X and its predecessor trade or business were in existence. X has average annual gross receipts for the 3-taxable-year period ending with 1986 of $7 million ($10 million + $7 million + $4 million ÷ 3). Thus, for taxable year 1987, this section applies and X must change from the cash method for such year.

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§ 1.448–2 Nonaccrual of certain amounts by service providers.

(a) *In general.* This section applies to taxpayers qualified to use a nonaccrual-experience method of accounting provided for in section 448(d)(5) with respect to amounts to be received for the performance of services. A taxpayer that satisfies the requirements of this section is not required to accrue any portion of amounts to be received from the performance of services that, on the basis of the taxpayer's experience, and to the extent determined under the computation or formula used by the taxpayer and allowed under this section, will not be collected. Except as otherwise provided in this section, a taxpayer is qualified to use a nonaccrual-experience method of accounting if the taxpayer uses an accrual method of accounting with respect to amounts to be received for the performance of services by the taxpayer and either—

(1) The services are in fields referred to in section 448(d)(2)(A) and described in § 1.448–1T(e)(4) (health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting); or

(2) The taxpayer meets the $5 million annual gross receipts test of section 448(c) and § 1.448–1T(f)(2) for all prior taxable years.

(b) *Application of method and treatment as method of accounting.* The rules of section 448(d)(5) and the regulations are applied separately to each taxpayer. For purposes of section 448(d)(5), the term *taxpayer* has the same meaning as the term *person* defined in section 7701(a)(1) (rather than the meaning of the term defined in section 7701(a)(14)). The nonaccrual of amounts to be received for the performance of services is a method of accounting (a nonaccrual-experience method). A change to a nonaccrual-experience method, from one nonaccrual-experience method to another nonaccrual-experience method, or to a periodic system (for example, *see* Notice 88–51 (1988–1 C.B. 535) and § 601.601(d)(2)(ii)(*b*) of this chapter), is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations apply. *See* also paragraphs (c)(2)(i), (c)(5), (d)(4), and (e)(3)(i) of this section. Except as provided in other published guidance, a taxpayer who wishes to adopt or change to any nonaccrual-experience method other than one of the safe harbor methods described in paragraph (f) of this section must request and receive advance consent from the Commissioner in accordance with the applicable administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent.

(c) *Definitions and special rules*—(1) *Accounts receivable*—(i) *In general.* Accounts receivable include only amounts that are earned by a taxpayer and otherwise recognized in income through the performance of services by the taxpayer. For purposes of determining a taxpayer's nonaccrual-experience under any method provided in this section, amounts described in paragraph (c)(1)(ii) of this section are not taken into account. Except as otherwise provided, for purposes of this section, accounts receivable do not include amounts that are not billed (such as for charitable or pro bono services) or amounts contractually not collectible (such as amounts in excess of a fee schedule agreed to by contract). *See* paragraph (g) *Examples 1* and *2* of this section for examples of this rule.

(ii) *Method not available for certain receivables*—(A) *Amounts not earned and recognized through the performance of services.* A nonaccrual-experience method of accounting may not be used with respect to amounts that are not earned by a taxpayer and otherwise recognized in income through the performance of services by the taxpayer. For example, a nonaccrual-experience method may not be used with respect to amounts owed to the taxpayer by reason of the taxpayer's activities with respect to lending money, selling goods, or acquiring accounts receivable or other rights to receive payment from other persons (including persons related to the taxpayer) regardless of whether those persons earned the amounts through the provision of services. However, *see* paragraph (d)(3) of this section for special rules regarding acquisitions of a trade or business or a unit of a trade or business.

(B) *If interest or penalty charged on amounts due.* A nonaccrual-experience method of accounting may not be used with respect to amounts due for which interest is required to be paid or for which there is any penalty for failure to timely pay any amounts due. For this purpose, a taxpayer will be treated as charging interest or penalties for late payment if the contract or agreement expressly provides for the charging of interest or penalties for late payment, regardless of the practice of the parties. If the contract or agreement does not expressly provide for the charging of interest or penalties for late payment, the determination of whether the taxpayer charges interest or penalties for late payment will be made based on all of the facts and circumstances of the transaction, and not merely on the characterization by the parties or the treatment of the transaction under state or local law. However, the offering of a discount for early payment of an amount due will not be regarded as the charging of interest or penalties for late payment under this section, if—

(*1*) The full amount due is otherwise accrued as gross income by the taxpayer at the time the services are provided; and

(*2*) The discount for early payment is treated as an adjustment to gross income in the year of payment, if payment is received within the time required for allowance of the discount. *See* paragraph (g) *Example 3* of this section for an example of this rule.

(2) *Applicable period*—(i) *In general.* The applicable period is the number of taxable years on which the taxpayer bases its nonaccrual-experience method. A change in the number of taxable years included in the applicable period is a change in method of accounting to which the procedures of section 446 apply. A change in the inclusion or exclusion of the current taxable year in the applicable period is a change in method of accounting to which the procedures of section 446 apply. A change in the number of taxable years included in the applicable period or the inclusion or exclusion of the current taxable year in the applicable period is made on a cut-off basis.

(ii) *Applicable period for safe harbors.* For purposes of the safe harbors under paragraph (f) of this section the applicable period may consist of at least three but not more than six of the immediately preceding consecutive taxable years. Alternatively, the applicable period may consist of the current taxable year and at least two but not more than five of the immediately preceding consecutive taxable years. A period shorter than six taxable years is permissible only if the period contains the most recent preceding taxable years and all of the taxable years in the applicable period are consecutive.

(3) *Bad debts.* Bad debts are accounts receivable determined to be uncollectible and charged off.

(4) *Charge-offs.* Amounts charged off include only those amounts that would otherwise be allowable under section 166(a).

(5) *Determination date.* The determination date in safe harbor 2 provided in paragraph (f)(2) of this section is used

as a cut-off date for determining all known data to be taken into account in the computation of the taxable year's uncollectible amount. The determination date may not be later than the earlier of the due date, including extensions, for filing the taxpayer's Federal income tax return for that taxable year or the date on which the taxpayer timely files the return for that taxable year. The determination date may be different in each taxable year. However, once a determination date is selected and used for a particular taxable year, it may not be changed for that taxable year. The choice of a determination date is not a method of accounting.

(6) *Recoveries.* Recoveries are amounts previously excluded from income under a nonaccrual-experience method or charged off that the taxpayer recovers.

(7) *Uncollectible amount.* The uncollectible amount is the portion of any account receivable amount due that, under the taxpayer's nonaccrual-experience method, will be not collected.

(d) *Use of experience to estimate uncollectible amounts*—(1) *In general.* In determining the portion of any amount due that, on the basis of experience, will not be collected, a taxpayer may use any nonaccrual-experience method that clearly reflects the taxpayer's nonaccrual-experience. The determination of whether a nonaccrual-experience method clearly reflects the taxpayer's nonaccrual-experience is made in accordance with the rules under paragraph (e) of this section. Alternatively, the taxpayer may use any one of the five safe harbor nonaccrual-experience methods of accounting provided in paragraphs (f)(1) through (f)(5) of this section, which are presumed to clearly reflect a taxpayer's nonaccrual-experience.

(2) *Application to specific accounts receivable.* The nonaccrual-experience method is applied with respect to each account receivable of the taxpayer that is eligible for this method. With respect to a particular account receivable, the taxpayer determines, in the manner prescribed in paragraphs (d)(1) or (f)(1) through (f)(5) of this section (whichever applies), the uncollectible amount. The determination is required to be made only once with respect to each account receivable, regardless of the term of the receivable. The uncollectible amount is not recognized as gross income. Thus, the amount recognized as gross income is the amount that would otherwise be recognized as gross income with respect to the account receivable, less the uncollectible amount. A taxpayer that excludes an amount from income during a taxable year as a result of the taxpayer's use of a nonaccrual-experience method may not deduct in any subsequent taxable year the amount excluded from income. Thus, the taxpayer may not deduct the excluded amount in a subsequent taxable year in which the taxpayer actually determines that the amount is uncollectible and charges it off. If a taxpayer using a nonaccrual-experience method determines that an amount that was not excluded from income is uncollectible and should be charged off (for example, a calendar-year taxpayer determines on November 1st that an account receivable that was originated on May 1st of the same taxable year is uncollectible and should be charged off), the taxpayer may deduct the amount charged off when it is charged off, but must include any subsequent recoveries in income. The reasonableness of a taxpayer's determination that amounts are uncollectible and should be charged off may be considered on examination. *See* paragraph (g) *Example 12* of this section for an example of this rule.

(3) *Acquisitions and dispositions*—(i) *Acquisitions.* If a taxpayer acquires the major portion of a trade or business of another person (predecessor) or the major portion of a separate unit of a trade or business of a predecessor, then, for purposes of applying this section for any taxable year ending on or after the acquisition, the experience from preceding taxable years of the predecessor attributable to the portion of the trade or business acquired, if available, must be used in determining the taxpayer's experience.

(ii) *Dispositions.* If a taxpayer disposes of a major portion of a trade or business or the major portion of a separate unit of a trade or business, and the taxpayer furnished the acquiring person the information necessary for the computations required by this section, then, for purposes of applying this section for any taxable year ending on or after the disposition, the experience from preceding taxable years attributable to the portion of the trade or business disposed may not be used in determining the taxpayer's experience.

(iii) *Meaning of terms.* For the meaning of the terms *acquisition, separate unit,* and *major portion, see* paragraph (b) of §1.52–2. The term *acquisition* includes an incorporation or a liquidation.

(4) *New taxpayers.* The rules of this paragraph (d)(4) apply to any newly formed taxpayer to which the rules of paragraph (d)(3)(i) of this section do not apply. Any newly formed taxpayer that wants to use a safe harbor nonaccrual-experience method of accounting described in paragraph (f)(1), (f)(2), (f)(3), (f)(4), or (f)(5) of this section applies the methods by using the experience of the actual number of taxable years available in the applicable period. A newly formed taxpayer that wants to use one of the safe harbor nonaccrual-experience methods of accounting described in paragraph (f)(2), (f)(4), or (f)(5) of this section in its first taxable year and does not have any accounts receivable upon formation may not exclude any portion of its year-end accounts receivable from income for its first taxable year. The taxpayer must begin creating its moving average in its second taxable year by tracking the accounts receivable as of the first day of its second taxable year. The use of one of the safe harbor nonaccrual-experience methods of accounting described in paragraph (f)(2), (f)(4), or (f)(5) of this section in a taxpayer's second taxable year in this situation is not a change in method of accounting. Although the taxpayer must maintain the books and records necessary to perform the computations under the adopted safe harbor nonaccrual-experience method, the taxpayer is not required to affirmatively elect the method on its Federal income tax return for its first taxable year.

(5) *Recoveries.* Regardless of the nonaccrual-experience method of accounting used by a taxpayer under this section, the taxpayer must take recoveries into account. If, in a subsequent taxable year, a taxpayer recovers an amount previously excluded from income under a nonaccrual-experience method or charged off, the taxpayer must include the recovered amount in income in that subsequent taxable year. *See* paragraph (g) *Example 13* of this section for an example of this rule.

(6) *Request to exclude taxable years from applicable period.* A period shorter than the applicable period generally is permissible only if the period consists of consecutive taxable years and there is a change in the type of a substantial portion of the outstanding accounts receivable such that the risk of loss is substantially increased. A decline in the general economic conditions in the area, which substantially increases the risk of loss, is a relevant factor in determining whether a shorter period is appropriate. However, approval to use a shorter period will not be granted unless the taxpayer supplies evidence that the accounts receivable outstanding at the close of the taxable years for the shorter period requested are more comparable in nature and risk to accounts receivable outstanding at the close of the current taxable year. A substantial increase in a taxpayer's bad debt experience is not, by itself, sufficient to justify the use of a shorter period. If approval is granted to use a shorter period, the experience for the excluded taxable years may not be used for any subsequent taxable year. A request for approval to exclude the experience of a prior taxable year must be made in accordance with the applicable procedures for requesting a letter ruling and must include a statement of the reasons the experience should be excluded. A request will not be considered unless it is sent to the Commissioner at least 30 days before the close of the first taxable year for which the approval is requested.

(7) *Short taxable years.* A taxpayer with a short taxable year that uses a nonaccrual-experience method that compares accounts receivable balance to total bad debts during the taxable year should make appropriate adjustments.

(8) *Recordkeeping requirements*—(i) A taxpayer using a nonaccrual-experience method of accounting must keep

sufficient books and records to establish the amount of any exclusion from gross income under section 448(d)(5) for the taxable year, including books and records demonstrating—

(A) The nature of the taxpayer's nonaccrual-experience method;

(B) Whether, for any particular taxable year, the taxpayer qualifies to use its nonaccrual-experience method (including the self-testing requirements of paragraph (e) of this section (if applicable));

(C) The taxpayer's determination that amounts are uncollectible;

(D) The proper amount that is excludable under the taxpayer's nonaccrual-experience method; and

(E) The taxpayer's determination date under paragraph (c)(5) of this section (if applicable).

(ii) If a taxpayer does not maintain records of the data that are sufficient to establish the amount of any exclusion from gross income under section 448(d)(5) for the taxable year, the Internal Revenue Service may change the taxpayer's method of accounting on examination. *See* §1.6001–1 for rules regarding records.

(e) *Requirements for nonaccrual method to clearly reflect experience*—(1) *In general.* A nonaccrual-experience method clearly reflects the taxpayer's experience if the taxpayer's nonaccrual-experience method meets the self-test requirements described in this paragraph (e). If a taxpayer is using one of the safe harbor nonaccrual-experience methods described in paragraphs (f)(1) through (f)(4) of this section, its method is deemed to clearly reflect its experience and is not subject to the self-testing requirements in paragraphs (e)(2) and (e)(3) of this section.

(2) *Requirement to self-test*—(i) *In general.* A taxpayer using, or desiring to use, a nonaccrual-experience method must self-test its nonaccrual-experience method for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method (first-year self-test) and every three taxable years thereafter (three-year self-test). Each self-test must be performed by comparing the uncollectible amount (under the taxpayer's nonaccrual-experience method) with the taxpayer's actual experience. A taxpayer using the safe harbor under paragraph (f)(5) of this section must self-test using the safe harbor comparison method in paragraph (e)(3) of this section.

(ii) *First-year self-test.* The first-year self-test must be performed by comparing the uncollectible amount with the taxpayer's actual experience for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method. If the uncollectible amount for the first-year self-test is less than or equal to the taxpayer's actual experience for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method, the taxpayer's nonaccrual-experience method is treated as clearly reflecting its experience for the first taxable year. If, as a result of the first-year self-test, the uncollectible amount for the test period is greater than the taxpayer's actual experience, then—

(A) The taxpayer's nonaccrual-experience method is treated as not clearly reflecting its experience;

(B) The taxpayer is not permitted to use that nonaccrual-experience method in that taxable year; and

(C) The taxpayer must change to (or adopt) for that taxable year either—

(*1*) Another nonaccrual-experience method that clearly reflects experience, that is, a nonaccrual-experience method that meets the first-year self-test requirement; or

(*2*) A safe harbor nonaccrual-experience method described in paragraphs (f)(1) through (f)(5) of this section.

(iii) *Three-year self-test*—(A) *In general.* The three-year self-test must be performed by comparing the sum of the uncollectible amounts for the current taxable year and prior two taxable years (cumulative uncollectible amount) with the sum of the taxpayer's actual experience for the current taxable year and prior two taxable years (cumulative actual experience amount).

(B) *Recapture.* If the cumulative uncollectible amount for the test period is greater than the cumulative actual experience amount for the test period, the taxpayer's uncollectible amount is limited to the cumulative actual experience amount for the test period. Any excess of the taxpayer's cumulative uncollectible amount over the taxpayer's cumulative actual nonaccrual-experience amount excluded from income during the test period must be recaptured into income in the third taxable year of the three-year self-test period.

(C) *Determination of whether method is permissible or impermissible.* If the cumulative uncollectible amount is less than 110 percent of the cumulative actual experience amount, the taxpayer's nonaccrual-experience method is treated as a permissible method and the taxpayer may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement of this paragraph (e)(2)(iii). If the cumulative uncollectible amount is greater than or equal to 110 percent of the cumulative actual experience amount, the taxpayer's nonaccrual-experience method is treated as impermissible in the taxable year subsequent to the three-year self-test year and does not clearly reflect its experience. The taxpayer must change to another nonaccrual-experience method that clearly reflects experience, including, for example, one of the safe harbor nonaccrual-experience methods described in paragraphs (f)(1) through (f)(5) of this section, for the subsequent taxable year. A change in method of accounting from an impermissible method under this paragraph (e)(2)(iii)(C) to a permissible method in the taxable year subsequent to the three-year self-test year is made on a cut-off basis.

(iv) *Determination of taxpayer's actual experience.* [Reserved]

(3) *Safe harbor comparison method*—(i) *In general.* A taxpayer using, or desiring to use, a nonaccrual-experience method under the safe harbor in paragraph (f)(5) of this section must self-test its nonaccrual-experience method for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method (first-year self-test) and every three taxable years thereafter (three-year self-test). A nonaccrual-experience method under the safe harbor in paragraph (f)(5) of this section is deemed to clearly reflect experience provided all the requirements of the safe harbor comparison method of this paragraph (e)(3) are met. Each self-test must be performed by comparing the uncollectible amount (under the taxpayer's nonaccrual-experience method) with the uncollectible amount that would have resulted from use of one of the safe harbor methods described in paragraph (f)(1), (f)(2), (f)(3), or (f)(4) of this section. A change from a nonaccrual-experience method that uses the safe harbor comparison method for self-testing to a nonaccrual-experience method that does not use the safe harbor comparison method for self-testing, and vice versa, is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations apply. A change solely to use or discontinue use of the safe harbor comparison method for purposes of determining whether the nonaccrual-experience method clearly reflects experience must be made on a cut-off basis and without audit protection.

(ii) *Requirements to use safe harbor comparison method*—(A) *First-year self-test.* The first-year self-test must be performed by comparing the uncollectible amount with the uncollectible amount determined under any of the safe harbor methods described in paragraph (f)(1), (f)(2), (f)(3), or (f)(4) of this section (safe harbor uncollectible amount) for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method. If the uncollectible amount for the first-year self-test is less than or equal to the safe harbor uncollectible amount, then the taxpayer's nonaccrual-experience method is treated as clearly reflecting its experience for the first taxable year. If, as a result of the first-year self-test, the uncollectible amount for the test period is greater than the safe harbor uncollectible amount, then—

(*1*) The taxpayer's nonaccrual-experience method is treated as not clearly reflecting its experience;

(*2*) The taxpayer is not permitted to use that nonaccrual-experience method in that taxable year; and

(*3*) The taxpayer must change to (or adopt) for that taxable year either—

(*i*) Another nonaccrual-experience method that clearly reflects experience, that is, a nonaccrual-experience method that meets the first-year self-test requirement; or

(*ii*) A safe harbor nonaccrual-experience method described in paragraphs (f)(1) through (f)(5) of this section.

(B) *Three-year self-test.* The three-year self-test must be performed by comparing the sum of the uncollectible amounts for the current taxable year and prior two taxable years (cumulative uncollectible amount) with the sum of the uncollectible amount determined under any of the safe harbor methods described in paragraph (f)(1), (f)(2), (f)(3), or (f)(4) of this section for the current taxable year and prior two taxable years (cumulative safe harbor uncollectible amounts). If the cumulative uncollectible amount for the three-year self-test is less than or equal to the cumulative safe harbor uncollectible amount for the test period, then the taxpayer's nonaccrual-experience method is treated as clearly reflecting its experience for the test period and the taxpayer may continue to use that nonaccrual-experience method, subject to a requirement to self-test again after three taxable years. If the cumulative uncollectible amount for the test period is greater than the cumulative safe harbor uncollectible amount for the test period, the taxpayer's uncollectible amount is limited to the cumulative safe harbor uncollectible amount for the test period. Any excess of the taxpayer's cumulative uncollectible amount over the taxpayer's cumulative safe harbor uncollectible amount excluded from income during the test period must be recaptured into income in the third taxable year of the three-year self-test period. If the cumulative uncollectible amount is less than 110 percent of the cumulative safe harbor uncollectible amount, the taxpayer's nonaccrual-experience method is treated as a permissible method and the taxpayer may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement of this paragraph (e)(3)(ii)(B). If the cumulative uncollectible amount is greater than or equal to 110 percent of the cumulative safe harbor uncollectible amount, the taxpayer's nonaccrual-experience method is treated as impermissible in the taxable year subsequent to the three-year self-test year and does not clearly reflect its experience. The taxpayer must change to another nonaccrual-experience method that clearly reflects experience, including, for example, one of the safe harbor nonaccrual-experience methods described in paragraphs (f)(1) through (f)(5) of this section, for the subsequent taxable year. A change in method of accounting from an impermissible method under this paragraph (e)(3)(ii)(B) to a permissible method in the taxable year subsequent to the three-year self-test year is made on a cut-off basis.

(4) *Methods that do not clearly reflect experience.* [Reserved]

(5) *Contemporaneous documentation.* For purposes of this paragraph (e), including the safe harbor comparison method of paragraph (e)(3) of this section, a taxpayer must document in its books and records, in the taxable year any first-year or three-year self-test is performed, the method used to conduct the self-test, including appropriate documentation and computations that resulted in the determination that the taxpayer's nonaccrual-experience method clearly reflected the taxpayer's nonaccrual-experience for the applicable test period.

(f) *Safe harbors*—(1) *Safe harbor 1: revenue-based moving average method.* A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (revenue-based moving average percentage). The revenue-based moving average percentage is computed by dividing the total bad debts sustained, adjusted by recoveries received, throughout the applicable period by the total revenue resulting in accounts receivable earned throughout the applicable period. *See* paragraph (g) *Example 4* of this section for an example of this method. Thus, the uncollectible amount under the revenue-based moving average method is computed:

$$\frac{\text{Bad debts sustained, adjusted by recoveries received, during the applicable period}}{\text{Total revenue resulting in accounts receivable during the applicable period}} \times \text{Accounts receivable at end of current taxable year}$$

(2) *Safe harbor 2: actual experience method—(i) Option A: single determination date*. A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (moving average nonaccrual-experience percentage) and then increasing the resulting amount by 5 percent. *See* paragraph (g) *Example 5* of this section for an example of safe harbor 2 in general, and paragraph (g) *Example 6* of this section for an example of the single determination date option of safe harbor 2. The taxpayer's moving average nonaccrual-experience percentage is computed by dividing the total bad debts sustained, adjusted by recoveries that are allocable to the bad debts, by the determination date of the current taxable year related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period by the sum of the accounts receivable at the beginning of each taxable year during the applicable period. Thus, the uncollectible amount under Option A of the actual experience method is computed:

$$\frac{\text{Bad debts sustained, adjusted by recoveries received that are allocable to the bad debts, by the determination date of the current taxable year related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period}}{\text{Sum of accounts receivable at the beginning of each taxable year during the applicable period}} \times \text{Accounts receivable at end of current taxable year} \times 1.05$$

(ii) *Option B: multiple determination dates*. Alternatively, in computing its bad debts related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period, a taxpayer may use the original determination date for each taxable year during the applicable period. That is, the taxpayer may use bad debts sustained, adjusted by recoveries received that are allocable to the bad debts, by the determination date of each taxable year during the applicable period rather than the determination date of the current taxable year. *See* paragraph (g) *Example 7* of this section for an example of the multiple determination date option of safe harbor 2. Thus, the uncollectible amount under Option B of the actual experience method is computed:

$$\frac{\text{Sum of, for each taxable year during the applicable period, bad debts sustained, adjusted by recoveries received that are allocable to the bad debts, by that taxable year's determination date and related to the taxpayer's accounts receivable balance at the beginning of the taxable year}}{\text{Sum of accounts receivable at the beginning of each taxable year during the applicable period}} \times \text{Accounts receivable at end of current taxable year} \times 1.05$$

(iii) *Tracing of recoveries*—(A) *In general*. Bad debts related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period must be adjusted by the portion, if any, of recoveries received that are properly allocable to the bad debts.

(B) *Specific tracing.* If a taxpayer, without undue burden, can trace all recoveries to their corresponding charge-offs, the taxpayer must specifically trace all recoveries.

(C) *Recoveries cannot be traced without undue burden.* If a taxpayer has any recoveries that cannot, without undue burden, be traced to corresponding charge-offs, the taxpayer may allocate those or all recoveries between charge-offs of amounts in the relevant beginning accounts receivable balances and other charge-offs using an allocation method that is reasonable under all of the facts and circumstances.

(*1*) *Reasonable allocations.* An allocation method is reasonable if there is a cause and effect relationship between the allocation base or ratio and the recoveries. A taxpayer may elect to trace recoveries that are traceable and allocate all untraceable recoveries to charge-offs of amounts in the relevant beginning accounts receivable balances. Such an allocation method will be deemed to be reasonable under all the facts and circumstances.

(*2*) *Allocations that are not reasonable.* Allocation methods that generally will not be considered reasonable include, for example, methods in which there is not a cause and effect relationship between the allocation base or ratio and methods in which receivables for which the nonaccrual-experience method is not allowed to be used are included in the allocation. *See* paragraph (c)(1)(ii) of this section for examples of receivables for which the nonaccrual-experience method is not allowed.

(3) *Safe harbor 3: modified Black Motor method.* A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (modified Black Motor moving average percentage) and then reducing the resulting amount by the bad debts written off during the current taxable year relating to accounts receivable generated during the current taxable year. The modified Black Motor moving average percentage is computed by dividing the total bad debts sustained, adjusted by recoveries received, during the applicable period by the sum of accounts receivable at the end of each taxable year during the applicable period. *See* paragraph (g) *Example 8* of this section for an example of this method. Thus, the uncollectible amount under the modified Black Motor method is computed:

$$\frac{\text{Bad debts sustained, adjusted by recoveries received, during the applicable period}}{\text{Sum of accounts receivable at the end of each taxable year during the applicable period}} \times \begin{array}{c}\text{Accounts}\\\text{receivable at}\\\text{end of current}\\\text{taxable year}\end{array} - \begin{array}{c}\text{Bad debts written off during the}\\\text{current taxable year relating to}\\\text{accounts receivable generated}\\\text{during the current taxable year}\end{array}$$

(4) *Safe harbor 4: modified moving average method.* A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (modified moving average percentage). The modified moving average percentage is computed by dividing the total bad debts sustained, adjusted by recoveries received, during the applicable period other than bad debts that were written off in the same taxable year the related accounts receivable were generated by the sum of accounts receivable at the beginning of each taxable year during the applicable period. *See* paragraph (g) *Example 9* of this section for an example of this method. Thus, the uncollectible amount under the modified moving average method is computed:

$$\frac{\begin{array}{c}\text{(Bad debts sustained, adjusted by recoveries}\\ \text{received, during the applicable period}\\ -\text{ Bad debts written off in same taxable year}\\ \text{accounts receivable generated)}\end{array}}{\begin{array}{c}\text{Sum of accounts receivable at the beginning of}\\ \text{each taxable year during the applicable period}\end{array}} \times \begin{array}{c}\text{Accounts receivable at end}\\ \text{of current taxable year}\end{array}$$

(5) *Safe harbor 5: alternative nonaccrual-experience method.* A taxpayer may use an alternative nonaccrual-experience method that clearly reflects the taxpayer's actual nonaccrual-experience, provided the taxpayer's alternative nonaccrual-experience method meets the self-test requirements described in paragraph (e)(3) of this section.

(g) *Examples.* The following examples illustrate the provisions of this section. In each example, the taxpayer uses a calendar year for Federal income tax purposes and an accrual method of accounting, does not require the payment of interest or penalties with respect to past due accounts receivable (except in the case of *Example 3*) and, in the case of *Examples 5* through *7*, selects an appropriate determination date for each taxable year. The examples are as follows:

Example 1. Contractual allowance or adjustment. B, a healthcare provider, performs a medical procedure on individual C, who has health insurance coverage with IC, an insurance company. B bills IC and C for $5,000, B's standard charge for this medical procedure. However, B has a contract with IC that obligates B to accept $3,500 as full payment for the medical procedure if the procedure is provided to a patient insured by IC. Under the contract, only $3,500 of the $5,000 billed by B is legally collectible from IC and C. The remaining $1,500 represents a contractual allowance or contractual adjustment. Under paragraph (c)(1)(i) of this section, the remaining $1,500 is not a contractually collectible amount for purposes of this section and B may not use a nonaccrual-experience method with respect to this portion of the receivable.

Example 2. Charitable or pro bono services. D, a law firm, agrees to represent individual E in a legal matter and to provide services to E on a pro bono basis. D normally charges $500 for these services. Because D provides its services to E pro bono, D's services are never billed or intended to result in revenue. Thus, under paragraph (c)(1)(i) of this section, the $500 is not a collectible amount for purposes of this section and D may not use a nonaccrual-experience method with respect to this portion of the receivable.

Example 3. Charging interest and/or penalties. Z has two billing methods for the amounts to be received from Z's provision of services described in paragraph (a)(1) of this section. Under one method, for amounts that are more than 90 days past due, Z charges interest at a market rate until the amounts (together with interest) are paid. Under the other billing method, Z charges no interest for amounts past due. Under paragraph (c)(1)(ii) of this section, A may not use a nonaccrual-experience method of accounting with respect to any of the amounts billed under the method that charges interest on amounts that are more than 90 days past due. Z may, however, use the nonaccrual-experience method with respect to the amounts billed under the method that does not charge interest for amounts past due.

Example 4. Safe harbor 1: Revenue-based moving average method. (i) F uses the revenue-based moving average method described in paragraph (f)(1) of this section with an applicable period of six taxable years. F's total accounts receivable and bad debt experience for the 2006 taxable year and the five immediately preceding consecutive taxable years are as follows:

Taxable year	Total accounts receivable earned during the taxable year	Bad debts adjusted for recoveries
2001	$40,000	$5,700
2002	40,000	7,200
2003	40,000	11,000
2004	60,000	10,200
2005	70,000	14,000
2006	80,000	16,800
Total	330,000	64,900

(ii) F's revenue-based moving average percentage is 19.67% ($64,900/$330,000). If $49,300 of accounts receivable remains outstanding as of the close of that taxable year (2006), F's uncollectible amount using the revenue-based moving average safe harbor method is computed by multiplying $49,300 by the revenue-based moving average percentage of 19.67%, or $9,697. Thus, F may exclude $9,697 from gross income for 2006.

Example 5. Safe harbor 2: Actual experience method . (i) G is eligible to use a nonaccrual-experience method and wishes to adopt the actual experience method of paragraph (f)(2) of this section. G elects to use a three-year applicable period consisting of the current and two immediately preceding consecutive taxable years. G determines that its actual accounts receivable collection experience is as follows:

Taxable year	Total A/R balance at beginning of taxable year	Bad debts, adjusted for recoveries, related to A/R balance at beginning of taxable year
2006	$1,000,000	$35,000
2007	760,000	75,000
2008	1,975,000	65,000
Total	3,735,000	175,000

(ii) G's ending A/R Balance on December 31, 2008, is $880,000. In 2008, G computes its uncollectible amount by using a three-year moving average under paragraph (f)(2) of this section. G's moving average nonaccrual-experience percentage is 4.7%, determined by dividing the sum of the amount of G's accounts receivable outstanding on January 1 of 2006, 2007, and 2008, that were determined to be bad debts (adjusted for recoveries allocable to the bad debts) on or before the corresponding determination date(s), by the sum of the amount of G's accounts receivable outstanding on January 1 of 2006, 2007, and 2008 ($175,000/$3,735,000 or 4.7%). G's uncollectible amount for 2008 is determined by multiplying this percentage by the balance of G's accounts receivable on December 31, 2008 ($880,000 × 4.7% = $41,360), and increasing this amount by 105% ($41,360 × 105% = $43,428). G may exclude $43,428 from gross income for 2008.

Example 6. Safe harbor 2: Single determination date (Option A). H is eligible to use a nonaccrual-experience method and wishes to adopt the actual experience method of paragraph (f)(2) of this section. H elects to use a six-year applicable period consisting of the current and five immediately preceding taxable years. H also elects to use a single determination date in accordance with paragraph (f)(2)(i) of this section. H selects December 31, its taxable year-end, as its determination date. Since H is using a single determination date from the current taxable year, its determination date for the 2001–2006 applicable period is December 31, 2006. H has a $800 charge-off in 2003 of an account receivable in the 2003 beginning accounts receivable balance. In 2005, H has a recovery of $100 which is traceable, without undue burden, to the $800 charge-off in 2003. Since the $100 recovery occurred prior to H's December 31, 2006, determination date, it reduces the amount of H's bad debts in the numerator of the formula for purposes of determining H's moving average nonaccrual-experience percentage. In addition, H must include the $100 recovery in income in 2005 (*see* paragraph (d)(5) of this section regarding recoveries).

Example 7. Safe harbor 2: Multiple determination dates (Option B). The facts are the same as in *Example 6,* except H elects to use multiple determination dates in accordance with paragraph (f)(2)(ii) of this section. Consequently, H's determination date is December 31, 2001, for its calculations of the portion of the numerator relating to the 2001 taxable year, December 31, 2002, for its calculations of the portion of the numerator relating to the 2002 taxable year, and so on through the final taxable year (2006), which has a determination date of December 31, 2006. Since the $100 recovery did not occur until after December 31, 2003 (the determination date for the 2003 taxable year), it does not reduce the amount of H's bad debts in the numerator of the formula for purposes of determining H's moving average nonaccrual-experience percentage. However, H still must include the $100 recovery in income in 2005 (*see* paragraph (d)(5) of this section regarding recoveries).

Example 8. Safe harbor 3: Modified Black Motor method. (i) J uses the modified Black Motor method described in paragraph (f)(3) of this section and a six-year applicable period. J's total accounts receivable and bad debt experience for the 2006 taxable year and the five immediately preceding consecutive taxable years are as follows:

Taxable year	Accounts receivable at end of taxable year	Bad debts (adjusted for recoveries)
2001	$130,000	$9,100
2002	140,000	7,000
2003	140,000	14,000
2004	160,000	14,400
2005	170,000	20,400
2006	180,000	10,800
Total	920,000	75,700

(ii) J's modified Black Motor moving average percentage is 8.228% ($75,700/$920,000). If the accounts receivable generated and written off during the current taxable year are $3,600, J's uncollectible amount is $11,210, computed by multiplying J's accounts receivable on December 31, 2006 ($180,000) by the modified Black Motor moving average percentage of 8.228% and reducing the resulting amount by $3,600 (J's accounts receivable generated and written off during the 2006 taxable year). J may exclude $11,210 from gross income for 2006.

Example 9. Safe harbor 4: Modified moving average method. (i) The facts are the same as in *Example 8,* except that the balances represent accounts receivable at the beginning of the taxable year, and J uses the modified moving average method described in paragraph (f)(4) of this section and a six-year applicable period. Furthermore, the accounts receivable that were written off in the same taxable year they were generated, adjusted for recoveries of bad debts during the period are as follows:

Taxable year	Accounts receivable written off in same taxable year as generated (adjusted for recoveries)
2001	$3,033
2002	2,333
2003	4,667
2004	4,800
2005	6,800
2006	3,600
Total	25,233

(ii) J's modified moving average percentage is 5.486% (($75,700 − $25,233)/$920,000). J's uncollectible amount is $9,875, computed by multiplying J's accounts receivable on December 31, 2006 ($180,000) by the modified moving average percentage of 5.486%. J may exclude $9,875 from gross income for 2006.

Example 10. First-year self-test. Beginning in 2006, K is eligible to use a nonaccrual-experience method and wants to adopt an alternative nonaccrual-experience method under paragraph (f)(5) of this section, and consequently is subject to the safe harbor comparison method of self-testing under paragraph (e)(3) of this section. K elects to self-test against safe harbor 1 for purposes of conducting its first-year self-test. K's uncollectible amount for 2006 is $22,000. K's safe harbor uncollectible amount under safe harbor 1 is $21,000. Because K's uncollectible amount for 2006 ($22,000) is greater than the safe harbor uncollectible amount ($21,000), K's alternative nonaccrual-experience method is treated as not clearly reflecting its nonaccrual experience for 2006. Accordingly, K must adopt either another nonaccrual-experience method that clearly reflects experience (subject to the self-testing requirements of paragraph (e)(2)(ii) of this section, or a safe harbor nonaccrual-experience method described in paragraph (f)(1) (revenue-based moving average), (f)(2) (actual experience method), (f)(3) (modified Black Motor method), (f)(4) (modified moving average method) of this section, or another alternative nonaccrual-experience method under paragraph (f)(5) of this section that meets the self-testing requirements of paragraph (e)(3) of this section.

Example 11. Three-year self-test. The facts are the same as in Example 10, except that K's safe harbor uncollectible amount under safe harbor 1 for 2006 is also $22,000. Consequently, K meets the first-year self-test requirement and may use its alternative nonaccrual-experience method. Subsequently, K's cumulative uncollectible amount for 2007 through 2009 is $300,000. K's safe harbor uncollectible amount for 2007 through 2009 under its chosen safe harbor method for self-testing (safe harbor 1) is $295,000. Because K's cumulative uncollectible amount for the three-year test period (taxable years 2007 through 2009) is greater than its safe harbor uncollectible amount for the three-year test period ($295,000), under paragraph (e)(3)(ii)(B) of this section, the $5,000 excess of K's cumulative uncollectible amount over K's safe harbor uncollectible amount for the three-year test period must be recaptured into income in 2009 in accordance with paragraph (e)(3)(ii)(B) of this section. Since K's cumulative uncollectible amount for the three-year test period ($300,000) is less than 110% of its safe harbor uncollectible amount ($295,000 × 110% = $324,500), under paragraph (e)(3)(ii)(B) of this section, K may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement.

Example 12. Subsequent worthlessness of year-end receivable. The facts are the same as in *Example 4*, except that one of the accounts receivable outstanding at the end of 2002 was for $8,000, and in 2003, under section 166, the entire amount of this receivable becomes wholly worthless. Because F does not accrue as income $1,573 of this account receivable ($8,000 × .1967) under the nonaccrual-experience method in 2002, under paragraph (d)(2) of this section F may not deduct this portion of the account receivable as a bad debt deduction under section 166 in 2003. F may deduct the remaining balance of the receivable in 2003 as a bad debt deduction under section 166 ($8,000 − $1,574 = $6,426).

Example 13. Subsequent collection of year-end receivable. The facts are the same as in *Example 4*. In 2007, F collects in full an account receivable of $1,700 that was outstanding at the end of 2006. Under paragraph (d)(5) of this section, F must recognize additional gross income in 2007 equal to the portion of this receivable that F excluded from gross income in the prior taxable year ($1,700 × .1967 = $334). That amount ($334) is a recovery under paragraph (d)(5) of this section.

(h) *Effective date.* This section is applicable for taxable years ending on or after August 31, 2006.

[T.D. 9285, 71 FR 52437, Sept. 6, 2006]

TAXABLE YEAR FOR WHICH ITEMS OF GROSS INCOME INCLUDED

§ 1.451–1 General rule for taxable year of inclusion.

(a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and paragraph (a) of § 1.706–1. If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

(b) *Special rule in case of death.* (1) A taxpayer's taxable year ends on the date of his death. See section 443(a)(2) and paragraph (a)(2) of § 1.443–1. In computing taxable income for such year, there shall be included only amounts properly includible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, amounts accrued only by reason of his death shall not be included in computing taxable income for such year. If the taxpayer uses no regular accounting method, only amounts actually or constructively received during such year shall be included. (For rules relating to the inclusion of partnership income in the return of a decedent partner, see subchapter K, chapter 1 of the Code, and the regulations thereunder.)

(2) If the decedent owned an installment obligation the income from which was taxable to him under section 453, no income is required to be reported in the return of the decedent by reason of the transmission at death of such obligation. See section 453(d)(3). For the treatment of installment obligations acquired by the decedent's estate or by any person by bequest, devise, or inheritance from the decedent, see section 691(a)(4) and the regulations thereunder.

(c) *Special rule for employee tips.* Tips reported by an employee to his employer in a written statement furnished to the employer pursuant to section 6053(a) shall be included in gross income of the employee for the taxable year in which the written statement is furnished the employer. For provisions relating to the reporting of tips by an employee to his employer, see section 6053 and § 31.6053–1 of this chapter (Employment Tax Regulations).

(d) *Special rule for ratable inclusion of original issue discount.* For ratable inclusion of original issue discount in respect of certain corporate obligations issued after May 27, 1969, see section 1232(a)(3).

(e) *Special rule for inclusion of qualified tax refund effected by allocation.* For rules relating to the inclusion in income of an amount paid by a taxpayer in respect of his liability for a qualified State individual income tax and allocated or reallocated in such a manner as to apply it toward the taxpayer's liability for the Federal income tax, see paragraph (f)(1) of §301.6361–1 of this chapter (Regulations on Procedure and Administration).

(f) *Timing of income from notional principal contracts.* For the timing of income with respect to notional principal contracts, see §1.446–3.

(g) *Timing of income from section 467 rental agreements.* For the timing of income with respect to section 467 rental agreements, see section 467 and the regulations thereunder.

[T.D. 6500, 25 FR 11709, Nov. 26, 1960, as amended by T.D. 7001, 34 FR 997, Jan. 23, 1969; T.D. 7154, 36 FR 24996, Dec. 28, 1971; 43 FR 59357, Dec. 20, 1978; T.D. 8491, 58 FR 53135, Oct. 14, 1993; T.D. 8820, 64 FR 26851, May 18, 1999]

§ 1.451–2 Constructive receipt of income.

(a) *General rule.* Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt. In the case of interest, dividends, or other earnings (whether or not credited) payable in respect of any deposit or account in a bank, building and loan association, savings and loan association, or similar institution, the following are not substantial limitations or restrictions on the taxpayer's control over the receipt of such earnings:

(1) A requirement that the deposit or account, and the earnings thereon, must be withdrawn in multiples of even amounts;

(2) The fact that the taxpayer would, by withdrawing the earnings during the taxable year, receive earnings that are not substantially less in comparison with the earnings for the corresponding period to which the taxpayer would be entitled had he left the account on deposit until a later date (for example, if an amount equal to three months' interest must be forfeited upon withdrawal or redemption before maturity of a one year or less certificate of deposit, time deposit, bonus plan, or other deposit arrangement then the earnings payable on premature withdrawal or redemption would be substantially less when compared with the earnings available at maturity);

(3) A requirement that the earnings may be withdrawn only upon a withdrawal of all or part of the deposit or account. However, the mere fact that such institutions may pay earnings on withdrawals, total or partial, made during the last three business days of any calendar month ending a regular quarterly or semiannual earnings period at the applicable rate calculated to the end of such calendar month shall not constitute constructive receipt of income by any depositor or account holder in any such institution who has not made a withdrawal during such period;

(4) A requirement that a notice of intention to withdraw must be given in advance of the withdrawal. In any case when the rate of earnings payable in respect of such a deposit or account depends on the amount of notice of intention to withdraw that is given, earnings at the maximum rate are constructively received during the taxable year regardless of how long the deposit or account was held during the year or whether, in fact, any notice of intention to withdraw is given during the year. However, if in the taxable year of withdrawal the depositor or account holder receives a lower rate of earnings because he failed to give the required notice of intention to withdraw, he

shall be allowed an ordinary loss in such taxable year in an amount equal to the difference between the amount of earnings previously included in gross income and the amount of earnings actually received. See section 165 and the regulations thereunder.

(b) *Examples of constructive receipt.* Amounts payable with respect to interest coupons which have matured and are payable but which have not been cashed are constructively received in the taxable year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. Dividends on corporate stock are constructively received when unqualifiedly made subject to the demand of the shareholder. However, if a dividend is declared payable on December 31 and the corporation followed its usual practice of paying the dividends by checks mailed so that the shareholders would not receive them until January of the following year, such dividends are not considered to have been constructively received in December. Generally, the amount of dividends or interest credited on savings bank deposits or to shareholders of organizations such as building and loan associations or cooperative banks is income to the depositors or shareholders for the taxable year when credited. However, if any portion of such dividends or interest is not subject to withdrawal at the time credited, such portion is not constructively received and does not constitute income to the depositor or shareholder until the taxable year in which the portion first may be withdrawn. Accordingly, if, under a bonus or forfeiture plan, a portion of the dividends or interest is accumulated and may not be withdrawn until the maturity of the plan, the crediting of such portion to the account of the shareholder or depositor does not constitute constructive receipt. In this case, such credited portion is income to the depositor or shareholder in the year in which the plan matures. However, in the case of certain deposits made after December 31, 1970, in banks, domestic building and loan associations, and similar financial institutions, the ratable inclusion rules of section 1232(a)(3) apply. See §1.1232–3A. Accrued interest on unwithdrawn insurance policy dividends is gross income to the taxpayer for the first taxable year during which such interest may be withdrawn by him.

[T.D. 6723, 29 FR 5342, Apr. 21, 1964, as amended by T.D. 7154, 36 FR 24997, Dec. 28, 1971; T.D. 7663, 44 FR 76782, Dec. 28, 1979]

§ 1.451–4 Accounting for redemption of trading stamps and coupons.

(a) *In general*—(1) *Subtraction from receipts.* If an accrual method taxpayer issues trading stamps or premium coupons with sales, or an accrual method taxpayer is engaged in the business of selling trading stamps or premium coupons, and such stamps or coupons are redeemable by such taxpayer in merchandise, cash, or other property, the taxpayer should, in computing the income from such sales, subtract from gross receipts with respect to sales of such stamps or coupons (or from gross receipts with respect to sales with which trading stamps or coupons are issued) an amount equal to—

(i) The cost to the taxpayer of merchandise, cash, and other property used for redemptions in the taxable year,

(ii) Plus the net addition to the provision for future redemptions during the taxable year (or less the net subtraction from the provision for future redemptions during the taxable year).

(2) *Trading stamp companies.* For purposes of this section, a taxpayer will be considered as being in the business of selling trading stamps or premium coupons if—

(i) The trading stamps or premium coupons sold by him are issued by purchasers to promote the sale of their merchandise or services,

(ii) The principal activity of the trade or business is the sale of such stamps or coupons,

(iii) Such stamps or coupons are redeemable by the taxpayer for a period of at least 1 year from the date of sale, and

(iv) Based on his overall experience, it is estimated that not more than two-thirds of the stamps or coupons sold which it is estimated, pursuant to paragraph (c) of this section, will be ultimately redeemed, will be redeemed within 6 months of the date of sale.

(b) *Computation of the net addition to or subtraction from the provision for future redemptions*—(1) *Determination of the provision for future redemptions.* (i) The provision for future redemptions as of the end of a taxable year is computed by multiplying "estimated future redemptions" (as defined in subdivision (ii) of this subparagraph) by the estimated average cost of redeeming each trading stamp or coupon (computed in accordance with subdivision (iii) of this subparagraph).

(ii) For purposes of this section, the term "estimated future redemptions" as of the end of a taxable year means the number of trading stamps or coupons outstanding as of the end of such year that it is reasonably estimated will ultimately be presented for redemption. Such estimate shall be determined in accordance with the rules contained in paragraph (c) of this section.

(iii) For purposes of this section, the estimated average cost of redeeming each trading stamp or coupon shall be computed by including only the costs to the taxpayer of acquiring the merchandise, cash, or other property needed to redeem such stamps or coupons. The term "the costs to the taxpayer of acquiring the merchandise, cash, or other property needed to redeem such stamps or coupons" includes only the price charged by the seller (less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer provided a consistent course is followed) plus transportation or other necessary charges in acquiring possession of the goods. Items such as the costs of advertising, catalogs, operating redemption centers, transporting merchandise or other property from a central warehouse to a branch warehouse (or from a warehouse to a redemption center), and storing the merchandise or other property used to redeem stamps or coupons should not be included in costs of redeeming stamps or premium coupons, but rather should be accounted for in accordance with the provisions of sections 162 and 263.

(2) *Changes in provision for future redemptions.* For purposes of this section, a "net addition to" or "net subtraction from" the provision for future redemptions for a taxable year is computed as follows:

(i) Carry over the provision for future redemptions (if any) as of the end of the preceding taxable year,

(ii) Compute the provision for future redemptions as of the end of the taxable year in accordance with subparagraph (1) of this paragraph, and

(iii) If the amount referred to in subdivision (ii) of this subparagraph exceeds the amount referred to in subdivision (i) of this subparagraph, such excess is the net addition to the provision for future redemptions for the taxable year. On the other hand, if the amount referred to in such subdivision (i) exceeds the amount referred to in such subdivision (ii), such excess is the net subtraction from the provision for future redemptions for the taxable year.

(3) *Example.* The provisions of this paragraph and paragraph (a)(1) of this section may be illustrated by the following example:

Example. (a) X Company, a calendar year accrual method taxpayer, is engaged in the business of selling trading stamps to merchants. In 1971, its first year of operation, X sells 10 million stamps at $5 per 1,000; it redeems 3 million stamps for merchandise and cash of an average value of $3 per 1,000 stamps. At the end of 1971 it is estimated (pursuant to paragraph (c) of this section) that a total of 9 million stamps of the 10 million stamps issued in 1971 will eventually be presented for redemption. At this time it is estimated that the average cost of redeeming stamps (as described in subparagraph (1)(iii) of this paragraph) would continue to be $3 per 1,000 stamps. Under these circumstances, X computes its gross income from sales of trading stamps as follows:

Gross receipts from sales (10 million stamps at $5 per 1,000)	....	$50,000
Less:		
Cost of actual redemptions (3 million stamps at $3 per 1,000)	$9,000	....
Provision for future redemptions on December 31, 1971 (9 million stamps − 3 million stamps × $3 per 1,000)	18,000	....
		27,000
1971 gross income from sales of stamps		23,000

(b) In 1972, X also sells 10 million stamps at $5 per 1,000 stamps. During 1972 X redeems 7 million stamps at an average cost of $3.01 per 1,000 stamps. At the end of 1972 it is determined that the estimated future redemptions (within the meaning of subparagraph (1)(ii) of this paragraph) is 8 million. It is further determined that the estimated average cost of redeeming stamps would continue to be $3.01 per 1,000 stamps. X thus computes its gross income from sales of trading stamps for 1972 as follows:

Gross receipts from sales (10 million stamps at $5 per 1,000)		$50,000
Less:		
Cost of actual redemptions (7 million stamps at $3.01 per 1,000)	$21,070	
Plus:		
Provision for future redemptions on Dec. 31, 1972 (8 million stamps at $3.01 per 1,000)	24,080	
Minus provision for future redemptions on Dec. 31, 1971	18,000	
Addition to provision for future redemptions	6,080	
Total cost of redemptions		27,150
1972 Gross income from sales of stamps		22,850

(c) *Estimated future redemptions*—(1) *In general*. A taxpayer may use any method of determining the estimated future redemptions as of the end of a year so long as—

(i) Such method results in a reasonably accurate estimate of the stamps or coupons outstanding at the end of such year that will ultimately be presented for redemption,

(ii) Such method is used consistently, and

(iii) Such taxpayer complies with the requirements of this paragraph and paragraphs (d) and (e) of this section.

(2) *Utilization of prior redemption experience*. Normally, the estimated future redemptions of a taxpayer shall be determined on the basis of such taxpayer's prior redemption experience. However, if the taxpayer does not have sufficient redemption experience to make a reasonable determination of his ''estimated future redemptions,'' or if because of a change in his mode of operation or other relevant factors the determination cannot reasonably be made completely on the basis of the taxpayer's own experience, the experiences of similarly situated taxpayers may be used to establish an experience factor.

(3) *One method of determining estimated future redemptions*. One permissible method of determining the estimated future redemptions as of the end of the current taxable year is as follows:

(i) Estimate for each preceding taxable year and the current taxable year the number of trading stamps or coupons issued for each such year which will ultimately be presented for redemption.

(ii) Determine the sum of the estimates under subdivision (i) of this subparagraph for each taxable year prior to and including the current taxable year.

(iii) The difference between the sum determined under subdivision (ii) of this subparagraph and the total number of trading stamps or coupons which have already been presented for redemption is the estimated future redemptions as of the end of the current taxable year.

(4) *Determination of an ''estimated redemption percentage.''* For purposes of applying subparagraph (3)(i) of this paragraph, one permissible method of estimating the number of trading stamps or coupons issued for a taxable year that will ultimately be presented for redemption is to multiply such number of stamps issued for such year by an ''estimated redemption percentage.'' For purposes of this section the term ''estimated redemption percentage'' for a taxable year means a fraction, the numerator of which is the number of trading stamps or coupons issued during a taxable year that it is reasonably estimated will ultimately be redeemed, and the denominator of which is the number of trading stamps or coupons issued during such year. Consequently, the product of such percentage and the number of stamps issued for such year equals the number of trading stamps or coupons issued for such year that it is estimated will ultimately be redeemed.

(5) *Five-year rule*. (i) One permissible method of determining the ''estimated redemption percentage'' for a taxable year is to—

(*a*) Determine the percentage which the total number of stamps or coupons redeemed in the taxable year and the 4 preceding taxable years is of the total number of stamps or coupons issued or sold in such 5 years; and

(*b*) Multiply such percentage by an appropriate growth factor as determined pursuant to guidelines published by the Commissioner.

(ii) If a taxpayer uses the method described in subdivision (i) of this subparagraph for a taxable year, it will normally be presumed that such taxpayer's ''estimated redemption percentage'' is reasonably accurate.

(6) *Other methods of determining estimated future redemptions.* (i) If a taxpayer uses a method of determining his ''estimated future redemptions'' (other than a method which applies the 5-year rule as described in subparagraph (5)(i) of this paragraph) such as a probability sampling technique, the appropriateness of the method (including the appropriateness of the sampling technique, if any) and the accuracy and reliability of the results obtained must, if requested, be demonstrated to the satisfaction of the district director.

(ii) No inference shall be drawn from subdivision (i) of this subparagraph that the use of any method to which such subdivision applies is less acceptable than the method described in subparagraph (5)(i) of this paragraph. Therefore, certain probability sampling techniques used in determining estimated future redemptions may result in reasonably accurate and reliable estimates. Such a sampling technique will be considered appropriate if the sample is—

(*a*) Taken in accordance with sound statistical sampling principles,

(*b*) In accordance with such principles, sufficiently broad to produce a reasonably accurate result, and

(*c*) Taken with sufficient frequency as to produce a reasonably accurate result.

In addition, if the sampling technique is appropriate, the results obtained therefrom in determining estimated future redemptions will be considered accurate and reliable if the evaluation of such results is consistent with sound statistical principles. Ordinarily, samplings and recomputations of the estimated future redemptions will be required annually. However, the facts and circumstances in a particular case may justify such a recomputation being taken less frequently than annually. In addition, the Commissioner may prescribe procedures indicating that samples made to update the results of a sample of stamps redeemed in a prior year need not be the same size as the sample of such prior year.

(d) *Consistency with financial reporting*—(1) *Estimated future redemptions.* For taxable years beginning after August 22, 1972, the estimated future redemptions must be no greater than the estimate that the taxpayer uses for purposes of all reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes.

(2) *Average cost of redeeming stamps.* For taxable years beginning after August 22, 1972, the estimated average cost of redeeming each stamp or coupon must be no greater than the average cost of redeeming each stamp or coupon (computed in accordance with paragraph (b)(1)(iii) of this section) that the taxpayer uses for purposes of all reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes.

(e) *Information to be furnished with return*—(1) *In general.* For taxable years beginning after August 22, 1972, a taxpayer described in paragraph (a) of this section who uses a method of determining the ''estimated future redemptions'' other than that described in paragraph (c)(5)(i) of this section shall file a statement with his return showing such information as is necessary to establish the correctness of the amount subtracted from gross receipts in the taxable year.

(2) *Taxpayers using the 5-year rule.* If a taxpayer uses the method of determining estimated future redemptions described in paragraph (c)(5)(i) of this section, he shall file a statement with his return showing, with respect to the taxable year and the 4 preceding taxable years—

(i) The total number of stamps or coupons issued or sold during each year, and

(ii) The total number of stamps or coupons redeemed in each such year.

(3) *Trading stamp companies.* In addition to the information required by subparagraph (1) or (2) of this paragraph, a taxpayer engaged in the trade or business of selling trading stamps or premium coupons shall include with

the statement described in subparagraph (1) or (2) of this paragraph such information as may be necessary to satisfy the requirements of paragraph (a)(2)(iv) of this section.

[T.D. 7201, 37 FR 16911, Aug. 23, 1972, as amended by T.D. 7201, 37 FR 18617, Sept. 14, 1972]

§ 1.451–5 Advance payments for goods and long-term contracts.

(a) *Advance payment defined.* (1) For purposes of this section, the term ''advance payment'' means any amount which is received in a taxable year by a taxpayer using an accrual method of accounting for purchases and sales or a long-term contract method of accounting (described in § 1.451–3), pursuant to, and to be applied against, an agreement:

(i) For the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(ii) For the building, installing, constructing or manufacturing by the taxpayer of items where the agreement is not completed within such taxable year.

(2) For purposes of subparagraph (1) of this paragraph:

(i) The term ''agreement'' includes (*a*) a gift certificate that can be redeemed for goods, and (*b*) an agreement which obligates a taxpayer to perform activities described in subparagraph (1)(i) or (ii) of this paragraph and which also contains an obligation to perform services that are to be performed as an integral part of such activities; and

(ii) Amounts due and payable are considered ''received''.

(3) If a taypayer (described in subparagraph (1) of this paragraph) receives an amount pursuant to, and to be applied against, an agreement that not only obligates the taxpayer to perform the activities described in subparagraph (1) (i) and (ii) of this paragraph, but also obligates the taxpayer to perform services that are not to be performed as an integral part of such activities, such amount will be treated as an ''advance payment'' (as defined in subparagraph (1) of this paragraph) only to the extent such amount is properly allocable to the obligation to perform the activities described in subparagraph (1) (i) and (ii) of this paragraph. The portion of the amount not so allocable will not be considered an ''advance payment'' to which this section applies. If, however, the amount not so allocable is less than 5 percent of the total contract price, such amount will be treated as so allocable except that such treatment cannot result in delaying the time at which the taxpayer would otherwise accrue the amounts attributable to the activities described in subparagraph (1) (i) and (ii) of this paragraph.

(b) *Taxable year of inclusion*—(1) *In general.* Advance payments must be included in income either—

(i) In the taxable year of receipt; or

(ii) Except as provided in paragraph (c) of this section.

(*a*) In the taxable year in which properly accruable under the taxpayer's method of accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all of his reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes, or

(*b*) If the taxpayer's method of accounting for purposes of such reports results in advance payments (or any portion of such payments) being included in gross receipts earlier than for tax purposes, in the taxable year in which includible in gross receipts pursuant to his method of accounting for purposes of such reports.

(2) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. S, a retailer who uses for tax purposes and for purposes of the reports referred to in subparagraph (1)(ii)(a) of this paragraph, an accrual method of accounting under which it accounts for its sales of goods when the goods are shipped, receives advance payments for such goods. Such advance payments must be included in gross receipts for tax purposes either in the taxable year the payments are received or in the taxable year such goods are shipped (except as provided in paragraph (c) of this section).

Example 2. T, a manufacturer of household furniture, is a calendar year taxpayer who uses an accrual method of accounting pursuant to which income is accrued when furniture is shipped for purposes of its financial reports (referred to in subparagraph (1)(ii)(*a*) of this paragraph) and an accrual method of accounting pursuant to which the income is accrued when furniture is delivered and accepted for tax purposes. See §1.446–1(c)(1)(ii). In 1974, T receives an advance payment of $8,000 from X with respect to an order of furniture to be manufactured for X for a total price of $20,000. The furniture is shipped to X in December 1974, but it is not delivered to and accepted by X until January 1975. As a result of this contract, T must include the entire advance payment in its gross income for tax purposes in 1974 pursuant to subparagraph (1)(ii)(*b*) of this paragraph. T must include the remaining $12,000 of the gross contract price in its gross income in 1975 for tax purposes.

(3) *Long-term contracts.* In the case of a taxpayer accounting for advance payments for tax purposes pursuant to a long-term contract method of accounting under §1.460–4, or of a taxpayer accounting for advance payments with respect to a long-term contract pursuant to an accrual method of accounting referred to in the succeeding sentence, advance payments shall be included in income in the taxable year in which properly included in gross receipts pursuant to such method of accounting (without regard to the financial reporting requirement contained in subparagraph (1)(ii) (*a*) or (*b*) of this paragraph). An accrual method of accounting to which the preceding sentence applies shall consist of any method of accounting under which the income is accrued when, and costs are accumulated until, the subject matter of the contract (or, if the subject matter of the contract consists of more than one item, an item) is shipped, delivered, or accepted.

(4) *Installment method.* The financial reporting requirement of subparagraph (1)(ii) (*a*) or (*b*) of this paragraph shall not be construed to prevent the use of the installment method under section 453. See §1.446–1(c)(1)(ii).

(c) *Exception for inventoriable goods.* (1)(i) If a taxpayer receives an advance payment in a taxable year with respect to an agreement for the sale of goods properly includible in his inventory, or with respect to an agreement (such as a gift certificate) which can be satisfied with goods or a type of goods that cannot be identified in such taxable year, and on the last day of such taxable year the taxpayer—

(*a*) Is accounting for advance payments pursuant to a method described in paragraph (b)(1)(ii) of this section for tax purposes,

(*b*) Has received ''substantial advance payments'' (as defined in subparagraph (3) of this paragraph) with respect to such agreement, and

(*c*) Has on hand (or available to him in such year through his normal source of supply) goods of substantially similar kind and in sufficient quantity to satisfy the agreement in such year,

then all advance payments received with respect to such agreement by the last day of the second taxable year following the year in which such substantial advance payments are received, and not previously included in income in accordance with the taxpayer's accrual method of accounting, must be included in income in such second taxable year.

(ii) If advance payments are required to be included in income in a taxable year solely by reason of subdivision (i) of this subparagraph, the taxpayer must take into account in such taxable year the costs and expenditures included in inventory at the end of such year with respect to such goods (or substantially similar goods) on hand or, if no such goods are on hand by the last day of such second taxable year, the estimated cost of goods necessary to satisfy the agreement.

(iii) Subdivision (ii) of this subparagraph does not apply if the goods or type of goods with respect to which the advance payment is received are not identifiable in the year the advance payments are required to be included in income by reason of subdivision (i) of this subparagraph (for example, where an amount is received for a gift certificate).

(2) If subparagraph (1)(i) of this paragraph is applicable to advance payments received with respect to an agreement, any advance payments received with respect to such agreement subsequent to such second taxable year must be included in gross income in the taxable year of receipt. To the extent estimated costs of goods are taken into account in a taxable year pursuant to subparagraph (1)(ii) of this paragraph, such costs may not again be taken into account in another year. In

addition, any variances between the costs or estimated costs taken into account pursuant to subparagraph (1)(ii) of this paragraph and the costs actually incurred in fulfilling the taxpayer's obligations under the agreement must be taken into account as an adjustment to the cost of goods sold in the year the taxpayer completes his obligations under such agreement.

(3) For purposes of subparagraph (1) of this paragraph, a taxpayer will be considered to have received ''substantial advance payments'' with respect to an agreement by the last day of a taxable year if the advance payments received with respect to such agreement during such taxable year plus the advance payments received prior to such taxable year pursuant to such agreement, equal or exceed the total costs and expenditures reasonably estimated as includible in inventory with respect to such agreement. Advance payments received in a taxable year with respect to an agreement (such as a gift certificate) under which the goods or type of goods to be sold are not identifiable in such year shall be treated as ''substantial advance payments'' when received.

(4) The application of this paragraph is illustrated by the following example:

Example. In 1971, X, a calendar year accrual method taxpayer, enters into a contract for the sale of goods (properly includible in X's inventory) with a total contract price of $100. X estimates that his total inventoriable costs and expenditures for the goods will be $50. X receives the following advance payments with respect to the contract:

1971	$35
1972	20
1973	15
1974	10
1975	10
1976	10

The goods are delivered pursuant to the customer's request in 1977. X's closing inventory for 1972 of the type of goods involved in the contract is sufficient to satisfy the contract. Since advance payments received by the end of 1972 exceed the inventoriable costs X estimates that he will incur, such payments constitute ''substantial advance payments''. Accordingly, all payments received by the end of 1974, the end of the second taxable year following the taxable year during which ''substantial advance payments'' are received, are includible in gross income for 1974. Therefore, for taxable year 1974 X must include $80 in his gross income. X must include in his cost of goods sold for 1974 the cost of such goods (or similar goods) on hand or, if no such goods are on hand, the estimated inventoriable costs necessary to satisfy the contract. Since no further deferral is allowable for such contract, X must include in his gross income for the remaining years of the contract, the advance payment received each year. Any variance between estimated costs and the costs actually incurred in fulfilling the contract is to be taken into account in 1977, when the goods are delivered. See paragraph (c)(2) of this section.

(d) *Information schedule.* If a taxpayer accounts for advance payments pursuant to paragraph (b)(1)(ii) of this section, he must attach to his income tax return for each taxable year to which such provision applies an annual information schedule reflecting the total amount of advance payments received in the taxable year, the total amount of advance payments received in prior taxable years which has not been included in gross income before the current taxable year, and the total amount of such payments received in prior taxable years which has been included in gross income for the current taxable year.

(e) *Adoption of method.* (1) For taxable years ending on or after December 31, 1969, and before January 1, 1971, a taxpayer (even if he has already filed an income tax return for a taxable year ending within such period) may secure the consent of the Commissioner to change his method of accounting for such year to a method prescribed in paragraph (b)(1)(ii) of this section in the manner prescribed in section 446 and the regulations thereunder, if an application to secure such consent is filed on Form 3115 within 180 days after March 23, 1971.

(2) A taxpayer who is already reporting his income in accordance with a method prescribed in paragraph (b)(1)(ii)(*a*) of this section need not secure the consent of the Commissioner to continue to utilize this method. However, such a taxpayer, for all taxable years ending after March 23, 1971, must comply with the requirements of paragraphs (b)(1)(ii)(*a*) (including the financial reporting requirement) and (d) (relating to an annual information schedule) of this section.

(f) *Cessation of taxpayer's liability.* If a taxpayer has adopted a method prescribed in paragraph (b)(1)(ii) of this section, and if in a taxable year the taxpayer dies, ceases to exist in a transaction other than one to which section 381(a) applies, or his liability under the agreement otherwise ends, then so much of the advance payment as was not includible in his gross income in preceding taxable years shall be included in his gross income for such taxable year.

(g) *Special rule for certain transactions concerning natural resources.* A transaction which is treated as creating a mortgage loan pursuant to section 636 and the regulations thereunder rather than as a sale shall not be considered a "sale or other disposition" within the meaning of paragraph (a)(1) of this section. Consequently, any payment received pursuant to such a transaction, which payment would otherwise qualify as an "advance payment", will not be treated as an "advance payment" for purposes of this section.

[T.D. 7103, 36 FR 5495, Mar. 24, 1971, as amended by T.D. 7397, 41 FR 2641, Jan. 19, 1976; T.D. 8067, 51 FR 393, Jan. 6, 1986; T.D. 8929, 66 FR 2224, Jan. 11, 2001]

§ 1.451–6 Election to include crop insurance proceeds in gross income in the taxable year following the taxable year of destruction or damage.

(a) *In general.* (1) For taxable years ending after December 30, 1969, a taxpayer reporting gross income on the cash receipts and disbursements method of accounting may elect to include insurance proceeds received as a result of the destruction of, or damage to, crops in gross income for the taxable year following the taxable year of the destruction or damage, if the taxpayer establishes that, under the taxpayer's normal business practice, the income from those crops would have been included in gross income for any taxable year following the taxable year of the destruction or damage. However, if the taxpayer receives the insurance proceeds in the taxable year following the taxable year of the destruction or damage, the taxpayer shall include the proceeds in gross income for the taxable year of receipt without having to make an election under section 451(d) and this section. For the purposes of this section only, federal payments received as a result of destruction or damage to crops caused by drought, flood, or any other natural disaster, or the inability to plant crops because of such a natural disaster, shall be treated as insurance proceeds received as a result of destruction or damage to crops. The preceding sentence shall apply to payments that are received by the taxpayer after December 31, 1973.

(2) In the case of a taxpayer who receives insurance proceeds as a result of the destruction of, or damage to, two or more specific crops, if such proceeds may, under section 451(d) and this section, be included in gross income for the taxable year following the taxable year of such destruction or damage, and if such taxpayer makes an election under section 451(d) and this section with respect to any portion of such proceeds, then such election will be deemed to cover all of such proceeds which are attributable to crops representing a single trade or business under section 446(d). A separate election must be made with respect to insurance proceeds attributable to each crop which represents a separate trade or business under section 446(d).

(b)(1) *Time and manner of making election.* The election to include in gross income insurance proceeds received as a result of destruction of, or damage to, the taxpayer's crops in the taxable year following the taxable year of such destruction or damage shall be made by means of a statement attached to the taxpayer's return (or an amended return) for the taxable year of destruction or damage. The statement shall include the name and address of the taxpayer (or his duly authorized representative), and shall set forth the following information:

(i) A declaration that the taxpayer is making an election under section 451(d) and this section;

(ii) Identification of the specific crop or crops destroyed or damaged;

(iii) A declaration that under the taxpayer's normal business practice the income derived from the crops which were destroyed or damaged would have been included in this gross income for a taxable year following the taxable year of such destruction or damage;

(iv) The cause of destruction or damage of crops and the date or dates on which such destruction or damage occurred;

(v) The total amount of payments received from insurance carriers, itemized with respect to each specific crop and with respect to the date each payment was received;

(vi) The name(s) of the insurance carrier or carriers from whom payments were received.

(2) *Scope of election.* Once made, an election under section 451(d) is binding for the taxable year for which made unless the district director consents to a revocation of such election. Requests for consent to revoke an election under section 451(d) shall be made by means of a letter to the district director for the district in which the taxpayer is required to file his return, setting forth the taxpayer's name, address, and identification number, the year for which it is desired to revoke the election, and the reasons therefor.

[T.D. 7097, 36 FR 5215, Mar. 18, 1971, as amended by T.D. 7526, 42 FR 64624, Dec. 27, 1977; T.D. 8429, 57 FR 38595, Aug. 26, 1992]

§ 1.451–7 Election relating to livestock sold on account of drought.

(a) *In general.* Section 451(e) provides that for taxable years beginning after December 31, 1975, a taxpayer whose principal trade or business is farming (within the meaning of § 6420 (c)(3)) and who reports taxable income on the cash receipts and disbursements method of accounting may elect to defer for one year a certain portion of income. The income which may be deferred is the amount of gain realized during the taxable year from the sale or exchange of that number of livestock sold or exchanged solely on account of a drought which caused an area to be designated as eligible for assistance by the Federal Government (regardless of whether the designation is made by the President or by an agency or department of the Federal Government). That number is equal to the excess of the number of livestock sold or exchanged over the number which would have been sold or exchanged had the taxpayer followed its usual business practices in the absence of such drought. For example, if in the past it has been a taxpayer's practice to sell or exchange annually 400 head of beef cattle but due to qualifying drought conditions 550 head were sold in a given taxable year, only income from the sale of 150 head may qualify for deferral under this section. The election is not available with respect to livestock described in section 1231(b)(3) (relating to cattle, horses (and other livestock) held by the taxpayer for 24 months (12 months) and used for draft, breeding, dairy, or sporting purposes).

(b) *Usual business.* The determination of the number of animals which a taxpayer would have sold if it had followed its usual business practice in the absence of drought will be made in light of all facts and circumstances. In the case of taxpayers who have not established a usual business practice, reliance will be placed upon the usual business practice of similarly situated taxpayers in the same general region as the taxpayer.

(c) *Special rules*—(1) *Connection with drought area.* To qualify under section 451(e) and this section, the livestock need not be raised, and the sale or exchange need not take place, in a drought area. However, the sale or exchange of the livestock must occur solely on account of drought conditions, the existence of which affected the water, grazing, or other requirements of the livestock so as to necessitate their sale or exchange.

(2) *Sale prior to designation of area as eligible for Federal assistance.* The provisions of this section will apply regardless of whether all or a portion of the excess number of animals were sold or exchanged before an area becomes eligible for Federal assistance, so long as the drought which caused such dispositions also caused the area to be designated as eligible for Federal assistance.

(d) *Classifications of livestock with respect to which the election may be made.* The election to have the provisions of section 451(e) apply must be made separately for each broad generic classification of animals (e.g., hogs, sheep, cattle) for which the taxpayer wishes the provisions to apply. Separate elections shall not be made solely by reason of the animals' age, sex, or breed.

(e) *Computation*—(1) *Determination of amount deferred.* The amount of income which may be deferred for a classification of livestock pursuant to this section shall be determined in the following manner. The total amount of income realized from the sale or exchange of all livestock in the classification during the taxable year shall be divided by the total number of all such livestock sold. The resulting quotient shall then be multiplied by the excess number of such livestock sold on account of drought.

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

Example. A, a calendar year taxpayer, normally sells 100 head of beef cattle a year. As the result of drought conditions existing during 1976, A sells 135 head during that year. A realizes $35,100 of income from the sale of the 135 head. On August 9, 1976, as a result of the drought, the affected area was declared a disaster area thereby eligible for Federal assistance. The amount of income which A may defer until 1977, presuming the other provisions of this section are met, is determined as follows:

$35,100 (total income from sales of beef cattle)/135 (total number of beef cattle sold) × 35 (excess number of beef cattle sold, i.e. 135 − 100) = $9,100 (amount which A may defer until 1977)

(f) *Successive elections.* If a taxpayer makes an election under section 451(e) for successive years, the amount deferred from one year to the next year shall not be deemed to have been received from the sale or exchange of livestock during the later year. In addition, in determining the taxpayer's normal business practice for the later year, earlier years for which an election under section 451(e) was made shall not be considered.

(g) *Time and manner of making election.* The election provided for in this section must be made by the later of (1) the due date for filing the income tax return (determined with regard to any extensions of time granted the taxpayer for filing such return) for the taxable year in which the early sale of livestock occurs, or (2) (the 90th day after the date these regulations are published as a Treasury decision in the FEDERAL REGISTER). The election must be made separately for each taxable year to which it is to apply. It must be made by attaching a statement to the return or an amended return for such taxable year. The statement shall include the name and address of the taxpayer and shall set forth the following information for each classification of livestock for which the election is made:

(1) A declaration that the taxpayer is making an election under section 451(e);

(2) Evidence of the existence of the drought conditions which forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the Federal Government as a result of the drought conditions.

(3) A statement explaining the relationship of the drought area to the taxpayer's early sale or exchange of the livestock;

(4) The total number of animals sold in each of the three preceding years;

(5) The number of animals which would have been sold in the taxable year had the taxpayer followed its normal business practice in the absence of drought;

(6) The total number of animals sold, and the number sold on account of drought, during the taxable year; and

(7) A computation, pursuant to paragraph (e) of this section, of the amount of income to be deferred for each such classification.

(h) *Revocation of election.* Once an election under this section is made for a taxable year, it may be revoked only with the approval of the Commissioner.

(i) *Cross reference.* For provisions relating to the involuntary conversion of livestock sold on account of drought see section 1033(e) and the regulations thereunder.

[T.D. 7526, 42 FR 64624, Dec. 27, 1977]

§§ 1.453–1—1.453–2 [Reserved]

§ 1.453–3 Purchaser evidences of indebtedness payable on demand or readily tradable.

(a) *In general.* A bond or other evidence of indebtedness (hereinafter in this section referred to as an obligation) issued by any person and payable on demand shall not be treated as an evidence of indebtedness of the purchaser in applying section 453(b) to a sale or other disposition of real property or to a casual sale or other casual disposition of personal property. In addition, an obligation issued by a corporation or a government or political subdivision thereof—

(1) With interest coupons attached (whether or not the obligation is readily tradable in an established securities market),

(2) In registered form (other than an obligation issued in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

(3) In any other form designed to render such obligation readily tradable in an established securities market shall not be treated as an evidence of indebtedness of the purchaser in applying section 453(b) to a sale or other disposition of real property or to a casual sale or other casual disposition of personal property. For purposes of this section, an obligation is to be considered in registered form if it is registered as to principal, interest, or both and if its transfer must be effected by the surrender of the old instrument and either the reissuance by the corporation of the old instrument to the new holder or the issuance by the corporation of a new instrument to the new holder.

(b) *Treatment as payment.* If under section 453(b)(3) an obligation is not treated as an evidence of indebtedness of the purchaser, then—

(1) For purposes of determining whether the payments received in the taxable year of the sale or disposition exceed 30 percent of the selling price, and

(2) For purposes of returning income on the installment method during the taxable year of the sale or disposition or in a subsequent taxable year, the receipt by the seller of such obligation shall be treated as a payment. The rules stated in this paragraph may be illustrated by the following examples:

Example 1. On July 1, 1970, A, an individual on the cash method of accounting reporting on a calendar year basis, transferred all of his stock in corporation X (traded on an established securities market and having a fair market value of $1 million) to corporation Y in exchange for 250 of corporation Y's registered bonds (which are traded in an over-the-counter bond market) each with a principal amount and fair market value of $1,000 (with interest payable at the rate of 8 percent per year), and Y's unsecured promissory note, with a principal amount of $750,000. At the time of such exchange A's basis in the corporation X stock is $900,000. The promissory note is payable at the rate of $75,000 annually, due on July 1, of each year following 1970, until the principal balance is paid. The note provides for the payment of interest at the rate of 10 percent per year also payable on July 1 of each year. Under the rule stated in subparagraph (1) of this paragraph, the 250 registered bonds of corporation Y are treated as a payment for purposes of the 30 percent test described in section 453(b)(2)(A)(ii). The payment on account of the bonds equals 25 percent of the selling price determined as follows:

$$\frac{\begin{array}{c}\$250{,}000 \text{ payment (i.e., 250 of} \\ \text{corporation Y's registered bonds} \\ \text{each with a principal amount and} \\ \text{fair market value of } \$1{,}000)\end{array}}{\begin{array}{c}\$1 \text{ million selling price (i.e.,} \\ \$250{,}000 \text{ of corporation Y's} \\ \text{registered bonds plus} \\ \text{promissory note of } \$750{,}000)\end{array}} = 25 \text{ percent}$$

Since the payments received in the taxable year of the sale do not exceed 30 percent of the selling price and the sales price exceeds $1,000, A may report the income received on the sale of his corporation X stock on the installment method. A elects to report the income on the installment method. The gross profit to be realized when the corporation X stock is fully paid for is 10 percent of the total contract price, computed as follows: $100,000 gross profit (i.e., $1 million contract price less $900,000 basis in corporation X stock) over $1 million contract price. However, since subparagraph (2) of this paragraph also treats the 250 corporation Y registered bonds as a payment for purposes of reporting income, A must include $25,000 (i.e., 10 percent times $250,000) in his gross income for calendar year 1970, the taxable year of sale.

Example 2. Assume the same facts as in Example 1. Assume further that on July 1, 1971, corporation Y makes its first installment payment to A under the terms of the unsecured promissory note with 75 more of its $1,000 registered bonds. A must include $7,500 (i.e., 10 percent gross profit percentage times $75,000) in his gross income for calendar year 1971. In addition, A includes the interest payment made by corporation Y on July 1, in his gross income for 1971.

(c) *Payable on demand.* Under section 453(b)(3), an obligation shall be treated as payable on demand only if the obligation is treated as payable on demand under applicable state or local law.

(d) *Designed to be readily tradable in an established securities market*—(1) *In general.* Obligations issued by a corporation or government or political subdivision thereof will be deemed to be in a form designed to render such obligations readily tradable in an established securities market if—

(i) Steps necessary to create a market for them are taken at the time of issuance (or later, if taken pursuant to an expressed or implied agreement or understanding which existed at the time of issuance),

(ii) If they are treated as readily tradable in an established securities market under subparagraph (2) of this paragraph, or

(iii) If they are convertible obligations to which paragraph (e) of this section applies.

(2) *Readily tradable in an established securities market.* An obligation will be treated as readily tradable in an established securities market if—

(i) The obligation is part of an issue or series of issues which are readily tradable in an established securities market, or

(ii) The corporation issuing the obligation has other obligations of a comparable character which are described in subdivision (i) of this subparagraph.

For purposes of subdivision (ii) of this subparagraph, the determination as to whether there exist obligations of a comparable character depends upon the particular facts and circumstances. Factors to be considered in making such determination include, but are not limited to, substantial similarity with respect to the presence and nature of security for the obligation, the number of obligations issued (or to be issued), the number of holders of such obligation, the principal amount of the obligation, and other relevant factors.

(3) *Readily tradable.* For purposes of subparagraph (2)(i) of this paragraph, an obligation shall be treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such obligation or is part of an issue a portion of which is in fact traded in an established securities market.

(4) *Established securities market.* For purposes of this paragraph, the term established securities market includes (i) a national securities exchange which is registered under section 6 of the Securities and Exchange Act of 1934 (15 U.S.C. 78f), (ii) an exchange which is exempted from registration under section 5 of the Securities Exchange Act of 1935 (15 U.S.C. 78e) because of its limited volume of transactions, and (iii) any over-the-counter market. For purposes of this subparagraph, an over-the-counter market is reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of obligations by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the regular course of his business and containing only quotations of such broker or dealer.

(5) *Examples.* The rules stated in this paragraph may be illustrated by the following examples:

Example 1. On June 1, 1971, 25 individuals owning equal interests in a tract of land with a fair market value of $1 million sell the land to corporation Y. The $1 million sales price is represented by 25 bonds issued by corporation Y each having a face value of $40,000. The bonds are not in registered form and do not have interest coupons attached, and, in addition, are payable in 120 equal installments each due on the first business day of each month. In addition, the bonds are negotiable and may be assigned by the holder to any other person. However, the bonds are not quoted by any brokers or dealers who deal in corporate bonds, and, furthermore, there are no comparable obligations of corporation Y (determined with reference to the characteristics set forth in subparagraph (2) of this paragraph) which are so quoted. Therefore, the bonds are not treated as readily tradable in an established securities market. In addition, under the particular facts and circumstances stated, the bonds will not be considered to be in a form designed to render them readily tradeable in an established securities market. Since the bonds are not in registered form, do not have coupons attached, are not in a form designed to render them readily tradable in an established securities market, the receipt of such bonds by the holder is not treated as a payment for purposes of section 453(b), notwithstanding that they are freely assignable.

Example 2. On April 1, 1972, corporation M purchases in a casual sale of personal property a fleet of trucks from corporation N in exchange for corporation M's negotiable notes, not in registered form and without coupons attached. The corporation M notes are comparable to earlier notes issued by corporation M, which notes are quoted in the Eastern Bond section of the National daily quotation sheet, which is an interdealer quotation system. Both issues of notes are unsecured, held by more than 100 holders, have a maturity date of more than 5 years, and were issued for a comparable principal amount. On the basis of these similar characteristics it appears that the latest notes will also be readily tradable. Since an interdealer system reflects an over-the-counter market, the earlier notes are treated as readily tradable in an established securities market. Since the later notes are obligations comparable to the earlier ones, which are treated as readily tradable in an established securities market, the later notes are also treated as readily tradable in an established securities market (whether or not such notes are actually traded).

(e) *Special rule for convertible securities*—(1) *General rule.* For purposes of paragraph (d)(1) of this section, if an obligation contains a right whereby the holder of such obligation may convert it directly or indirectly into another obligation which would be treated as a payment under paragraph (b) of this section or may convert it directly or indirectly into stock which would be treated as readily tradable or designed to be readily tradable in an established securities market under paragraph (d) of this section, the convertible obligation shall be considered to be in a form designed to render such obligation readily tradable in an established securities market unless such obligation is convertible only at a substantial discount. In determining whether the stock or obligation, into which an obligation is convertible, is readily tradable or designed to be readily tradable in an established securities market, the rules stated in paragraph (d) of this section shall apply, and for purposes of such paragraph (d) if such obligation is convertible into stock then the term ''stock'' shall be substituted for the term ''obligation'' wherever it appears in such paragraph (d).

(2) *Substantial discount rule.* Whether an obligation is convertible at a substantial discount depends upon the particular facts and circumstances. A substantial discount shall be considered to exist if at the time the convertible obligation is issued, the fair market value of the stock or obligation into which the obligation is convertible is less than 80 percent of the fair market value of the obligation (determined by taking into account all relevant factors, including proper discount to reflect the fact that the convertible obligation is not readily tradable in an established securities market and any additional consideration required to be paid by the taxpayer). Also, if a privilege to convert an obligation into stock or an obligation which is readily tradable in an established securities market may not be exercised within a period of 1 year from the date the obligation is issued, a substantial discount shall be considered to exist.

(f) *Effective date.* The provisions of this section shall apply to sales or other dispositions occurring after May 27, 1969, which are not made pursuant to a binding written contract entered into on or before such date. No inference shall be drawn from this section as to any question of law concerning the application of section 453 to sales or other dispositions occurring on or before May 27, 1969.

[T.D. 7197, 37 FR 13532, July 11, 1972]

§ 1.453–4 Sale of real property involving deferred periodic payments.

(a) *In general.* Sales of real property involving deferred payments include (1) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (2) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

(b) *Classes of sales.* Such sales, under either paragraph (a) (1) or (2) of this section, fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of real property which may be accounted for on the installment method, that is, sales of real property in which (i) there are no payments during the taxable year of the sale or (ii) the payments in such taxable year (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price, or

(2) Deferred-payment sales of real property in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

(c) *Determination of ''selling price''.* In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall, for the purpose of determining whether a sale is on the installment plan, be included as a part of the ''selling price''; and for the purpose of determining the payments and the total contract price as those terms are used in section 453, and §§1.453–1 through 1.453–7, the amount of such mortgage shall be included only to the extent that it exceeds the basis of the property. The term ''payments'' does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor shall not reduce the amount of the payments, the total contract price, or the selling price.

[T.D. 6500, 25 FR 11715, Nov. 26, 1960]

§ 1.453–5 Sale of real property treated on installment method.

(a) *In general.* In any transaction described in paragraph (b)(1) of §1.453–4, that is, sales of real property in which there are no payments during the year of sale or the payments in that year do not exceed 30 percent of the selling price, the vendor may return as income from each such transaction in any taxable year that proportion of the installment payments actually received in that year which the gross profit (as described in paragraph (b) of §1.453–1) realized or to be realized when the property is paid for bears to the total contract price. In any case, the sale of each lot or parcel of a subdivided tract must be treated as a separate transaction and gain or loss computed accordingly. (See paragraph (a) of §1.61–6.)

(b) *Defaults and repossessions*—(1) *Effective date.* This paragraph shall apply only with respect to taxable years beginning before September 3, 1964, in respect of which an election has not been properly made to have the provisions of section 1038 apply. For rules applicable to taxable years beginning after September 2, 1964, and for taxable years beginning after December 31, 1957, to which such an election applies, see section 1038, and §§1.1038–1 through 1.1038–3.

(2) *Gain or loss on reacquisition of property.* If the purchaser of real property on the installment plan defaults in any of his payments, and the vendor returning income on the installment method reacquires the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the reacquisition occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the reacquisition or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value at the date of reacquisition of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the reacquisition.

(3) *Fair market value of reacquired property.* If the property reacquired is

bid in by the vendor at a foreclosure sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary.

(4) *Basis of obligations.* The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the reacquisition of the property will be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. For definition of the basis of an installment obligation, see section 453(d)(2) and paragraph (b)(2) of §1.453–9.

(5) *Bad debt deduction.* No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the reacquisition of the property, unless it is clearly shown that after the property was reacquired the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the reacquisition. See section 166 and the regulations thereunder.

(6) *Basis of reacquired property.* If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition, including the fair market value of any fixed improvements placed on the property by the purchaser.

[T.D. 6500, 25 FR 11716, Nov. 26, 1960, as amended by T.D. 6916, 32 FR 5923, Apr. 13, 1967]

§ 1.453–6 Deferred payment sale of real property not on installment method.

(a) *Value of obligations.* (1) In transactions included in paragraph (b)(2) of §1.453–4, that is, sales of real property involving deferred payments in which the payments received during the year of sale exceed 30 percent of the selling price, the obligations of the purchaser received by the vendor are to be considered as an amount realized to the extent of their fair market value in ascertaining the profit or loss from the transaction. Such obligations, however, are not considered in determining whether the payments during the year of sale exceed 30 percent of the selling price.

(2) If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

(b) *Repossession of property where title is retained by vendor*—(1) *Gain or loss on repossession.* If the vendor in sales referred to in paragraph (a) of this section has retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property, the difference between—

(i) The entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser, and

(ii) The sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made, will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed.

(2) *Basis of repossessed property.* The basis of the property described in subparagraph (1) of this paragraph in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser, except that, with respect to repossessions

occurring after September 18, 1958, the basis of the property shall be reduced by what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser if the sale had not been made.

(c) *Reacquisition of property where title is transferred to purchaser*—(1) *Gain or loss on reacquisition.* If the vendor in sales described in paragraph (a) of this section has previously transferred title to the purchaser, and the purchaser defaults in any of his payments, and the vendor accepts a voluntary reconveyance of the property, in partial or full satisfaction of the unpaid portion of the purchase price, the receipt of the property so reacquired, to the extent of its fair market value at that time, including the fair market value of fixed improvements placed on the property by the purchaser, shall be considered as the receipt of payment on the obligations satisfied. If the fair market value of the property is greater than the basis of the obligations of the purchaser so satisfied (generally, such basis being the fair market value of such obligations previously recognized in computing income), the excess constitutes ordinary income. If the value of such property is less than the basis of such obligations, the difference may be deducted as a bad debt if uncollectible, except that, if the obligations satisfied are securities (as defined in section 165(g)(2)(C)), any gain or loss resulting from the transaction is a capital gain or loss subject to the provisions of sections 1201 through 1241.

(2) *Basis of reacquired property.* If the reacquired property described in subparagraph (1) of this paragraph is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition, including the fair market value of the fixed improvements placed on the property by the purchaser. See section 166 and the regulations thereunder with respect to property reacquired by the vendor in a foreclosure proceeding.

(d) *Effective date.* Paragraphs (b) and (c) of this section shall apply only with respect to taxable years beginning before September 3, 1964, in respect of which an election has not been properly made to have the provisions of section 1038 apply. For rules applicable to taxable years beginning after September 2, 1964, and for taxable years beginning after December 31, 1957, to which such an election applies, see section 1038, and §§ 1.1038–1 through 1.1038–3.

[T.D. 6500, 25 FR 11716, Nov. 26, 1960, as amended by T.D. 6916, 32 FR 5923, Apr. 13, 1967]

§§ 1.453–7—1.453–8 [Reserved]

§ 1.453–9 Gain or loss on disposition of installment obligations.

(a) *In general.* Subject to the exceptions contained in section 453(d)(4) and paragraph (c) of this section, the entire amount of gain or loss resulting from any disposition or satisfaction of installment obligations, computed in accordance with section 453(d), is recognized in the taxable year of such disposition or satisfaction and shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received by the taxpayer.

(b) *Computation of gain or loss.* (1) The amount of gain or loss resulting under paragraph (a) of this section is the difference between the basis of the obligation and (i) the amount realized, in the case of satisfaction at other than face value or in the case of a sale or exchange, or (ii) the fair market value of the obligation at the time of disposition, if such disposition is other than by sale or exchange.

(2) The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

(3) The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. In 1960 the M Corporation sold a piece of unimproved real estate to B for $20,000. The company acquired the property in 1948 at a cost of $10,000. During 1960 the company received $5,000 cash and vendee's notes for the remainder of the selling price, or $15,000, payable in subsequent years. In 1962, before the vendee made any further payments, the company sold the notes for

$13,000 in cash. The corporation makes its returns on the calendar year basis. The income to be reported for 1962 is $5,500, computed as follows:

Proceeds of sale of notes	....	$13,000
Selling price of property	$20,000	
Cost of property	10,000	
Total profit	10,000	
Total contract price	20,000	
Percent of profit, or proportion of each payment returnable as income, $10,000 divided by $20,000, 50 percent.		
Face value of notes	15,000	
Amount of income returnable were the notes satisfied in full, 50 percent of $15,000	7,500	
Basis of obligation—excess of face value of notes over amount of income returnable were the notes satisfied in full	7,500	
Taxable income to be reported for 1962		5,500

Example 2. Suppose in Example 1 the M Corporation, instead of selling the notes, distributed them in 1962 to its shareholders as a dividend, and at the time of such distribution, the fair market value of the notes was $14,000. The income to be reported for 1962 is $6,500, computed as follows:

Fair market value of notes	$14,000
Basis of obligation—excess of face value of notes over amount of income returnable were the notes satisfied in full (computed as in Example 1)	7,500
Taxable income to be reported for 1962	6,500

(c) *Disposition from which no gain or loss is recognized.* (1)(i) Under section 453(d)(4)(A), no gain or loss shall be recognized to a distributing corporation with respect to the distribution made after November 13, 1966, of installment obligations if (*a*) the distribution is made pursuant to a plan for the complete liquidation of a subsidiary under section 332, and (*b*) the basis of the such obligations in the hands of the distributee is determined under section 334(b)(1).

(ii) Under section 453(d)(4)(B), no gain or loss shall be recognized to a distributing corporation with respect to the distribution of installment obligations if the distribution is made, pursuant to a plan for the complete liquidation of a corporation which meets the requirements of section 337, under conditions whereby no gain or loss would have been recognized to the corporation had such installment obligations been sold or exchanged on the day of the distribution. The preceding sentence shall not apply to the extent that under section 453(d)(1) gain to the distributing corporation would be considered as gain to which section 341(f)(2), 617(d)(1), 1245(a)(1), 1250(a)(1), 1251(c)(1), 1252(a)(1), or 1254(a)(1) applies, computed under the principles of the regulations under such provisions. See paragraph (d) of §1.1245–6, paragraph (c)(6) of §1.1250–1, paragraph (e)(6) of §1.1251–1, paragraph (d)(3) of §1.1252–1, and paragraph (d) of §1.1254–1.

(2) Where the Code provides for exceptions to the recognition of gain or loss in the case of certain dispositions, no gain or loss shall result under section 453(d) in the case of a disposition of an installment obligation. Such exceptions include: Certain transfers to corporations under sections 351 and 361; contributions of property to a partnership by a partner under section 721; and distributions by a partnership to a partner under section 731 (except as provided by section 736 and section 751).

(3) Any amount received by a person in payment or settlement of an installment obligation acquired in a transaction described in subparagraphs (1) or (2) of this paragraph (other than an amount received by a stockholder with respect to an installment obligation distributed to him pursuant to section 337) shall be considered to have the character it would have had in the hands of the person from whom such installment obligation was acquired.

(d) *Carryover of installment method.* For the treatment of income derived from installment obligations received in transactions to which section 381 (a) is applicable, see section 381(c)(8) and the regulations thereunder.

(e) *Installment obligations transmitted at death.* Where installment obligations are transmitted at death, see section 691(a)(4) and the regulations thereunder for the treatment of amounts considered income in respect of a decedent.

(f) *Losses.* See subchapter P (section 1201 and following), chapter 1 of the Code, as to the limitation on capital losses sustained by corporations and the limitation as to both capital gains and capital losses of individuals.

(g) *Disposition of installment obligations to life insurance companies.* (1) Notwithstanding the provisions of section

453(d)(4) and paragraph (c) of this section or any provision of subtitle A relating to the nonrecognition of gain, the entire amount of any gain realized on the disposition of an installment obligation by any person, other than a life insurance company (as defined in section 801(a) and paragraph (b) of §1.801–3), to a life insurance company or to a partnership of which a life insurance company is a partner shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section. If a corporation which is a life insurance company for the taxable year was a corporation which was not a life insurance company for the preceding taxable year, such corporation shall be treated, for purposes of section 453(d)(1) and this paragraph, as having transferred to a life insurance company, on the last day of the preceding taxable year, all installment obligations which it held on such last day. The gain, if any, realized by reason of the installment obligations being so transferred shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section. Similarly, a partnership of which a life insurance company becomes a partner shall be treated, for purposes of section 453(d)(1) and this paragraph, as having transferred to a life insurance company, on the last day of the preceding taxable year of such partnership, all installment obligations which it holds at the time such life insurance company becomes a partner. The gain, if any, realized by reason of the installment obligations being so transferred shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section.

(2) The provisions of section 453(d)(5) and subparagraph (1) of this paragraph shall not apply to losses sustained in connection with the disposition of installment obligations to a life insurance company.

(3) For the effective date of the provisions of section 453(d)(5) and this paragraph, see paragraph (f) of §1.453–10.

(4) Application of the provisions of this paragraph may be illustrated by the following examples:

Example 1. A, an individual, in a transaction to which section 351 applies, transfers in 1961 certain assets, including installment obligations, to a new corporation, X, which qualifies as a life insurance company (as defined in section 801(a)) for the year 1961. A makes his return on the calendar year basis. Section 453(d)(5) provides that the nonrecognition provisions of section 351 will not apply to the installment obligations transferred by A to X Corporation. Therefore, the entire amount of any gain realized by A on the transfer of the installment obligations shall be recognized in 1961, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example 2. The M Corporation did not qualify as a life insurance company (as defined in section 801(a)) for the taxable year 1958. On December 31, 1958, it held $60,000 of installment obligations. The M Corporation qualified as a life insurance company for the taxable year 1959. Accordingly, the M Corporation is treated as having transferred to a life insurance company, on December 31, 1958, the $60,000 of installment obligations it held on such date. The gain, if any, realized by M by reason of such installment obligations being so transferred shall be recognized in the taxable year 1958, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example 3. During its taxable year 1958, none of the partners of the N partnership qualified as a life insurance company (as defined in section 801(a)). The N partnership held $30,000 of installment obligations on December 31, 1958. On July 30, 1959, the O Corporation, a life insurance company (as defined in section 801(a)), became a partner in the partnership. The N partnership held $50,000 of installment obligations on July 30, 1959. Pursuant to section 453(d)(5), the N partnership is treated as having transferred to a life insurance company, on December 31, 1958, the $50,000 of installment obligations it held on July 30, 1959. The gain, if any, realized by the N partnership by reason of such installment obligations being so transferred shall be recognized in the taxable year 1958, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example 4. In 1960, the P Corporation, in a reorganization qualifying under section 368(a), transferred certain assets (including installment obligations) to the R Corporation, a life insurance company as defined in section 801(a). P realized a loss upon the transfer of the installment obligations, which was not recognized under section 361. Pursuant to subparagraph (2) of paragraph (c) of this section, no loss with respect to the transfer of these obligations will be recognized to P under section 453(d)(1).

[T.D. 6500, 25 FR 11718, Nov. 26, 1960, as amended by T.D. 6590, 27 FR 1319, Feb. 13, 1962; T.D. 7084, 36 FR 267, Jan. 8, 1971; T.D. 7418, 41 FR 18812, May 7, 1976; T.D. 8586, 60 FR 2500, Jan. 10, 1995]

§ 1.453–10 Effective date.

(a) Except as provided in this section, the provisions of section 453 and §§ 1.453–1 through 1.453–9 shall apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(b) The provisions of paragraphs (a) (2) and (3), (b), and (c) of § 1.453–8 shall apply to taxable years ending after December 17, 1958.

(c) Under the provisions of sections 453(b) and 7851(a)(1)(C), section 453(b)(1) and the regulations with respect thereto shall also apply—

(1) To a sale or other disposition during a taxable year beginning before January 1, 1954, only if the income was returnable (by reason of section 44(b) of the Internal Revenue Code of 1939) on the basis and in the manner prescribed in section 44(a) of such code.

(2) To a sale or other disposition during a taxable year beginning after December 31, 1953, and ending before August 17, 1954, though such taxable year is subject to the provisions of the Internal Revenue Code of 1939.

(d) Under the provisions of sections 453(c)(1)(B) and 7851(a)(1)(C) section 453(c) and the regulations with respect thereto shall also apply to taxable years beginning after December 31, 1953, and ending before August 17, 1954, though such taxable years are subject to the provisions of the Internal Revenue Code of 1939.

(e) The provisions of paragraph (b)(3) of § 1.453–6 shall apply to repossessions occurring after December 18, 1958.

(f) The provisions of section 453(d)(5) and paragraph (g) of § 1.453–9 shall apply to taxable years ending after December 31, 1957, but only as to transfers or other dispositions of installment obligations occurring after such date.

[T.D. 6500, 25 FR 11718, Nov. 26, 1960, as amended by T.D. 6590, 27 FR 1320, Feb. 13, 1962; T.D. 6682, 28 FR 11177, Oct. 18, 1963]

§ 1.453–11 Installment obligations received from a liquidating corporation.

(a) *In general*—(1) *Overview*. Except as provided in section 453(h)(1)(C) (relating to installment sales of depreciable property to certain closely related persons), a qualifying shareholder (as defined in paragraph (b) of this section) who receives a qualifying installment obligation (as defined in paragraph (c) of this section) in a liquidation that satisfies section 453(h)(1)(A) treats the receipt of payments in respect of the obligation, rather than the receipt of the obligation itself, as a receipt of payment for the shareholder's stock. The shareholder reports the payments received on the installment method unless the shareholder elects otherwise in accordance with § 15a.453–1(d) of this chapter.

(2) *Coordination with other provisions*—(i) *Deemed sale of stock for installment obligation*. Except as specifically provided in section 453(h)(1)(C), a qualifying shareholder treats a qualifying installment obligation, for all purposes of the Internal Revenue Code, as if the obligation is received by the shareholder from the person issuing the obligation in exchange for the shareholder's stock in the liquidating corporation. For example, if the stock of a corporation that is liquidating is traded on an established securities market, an installment obligation distributed to a shareholder of the corporation in exchange for the shareholder's stock does not qualify for installment reporting pursuant to section 453(k)(2).

(ii) *Special rules to account for the qualifying installment obligation*—(A) *Issue price*. A qualifying installment obligation is treated by a qualifying shareholder as newly issued on the date of the distribution. The issue price of the qualifying installment obligation on that date is equal to the sum of the adjusted issue price of the obligation on the date of the distribution (as determined under § 1.1275–1(b)) and the amount of any qualified stated interest (as defined in § 1.1273–1(c)) that has accrued prior to the distribution but that is not payable until after the distribution. For purposes of the preceding sentence, if the qualifying installment obligation is subject to § 1.446–2 (e.g., a debt instrument that has unstated interest under section 483), the adjusted issue price of the obligation is determined under §1.446–2(c) and (d).

(B) *Variable rate debt instrument.* If the qualifying installment obligation is a variable rate debt instrument (as defined in §1.1275–5), the shareholder uses the equivalent fixed rate debt instrument (within the meaning of §1.1275–5(e)(3)(ii)) constructed for the qualifying installment obligation as of the date the obligation was issued to the liquidating corporation to determine the accruals of original issue discount, if any, and interest on the obligation.

(3) *Liquidating distributions treated as selling price.* All amounts distributed or treated as distributed to a qualifying shareholder incident to the liquidation, including cash, the issue price of qualifying installment obligations as determined under paragraph (a)(2)(ii)(A) of this section, and the fair market value of other property (including obligations that are not qualifying installment obligations) are considered as having been received by the shareholder as the selling price (as defined in §15a.453–1(b)(2)(ii) of this chapter) for the shareholder's stock in the liquidating corporation. For the proper method of reporting liquidating distributions received in more than one taxable year of a shareholder, see paragraph (d) of this section. An election not to report on the installment method an installment obligation received in the liquidation applies to all distributions received in the liquidation.

(4) *Assumption of corporate liability by shareholders.* For purposes of this section, if in the course of a liquidation a shareholder assumes secured or unsecured liabilities of the liquidating corporation, or receives property from the corporation subject to such liabilities (including any tax liabilities incurred by the corporation on the distribution), the amount of the liabilities is added to the shareholder's basis in the stock of the liquidating corporation. These additions to basis do not affect the shareholder's holding period for the stock. These liabilities do not reduce the amounts received in computing the selling price.

(5) *Examples.* The provisions of this paragraph (a) are illustrated by the following examples. Except as otherwise provided, assume in each example that A, an individual who is a calendar-year taxpayer, owns all of the stock of T corporation. A's adjusted tax basis in that stock is $100,000. On February 1, 1998, T, an accrual method taxpayer, adopts a plan of complete liquidation that satisfies section 453(h)(1)(A) and immediately sells all of its assets to unrelated B corporation in a single transaction. The examples are as follows:

Example 1. (i) The stated purchase price for T's assets is $3,500,000. In consideration for the sale, B makes a down payment of $500,000 and issues a 10-year installment obligation with a stated principal amount of $3,000,000. The obligation provides for interest payments of $150,000 on January 31 of each year, with the total principal amount due at maturity.

(ii) Assume that for purposes of section 1274, the test rate on February 1, 1998, is 8 percent, compounded semi-annually. Also assume that a semi-annual accrual period is used. Under §1.1274–2, the issue price of the obligation on February 1, 1998, is $2,368,450. Accordingly, the obligation has $631,550 of original issue discount ($3,000,000–$2,368,450). Between February 1 and July 31, $19,738 of original issue discount and $75,000 of qualified stated interest accrue with respect to the obligation and are taken into account by T.

(iii) On July 31, 1998, T distributes the installment obligation to A in exchange for A's stock. No other property is ever distributed to A. On January 31, 1999, A receives the first annual payment of $150,000 from B.

(iv) When the obligation is distributed to A on July 31, 1998, it is treated as if the obligation is received by A in an installment sale of shares directly to B on that date. Under §1.1275–1(b), the adjusted issue price of the obligation on that date is $2,388,188 (original issue price of $2,368,450 plus accrued original issue discount of $19,738). Accordingly, the issue price of the obligation under paragraph (a)(2)(ii)(A) of this section is $2,463,188, the sum of the adjusted issue price of the obligation on that date ($2,388,188) and the amount of accrued but unpaid qualified stated interest ($75,000).

(v) The selling price and contract price of A's stock in T is $2,463,188, and the gross profit is $2,363,188 ($2,463,188 selling price less A's adjusted tax basis of $100,000). A's gross profit ratio is thus 96 percent (gross profit of $2,363,188 divided by total contract price of $2,463,188).

(vi) Under §§ 1.446–2(e)(1) and 1.1275–2(a), $98,527 of the $150,000 payment is treated as a payment of the interest and original issue discount that accrued on the obligation from July 31, 1998, to January 31, 1999 ($75,000 of qualified stated interest and $23,527 of original issue discount). The balance of the payment ($51,473) is treated as a payment of principal. A's gain recognized in 1999 is $49,414 (96 percent of $51,473).

Example 2. (i) T owns Blackacre, unimproved real property, with an adjusted tax basis of $700,000. Blackacre is subject to a mortgage (underlying mortgage) of $1,100,000. A is not personally liable on the underlying mortgage and the T shares held by A are not encumbered by the underlying mortgage. The other assets of T consist of $400,000 of cash and $600,000 of accounts receivable attributable to sales of inventory in the ordinary course of business. The unsecured liabilities of T total $900,000.

(ii) On February 1, 1998, T adopts a plan of complete liquidation complying with section 453(h)(1)(A), and promptly sells Blackacre to B for a 4-year mortgage note (bearing adequate stated interest and otherwise meeting all of the requirements of section 453) in the face amount of $4 million. Under the agreement between T and B, T (or its successor) is to continue to make principal and interest payments on the underlying mortgage. Immediately thereafter, T completes its liquidation by distributing to A its remaining cash of $400,000 (after payment of T's tax liabilities), accounts receivable of $600,000, and the $4 million B note. A assumes T's $900,000 of unsecured liabilities and receives the distributed property subject to the obligation to make payments on the $1,100,000 underlying mortgage. A receives no payments from B on the B note during 1998.

(iii) Unless A elects otherwise, the transaction is reported by A on the installment method. The selling price is $5 million (cash of $400,000, accounts receivable of $600,000, and the B note of $4 million). The total contract price also is $5 million. A's adjusted tax basis in the T shares, initially $100,000, is increased by the $900,000 of unsecured T liabilities assumed by A and by the obligation (subject to which A takes the distributed property) to make payments on the $1,100,000 underlying mortgage on Blackacre, for an aggregate adjusted tax basis of $2,100,000. Accordingly, the gross profit is $2,900,000 (selling price of $5 million less aggregate adjusted tax basis of $2,100,000). The gross profit ratio is 58 percent (gross profit of $2,900,000 divided by the total contract price of $5 million). The 1998 payments to A are $1 million ($400,000 cash plus $600,000 receivables) and A recognizes gain in 1998 of $580,000 (58 percent of $1 million).

(iv) In 1999, A receives payment from B on the B note of $1 million (exclusive of interest). A's gain recognized in 1999 is $580,000 (58 percent of $1 million).

(b) *Qualifying shareholder.* For purposes of this section, *qualifying shareholder* means a shareholder to which, with respect to the liquidating distribution, section 331 applies. For example, a creditor that receives a distribution from a liquidating corporation, in exchange for the creditor's claim, is not a qualifying shareholder as a result of that distribution regardless of whether the liquidation satisfies section 453(h)(1)(A).

(c) *Qualifying installment obligation*—(1) *In general.* For purposes of this section, *qualifying installment obligation* means an installment obligation (other than an evidence of indebtedness described in § 15a.453–1(e) of this chapter, relating to obligations that are payable on demand or are readily tradable) acquired in a sale or exchange of corporate assets by a liquidating corporation during the 12-month period beginning on the date the plan of liquidation is adopted. See paragraph (c)(4) of this section for an exception for installment obligations acquired in respect of certain sales of inventory. Also see paragraph (c)(5) of this section for an exception for installment obligations attributable to sales of certain property that do not generally qualify for installment method treatment.

(2) *Corporate assets.* Except as provided in section 453(h)(1)(C), in paragraph (c)(4) of this section (relating to certain sales of inventory), and in paragraph (c)(5) of this section (relating to certain tax avoidance transactions), the nature of the assets sold by, and the tax consequences to, the selling corporation do not affect whether an installment obligation is a qualifying installment obligation. Thus, for example, the fact that the fair market value of an asset is less than the adjusted basis of that asset in the hands of the corporation; or that the sale of an asset will subject the corporation to depreciation recapture (e.g., under section 1245 or section 1250); or that the assets of a trade or business sold by the corporation for an installment obligation include depreciable property, certain marketable securities, accounts receivable, installment obligations, or cash; or that the distribution of assets

to the shareholder is or is not taxable to the corporation under sections 336 and 453B, does not affect whether installment obligations received in exchange for those assets are treated as qualifying installment obligations by the shareholder. However, an obligation received by the corporation in exchange for cash, in a transaction unrelated to a sale or exchange of noncash assets by the corporation, is not treated as a qualifying installment obligation.

(3) *Installment obligations distributed in liquidations described in section 453(h)(1)(E)*—(i) *In general*. In the case of a liquidation to which section 453(h)(1)(E) (relating to certain liquidating subsidiary corporations) applies, a qualifying installment obligation acquired in respect of a sale or exchange by the liquidating subsidiary corporation will be treated as a qualifying installment obligation if distributed by a controlling corporate shareholder (within the meaning of section 368(c)) to a qualifying shareholder. The preceding sentence is applied successively to each controlling corporate shareholder, if any, above the first controlling corporate shareholder.

(ii) *Examples*. The provisions of this paragraph (c)(3) are illustrated by the following examples:

Example 1. (i) A, an individual, owns all of the stock of T corporation, a C corporation. T has an operating division and three wholly-owned subsidiaries, X, Y, and Z. On February 1, 1998, T, Y, and Z all adopt plans of complete liquidation.

(ii) On March 1, 1998, the following sales are made to unrelated purchasers: T sells the assets of its operating division to B for cash and an installment obligation. T sells the stock of X to C for an installment obligation. Y sells all of its assets to D for an installment obligation. Z sells all of its assets to E for cash. The B, C, and D installment obligations bear adequate stated interest and meet the requirements of section 453.

(iii) In June 1998, Y and Z completely liquidate, distributing their respective assets (the D installment obligation and cash) to T. In July 1998, T completely liquidates, distributing to A cash and the installment obligations respectively issued by B, C, and D. The liquidation of T is a liquidation to which section 453(h) applies and the liquidations of Y and Z into T are liquidations to which section 332 applies.

(iv) Because T is in control of Y (within the meaning of section 368(c)), the D obligation acquired by Y is treated as acquired by T pursuant to section 453(h)(1)(E). A is a qualifying shareholder and the installment obligations issued by B, C, and D are qualifying installment obligations. Unless A elects otherwise, A reports the transaction on the installment method as if the cash and installment obligations had been received in an installment sale of the stock of T corporation. Under section 453B(d), no gain or loss is recognized by Y on the distribution of the D installment obligation to T. Under sections 453B(a) and 336, T recognizes gain or loss on the distribution of the B, C, and D installment obligations to A in exchange for A's stock.

Example 2. (i) A, a cash-method individual taxpayer, owns all of the stock of P corporation, a C corporation. P owns 30 percent of the stock of Q corporation. The balance of the Q stock is owned by unrelated individuals. On February 1, 1998, P adopts a plan of complete liquidation and sells all of its property, other than its Q stock, to B, an unrelated purchaser for cash and an installment obligation bearing adequate stated interest. On March 1, 1998, Q adopts a plan of complete liquidation and sells all of its property to an unrelated purchaser, C, for cash and installment obligations. Q immediately distributes the cash and installment obligations to its shareholders in completion of its liquidation. Promptly thereafter, P liquidates, distributing to A cash, the B installment obligation, and a C installment obligation that P received in the liquidation of Q.

(ii) In the hands of A, the B installment obligation is a qualifying installment obligation. In the hands of P, the C installment obligation was a qualifying installment obligation. However, in the hands of A, the C installment obligation is not treated as a qualifying installment obligation because P owned only 30 percent of the stock of Q. Because P did not own the requisite 80 percent stock interest in Q, P was not a controlling corporate shareholder of Q (within the meaning of section 368(c)) immediately before the liquidation. Therefore, section 453(h)(1)(E) does not apply. Thus, in the hands of A, the C obligation is considered to be a third-party note (not a purchaser's evidence of indebtedness) and is treated as a payment to A in the year of distribution. Accordingly, for 1998, A reports as payment the cash and the fair market value of the C obligation distributed to A in the liquidation of P.

(iii) Because P held 30 percent of the stock of Q, section 453B(d) is inapplicable to P. Under sections 453B(a) and 336, accordingly, Q recognizes gain or loss on the distribution of the C obligation. P also recognizes gain or loss on the distribution of the B and C installment obligations to A in exchange for A's stock. See sections 453B and 336.

(4) *Installment obligations attributable to certain sales of inventory*—(i) *In general.* An installment obligation acquired by a corporation in a liquidation that satisfies section 453(h)(1)(A) in respect of a broken lot of inventory is not a qualifying installment obligation. If an installment obligation is acquired in respect of a broken lot of inventory and other assets, only the portion of the installment obligation acquired in respect of the broken lot of inventory is not a qualifying installment obligation. The portion of the installment obligation attributable to other assets is a qualifying installment obligation. For purposes of this section, the term *broken lot of inventory* means inventory property that is sold or exchanged other than in bulk to one person in one transaction involving substantially all of the inventory property attributable to a trade or business of the corporation. See paragraph (c)(4)(ii) of this section for rules for determining what portion of an installment obligation is not a qualifying installment obligation and paragraph (c)(4)(iii) of this section for rules determining the application of payments on an installment obligation only a portion of which is a qualifying installment obligation.

(ii) *Rules for determining nonqualifying portion of an installment obligation.* If a broken lot of inventory is sold to a purchaser together with other corporate assets for consideration consisting of an installment obligation and either cash, other property, the assumption of (or taking property subject to) corporate liabilities by the purchaser, or some combination thereof, the installment obligation is treated as having been acquired in respect of a broken lot of inventory only to the extent that the fair market value of the broken lot of inventory exceeds the sum of unsecured liabilities assumed by the purchaser, secured liabilities which encumber the broken lot of inventory and are assumed by the purchaser or to which the broken lot of inventory is subject, and the sum of the cash and fair market value of other property received. This rule applies solely for the purpose of determining the portion of the installment obligation (if any) that is attributable to the broken lot of inventory.

(iii) *Application of payments.* If, by reason of the application of paragraph (c)(4)(ii) of this section, a portion of an installment obligation is not a qualifying installment obligation, then for purposes of determining the amount of gain to be reported by the shareholder under section 453, payments on the obligation (other than payments of qualified stated interest) shall be applied first to the portion of the obligation that is not a qualifying installment obligation.

(iv) *Example.* The following example illustrates the provisions of this paragraph (c)(4). In this example, assume that all obligations bear adequate stated interest within the meaning of section 1274(c)(2) and that the fair market value of each nonqualifying installment obligation equals its face amount. The example is as follows:

Example. (i) P corporation has three operating divisions, X, Y, and Z, each engaged in a separate trade or business, and a minor amount of investment assets. On July 1, 1998, P adopts a plan of complete liquidation that meets the criteria of section 453(h)(1)(A). The following sales are promptly made to purchasers unrelated to P: P sells all of the assets of the X division (including all of the inventory property) to B for $30,000 cash and installment obligations totalling $200,000. P sells substantially all of the inventory property of the Y division to C for a $100,000 installment obligation, and sells all of the other assets of the Y division (excluding cash but including installment receivables previously acquired in the ordinary course of the business of the Y division) to D for a $170,000 installment obligation. P sells ⅓ of the inventory property of the Z division to E for $100,000 cash, ⅓ of the inventory property of the Z division to F for a $100,000 installment obligation, and all of the other assets of the Z division (including the remaining ⅓ of the inventory property worth $100,000) to G for $60,000 cash, a $240,000 installment obligation, and the assumption by G of the liabilities of the Z division. The liabilities assumed by G, which are unsecured liabilities and liabilities encumbering the inventory property acquired by G, aggregate $30,000. Thus, the total purchase price G pays is $330,000.

(ii) P immediately completes its liquidation, distributing the cash and installment obligations, which otherwise meet the requirements of section 453, to A, an individual cash-method taxpayer who is its sole shareholder. In 1999, G makes a payment to A of

$100,000 (exclusive of interest) on the $240,000 installment obligation.

(iii) In the hands of A, the installment obligations issued by B, C, and D are qualifying installment obligations because they were timely acquired by P in a sale or exchange of its assets. In addition, the installment obligation issued by C is a qualifying installment obligation because it arose from a sale to one person in one transaction of substantially all of the inventory property of the trade or business engaged in by the Y division.

(iv) The installment obligation issued by F is not a qualifying installment obligation because it is in respect of a broken lot of inventory. A portion of the installment obligation issued by G is a qualifying installment obligation and a portion is not a qualifying installment obligation, determined as follows: G purchased part of the inventory property (with a fair market value of $100,000) and all of the other assets of the Z division by paying cash ($60,000), issuing an installment obligation ($240,000), and assuming liabilities of the Z division ($30,000). The assumed liabilities ($30,000) and cash ($60,000) are attributed first to the inventory property. Therefore, only $10,000 of the $240,000 installment obligation is attributed to inventory property. Accordingly, in the hands of A, the G installment obligation is a qualifying installment obligation to the extent of $230,000, but is not a qualifying installment obligation to the extent of the $10,000 attributable to the inventory property.

(v) In the 1998 liquidation of P, A receives a liquidating distribution as follows:

Item	Qualifying installment obligations	Cash and other property
Cash	....	$190,000
B note	$200,000	....
C note	$100,000	....
D note	$170,000	....
F note	....	$100,000
G note [1]	$230,000	$ 10,000
Total	$700,000	$300,000

[1] Face amount $240,000.

(vi) Assume that A's adjusted tax basis in the stock of P is $100,000. Under the installment method, A's selling price and the contract price are both $1 million, the gross profit is $900,000 (selling price of $1 million less adjusted tax basis of $100,000), and the gross profit ratio is 90 percent (gross profit of $900,000 divided by the contract price of $1 million). Accordingly, in 1998, A reports gain of $270,000 (90 percent of $300,000 payment in cash and other property). A's adjusted tax basis in each of the qualifying installment obligations is an amount equal to 10 percent of the obligation's respective face amount. A's adjusted tax basis in the F note, a nonqualifying installment obligation, is $100,000, i.e., the fair market value of the note when received by A. A's adjusted tax basis in the G note, a mixed obligation, is $33,000 (10 percent of the $230,000 qualifying installment obligation portion of the note, plus the $10,000 nonqualifying portion of the note).

(vii) With respect to the $100,000 payment received from G in 1999, $10,000 is treated as the recovery of the adjusted tax basis of the nonqualifying portion of the G installment obligation and $9,000 (10 percent of $90,000) is treated as the recovery of the adjusted tax basis of the portion of the note that is a qualifying installment obligation. The remaining $81,000 (90 percent of $90,000) is reported as gain from the sale of A's stock. See paragraph (c)(4)(iii) of this section.

(5) *Installment obligations attributable to sales of certain property*—(i) *In general.* An installment obligation acquired by a liquidating corporation, to the extent attributable to the sale of property described in paragraph (c)(5)(ii) of this section, is not a qualifying obligation if the corporation is formed or availed of for a principal purpose of avoiding section 453(b)(2) (relating to dealer dispositions and certain other dispositions of personal property), section 453(i) (relating to sales of property subject to recapture), or section 453(k) (relating to dispositions under a revolving credit plan and sales of stock or securities traded on an established securities market) through the use of a party bearing a relationship, either directly or indirectly, described in section 267(b) to any shareholder of the corporation.

(ii) *Covered property.* Property is described in this paragraph (c)(5)(ii) if, within 12 months before or after the adoption of the plan of liquidation, the property was owned by any shareholder and—

(A) The shareholder regularly sold or otherwise disposed of personal property of the same type on the installment plan or the property is real property that the shareholder held for sale to customers in the ordinary course of a trade or business (provided the property is not described in section 453(l)(2) (relating to certain exceptions to the definition of dealer dispositions));

(B) The sale of the property by the shareholder would result in recapture income (within the meaning of section 453(i)(2)), but only if the amount of the recapture income is equal to or greater than 50 percent of the property's fair market value on the date of the sale by the corporation;

(C) The property is stock or securities that are traded on an established securities market; or

(D) The sale of the property by the shareholder would have been under a revolving credit plan.

(iii) *Safe harbor*. Paragraph (c)(5)(i) of this section will not apply to the liquidation of a corporation if, on the date the plan of complete liquidation is adopted and thereafter, less than 15 percent of the fair market value of the corporation's assets is attributable to property described in paragraph (c)(5)(ii) of this section.

(iv) *Example*. The provisions of this paragraph (c)(5) are illustrated by the following example:

Example. Ten percent of the fair market value of the assets of T is attributable to stock and securities traded on an established securities market. T owns no other assets described in paragraph (c)(5)(ii) of this section. T, after adopting a plan of complete liquidation, sells all of its stock and securities holdings to C corporation in exchange for an installment obligation bearing adequate stated interest, sells all of its other assets to B corporation for cash, and distributes the cash and installment obligation to its sole shareholder, A, in a complete liquidation that satisfies section 453(h)(1)(A). Because the C installment obligation arose from a sale of publicly traded stock and securities, T cannot report the gain on the sale under the installment method pursuant to section 453(k)(2). In the hands of A, however, the C installment obligation is treated as having arisen out of a sale of the stock of T corporation. In addition, the general rule of paragraph (c)(5)(i) of this section does not apply, even if a principal purpose of the liquidation was the avoidance of section 453(k)(2), because the fair market value of the publicly traded stock and securities is less than 15 percent of the total fair market value of T's assets. Accordingly, section 453(k)(2) does not apply to A, and A may use the installment method to report the gain recognized on the payments it receives in respect of the obligation.

(d) *Liquidating distributions received in more than one taxable year*. If a qualifying shareholder receives liquidating distributions to which this section applies in more than one taxable year, the shareholder must reasonably estimate the gain attributable to distributions received in each taxable year. In allocating basis to calculate the gain for a taxable year, the shareholder must reasonably estimate the anticipated aggregate distributions. For this purpose, the shareholder must take into account distributions and other relevant events or information that the shareholder knows or reasonably could know up to the date on which the federal income tax return for that year is filed. If the gain for a taxable year is properly taken into account on the basis of a reasonable estimate and the exact amount is subsequently determined the difference, if any, must be taken into account for the taxable year in which the subsequent determination is made. However, the shareholder may file an amended return for the earlier year in lieu of taking the difference into account for the subsequent taxable year.

(e) *Effective date*. This section is applicable to distributions of qualifying installment obligations made on or after January 28, 1998.

[T.D. 8762, 63 FR 4170, Jan. 28, 1998]

§ 1.453–12 Allocation of unrecaptured section 1250 gain reported on the installment method.

(a) *General rule*. Unrecaptured section 1250 gain, as defined in section 1(h)(7), is reported on the installment method if that method otherwise applies under section 453 or 453A and the corresponding regulations. If gain from an installment sale includes unrecaptured section 1250 gain and adjusted net capital gain (as defined in section 1(h)(4)), the unrecaptured section 1250 gain is taken into account before the adjusted net capital gain.

(b) *Installment payments from sales before May 7, 1997*. The amount of unrecaptured section 1250 gain in an installment payment that is properly taken into account after May 6, 1997, from a sale before May 7, 1997, is determined as if, for all payments properly taken into account after the date of sale but before May 7, 1997, unrecaptured section 1250 gain had been taken into account before adjusted net capital gain.

(c) *Installment payments received after May 6, 1997, and on or before August 23, 1999*. If the amount of unrecaptured section 1250 gain in an installment payment that is properly taken into account after May 6, 1997, and on or before August 23, 1999, is less than the amount that would have been taken into account under this section, the lesser amount is used to determine the amount of unrecaptured section 1250 gain that remains to be taken into account.

(d) *Examples*. In each example, the taxpayer, an individual whose taxable year is the calendar year, does not elect out of the installment method. The installment obligation bears adequate stated interest, and the property sold is real property held in a trade or business that qualifies as both section 1231 property and section 1250 property. In all taxable years, the taxpayer's marginal tax rate on ordinary income is 28 percent. The following examples illustrate the rules of this section:

Example 1. General rule. This example illustrates the rule of paragraph (a) of this section as follows:

(i) In 1999, A sells property for $10,000, to be paid in ten equal annual installments beginning on December 1, 1999. A originally purchased the property for $5000, held the property for several years, and took straight-line depreciation deductions in the amount of $3000. In each of the years 1999–2008, A has no other capital or section 1231 gains or losses.

(ii) A's adjusted basis at the time of the sale is $2000. Of A's $8000 of section 1231 gain on the sale of the property, $3000 is attributable to prior straight-line depreciation deductions and is unrecaptured section 1250 gain. The gain on each installment payment is $800.

(iii) As illustrated in the table in this paragraph (iii) of this *Example 1.*, A takes into account the unrecaptured section 1250 gain first. Therefore, the gain on A's first three payments, received in 1999, 2000, and 2001, is taxed at 25 percent. Of the $800 of gain on the fourth payment, received in 2002, $600 is taxed at 25 percent and the remaining $200 is taxed at 20 percent. The gain on A's remaining six installment payments is taxed at 20 percent. The table is as follows:

	1999	2000	2001	2002	2003	2004–2008	Total gain
Installment gain	800	800	800	800	800	4000	8000
Taxed at 25%	800	800	800	600			3000
Taxed at 20%				200	800	4000	5000
Remaining to be taxed at 25%	2200	1400	600				

Example 2. Installment payments from sales prior to May 7, 1997. This example illustrates the rule of paragraph (b) of this section as follows:

(i) The facts are the same as in *Example 1* except that A sold the property in 1994, received the first of the ten annual installment payments on December 1, 1994, and had no other capital or section 1231 gains or losses in the years 1994–2003.

(ii) As in *Example 1*, of A's $8000 of gain on the sale of the property, $3000 was attributable to prior straight-line depreciation deductions and is unrecaptured section 1250 gain.

(iii) As illustrated in the following table, A's first three payments, in 1994, 1995, and 1996, were received before May 7, 1997, and taxed at 28 percent. Under the rule described in paragraph (b) of this section, A determines the allocation of unrecaptured section 1250 gain for each installment payment after May 6, 1997, by taking unrecaptured section 1250 gain into account first, treating the general rule of paragraph (a) of this section as having applied since the time the property was sold, in 1994. Consequently, of the $800 of gain on the fourth payment, received in 1997, $600 is taxed at 25 percent and the remaining $200 is taxed at 20 percent. The gain on A's remaining six installment payments is taxed at 20 percent. The table is as follows:

	1994	1995	1996	1997	1998	1999-2003	Total gain
Installment gain	800	800	800	800	800	4000	8000
Taxed at 28%	800	800	800				2400
Taxed at 25%				600			600
Taxed at 20%				200	800	4000	5000
Remaining to be taxed at 25%	2200	1400	600				

Example 3. Effect of section 1231(c) recapture. This example illustrates the rule of paragraph (a) of this section when there are non-recaptured net section 1231 losses, as defined in section 1231(c)(2), from prior years as follows:

(i) The facts are the same as in *Example 1,* except that in 1999 A has non-recaptured net section 1231 losses from the previous four years of $1000.

(ii) As illustrated in the table in paragraph (iv) of this *Example 3,* in 1999, all of A's $800 installment gain is recaptured as ordinary income under section 1231(c). Under the rule described in paragraph (a) of this section, for purposes of determining the amount of unrecaptured section 1250 gain remaining to be taken into account, the $800 recaptured as ordinary income under section 1231(c) is treated as reducing unrecaptured section 1250 gain, rather than adjusted net capital gain. Therefore, A has $2200 of unrecaptured section 1250 gain remaining to be taken into account.

(iii) In the year 2000, A's installment gain is taxed at two rates. First, $200 is recaptured as ordinary income under section 1231(c). Second, the remaining $600 of gain on A's year 2000 installment payment is taxed at 25 percent. Because the full $800 of gain reduces unrecaptured section 1250 gain, A has $1400 of unrecaptured section 1250 gain remaining to be taken into account.

(iv) The gain on A's installment payment received in 2001 is taxed at 25 percent. Of the $800 of gain on the fourth payment, received in 2002, $600 is taxed at 25 percent and the remaining $200 is taxed at 20 percent. The gain on A's remaining six installment payments is taxed at 20 percent. The table is as follows:

	1999	2000	2001	2002	2003	2004-2008	Total gain
Installment gain	800	800	800	800	800	4000	8000
Taxed at ordinary rates under section 1231(c)	800	200					1000
Taxed at 25%		600	800	600			2000
Taxed at 20%				200	800	4000	5000
Remaining non-recaptured net section 1231 losses	200						
Remaining to be taxed at 25%	2200	1400	600				

Example 4. Effect of a net section 1231 loss. This example illustrates the application of paragraph (a) of this section when there is a net section 1231 loss as follows:

(i) The facts are the same as in *Example 1* except that A has section 1231 losses of $1000 in 1999.

(ii) In 1999, A's section 1231 installment gain of $800 does not exceed A's section 1231 losses of $1000. Therefore, A has a net section 1231 loss of $200. As a result, under section 1231(a) all of A's section 1231 gains and losses are treated as ordinary gains and losses. As illustrated in the following table, A's entire $800 of installment gain is ordinary gain. Under the rule described in paragraph (a) of this section, for purposes of determining the amount of unrecaptured section 1250 gain remaining to be taken into account, A's $800 of ordinary section 1231 installment gain in 1999 is treated as reducing unrecaptured section 1250 gain. Therefore, A has $2200 of unrecaptured section 1250 gain remaining to be taken into account.

(iii) In the year 2000, A has $800 of section 1231 installment gain, resulting in a net section 1231 gain of $800. A also has $200 of non-recaptured net section 1231 losses. The $800 gain is taxed at two rates. First, $200 is taxed at ordinary rates under section 1231(c), recapturing the $200 net section 1231 loss sustained in 1999. Second, the remaining $600 of gain on A's year 2000 installment payment is taxed at 25 percent. As in *Example 3,* the $200 of section 1231(c) gain is treated as reducing unrecaptured section 1250 gain, rather than adjusted net capital gain. Therefore, A has $1400 of unrecaptured section 1250 gain remaining to be taken into account.

(iv) The gain on A's installment payment received in 2001 is taxed at 25 percent, reducing the remaining unrecaptured section 1250 gain to $600. Of the $800 of gain on the fourth payment, received in 2002, $600 is taxed at 25 percent and the remaining $200 is taxed at 20 percent. The gain on A's remaining six installment payments is taxed at 20 percent. The table is as follows:

	1999	2000	2001	2002	2003	2004–2008	Total gain
Installment gain	800	800	800	800	800	4000	8000
Ordinary gain under section 1231(a)	800						800
Taxed at ordinary rates under section 1231(c)		200					200
Taxed at 25%		600	800	600			2000
Taxed at 20%				200	800	4000	5000
Net section 1231 loss	200						

	1999	2000	2001	2002	2003	2004–2008	Total gain
Remaining to be taxed at 25%	2200	1400	600	....	....	....	....

(e) *Effective date.* This section applies to installment payments properly taken into account after August 23, 1999.

[T.D. 8836, 64 FR 45875, Aug. 23, 1999]

§ 1.453A–0 Table of contents.

This section lists the paragraphs and subparagraphs contained in §§ 1.453A–1 through 1.453A–3.

[T.D. 8270, 54 FR 46376, Nov. 3, 1989]

§ 1.453A–1 Installment method of reporting income by dealers on personal property.

(a) *In general.* A dealer (as defined in paragraph (c)(1) of this section) may elect to return the income from the sale of personal property on the installment method if such sale is a sale on the installment plan (as defined in paragraphs (c)(3) and (d) of this section). Under the installment method of accounting, a taxpayer may return as income from installment sales in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when the property is paid for bears to the total contract price. For this purpose, gross profit means sales less cost of goods sold. See paragraph (d) of this section for additional rules relating to the computation of income under the installment method of accounting. In addition, see § 1.453A–2 for rules treating revolving credit plans as installment plans for taxable years beginning on or before December 31, 1986.

(b) *Effect of security.* A dealer may adopt (but is not required to do so) one of the following four ways of protecting against loss in case of default by the purchaser:

(1) An agreement that title is to remain in the vendor until performance of the purchaser's part of the transaction is completed;

(2) A form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the selling price;

(3) A present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the vendor; or

(4) A conveyance to a trustee pending performance of the contract and subject to its provisions.

(c) *Definitions of dealer, sale, and sale on the installment plan.* For purposes of the regulations under section 453A—

(1) The term ''dealer'' means a person who regularly sells or otherwise disposes of personal property on the installment plan;

(2) The term ''sale'' includes sales and other dispositions; and

(3) Except as provided in paragraph (d)(2) of this section, the term ''sale on the installment plan'' means—

(i) A sale of personal property by the taxpayer under any plan for the sale of personal property, which plan, by its terms and conditions, contemplates that each sale under the plan will be paid for in two or more payments; or

(ii) A sale of personal property by the taxpayer under any plan for the sale of personal property—

(A) Which plan, by its terms and conditions, contemplates that such sale will be paid for in two or more payments; and

(B) Which sale is in fact paid for in two or more payments.

(d) *Installment plans*—(1) *Traditional installment plans.* A traditional installment plan usually has the following characteristics:

(i) The execution of a separate installment contract for each sale or disposition of personal property; and

(ii) The retention by the dealer of some type of security interest in such property.

Normally, a sale under a traditional installment plan meets the requirements of paragraph (c)(3)(i) of this section.

(2) *Revolving credit plans.* Sales under a revolving credit plan (within the meaning of § 1.453A–2(c)(1))—

(i) Are treated, for taxable years beginning on or before December 31, 1986, as sales on the installment plan to the extent provided in § 1.453A–2, which provides for the application of the requirements of paragraph (c)(3)(ii) of this section to sales under revolving credit plans; and

(ii) Are not treated as sales on the installment plan for taxable years beginning after December 31, 1986.

(e) *Installment income of dealers in personal property*—(1) *In general.* The income from sales on the installment plan of a dealer may be ascertained by treating as income that proportion of the total payments received in the taxable year from sales on the installment plan (such payments being allocated to the year against the sales of which they apply) which the gross profit realized or to be realized on the total sales on the installment plan made during each year bears to the total contract price of all such sales made during that respective year. However, if the dealer demonstrates to the satisfaction of the district director that income from sales on the installment plan is clearly reflected, the income from such sales may be ascertained by treating as income that proportion of the total payments received in the taxable year from sales on the installment plan (such payments being allocated to the year against the sales of which they apply) which either:

(i) The gross profit realized or to be realized on the total credit sales made during each year bears to the total contract price of all credit sales during that respective year, or

(ii) The gross profit realized or to be realized on all sales made during each year bears to the total contract price of all sales made during that respective year.

A dealer who desires to compute income by the installment method shall maintain accounting records in such a manner as to enable an accurate computation to be made by such method in accordance with the provisions of this section, section 446, and § 1.446–1.

(2) *Gross profit and total contract price.* For purposes of paragraph (e)(1) of this section, in computing the gross profit realized or to be realized on the total sales on the installment plan, there shall be included in the total selling price and, thus, in the total contract price of all such sales.

(i) The amount of carrying charges or interest which is determined at the time of each sale and is added to the established cash selling price of such property and is treated as part of the selling price for customer billing purposes, and

(ii) In the case of sales made in taxable years beginning on or after January 1, 1960, the amount of carrying charges or interest determined with respect to such sales which are added contemporaneously with the sale on the books of account of the seller but are treated as periodic service charges for customer billing purposes.

Any change in the amount of the carrying charges or interest in a year subsequent to the sale will not affect the computation of the gross profit for the year of sale but will be taken into account at the time the carrying charges or interest are adjusted. The application of this paragraph (e)(2) to carrying charges or interest described in paragraph (e)(2)(ii) of this section may be illustrated by the following example:

Example. X Corporation makes sales on the traditional installment plan. The customer's order specifies that the total price consists of a cash price plus a "time price differential" of 1½ percent per month on the outstanding balance in the customer's account, and the customer is billed in this manner. On its books and for purposes of reporting to stockholders, X Corporation consistently makes the following entries each month when it records its sales. A debit entry is make to accounts receivable (for the total price) and balancing credit entries are made to sales (for the established selling price) and to a reserve account for collection expense (for the amount of the time price differential). In computing the gross profit realized or to be realized on the total sales on the installment plan, the total selling price and, thus, the total contract price for purposes of this paragraph (e) would, with respect to sales made in taxable years beginning on or after January 1, 1960, include the time price differential.

(3) *Carrying charges not included in total contract price.* In the case of sales by dealers in personal property made during taxable years beginning after December 31, 1963, the income from which is returned on the installment method, if the carrying charges or interest with respect to such sales is not included in the total contract price, payments received with respect to such sales shall be treated as applying first against such carrying charges or interest.

(f) Other accounting methods. If the vendor chooses as a matter of consistent practice to return the income from installment sales on an accrual method (,) such a course is permissible.

(g) Records. In adopting the installment method of accounting the seller must maintain such records as are necessary to clearly reflect income in accordance with this section, section 446 and §1.446–1.

(h) *Effective date.* This section applies for taxable years beginning after December 31, 1953, and ending after August 16, 1954, but generally does not apply to sales made after December 31, 1987, in taxable years ending after such date. For sales made after December 31, 1987, sales made by a dealer in personal or real property shall not be treated as sales on the installment plan. (However, see section 453(l)(2) for exceptions to this rule.)

[T.D. 8270, 54 FR 46377, Nov. 3, 1989]

§ 1.453A–2 Treatment of revolving credit plans; taxable years beginning on or before December 31, 1986.

(a) *In general.* If a dealer sells or otherwise disposes of personal property under a revolving credit plan—

(1) Such sales will be treated as sales on the installment plan to the extent provided in paragraph (c) of this section;

(2) Income from sales treated as sales on the installment plan under paragraph (c) of this section may be returned on the installment method; and

(3) Income returned on the installment method is computed in accordance with §1.453A–1, except that—

(i) The gross profit on such sales is computed without regard to §1.453A–1(e)(2);

(ii) Under the circumstances described in paragraph (c)(6)(vi) of this section, the taxpayer may, in computing income for a taxable year, treat all such sales as sales made in such taxable year for purposes of applying the gross profit percentage; and

(iii) The rule contained in §1.453A–1(e)(3) is applied in accordance with paragraph (c)(6)(v) of this section.

(b) *Coordination with traditional installment plan.* A dealer who makes sales of personal property under both a revolving credit plan and a traditional installment plan (1) may elect to report only sales under the traditional installment plan on the installment method, (2) may elect to report only sales under the revolving credit plan on the installment method, or (3) may elect to report both sales under the revolving credit plan and the traditional installment plan on the installment method.

(c) *Revolving credit plans.* (1) To the extent provided in this paragraph (c) sales under a revolving credit plan will be treated as sales on the installment plan. The term ''revolving credit plan'' includes cycle budget accounts, flexible budget accounts, continuous budget accounts, and other similar plans or arrangements for the sale of personal property under which the customer agrees to pay each billing-month (as defined in paragraph (c)(6)(iii) of this section) a part of the outstanding balance of the customer's account. Sales under a revolving credit plan do not constitute sales on the installment plan merely by reason of the fact that the total debt at the end of a billing-month is paid in installments. The terms and conditions of a revolving credit plan do not contemplate that each sale under the plan will be paid for in two or more payments and thus do not meet the requirements of §1.453A–1(c)(3)(i). In addition, since under a revolving credit plan payments are not generally applied to liquidate any particular sale, and since the terms and conditions of such plan contemplate that account balances may be paid in full or in installments, it is generally impossible to determine that a particular sale under a revolving credit plan is to be or is in fact paid for in installments so as to meet the requirements of §1.453A–1 (c)(3)(ii). However, paragraphs (c) (2) and (3) of this section provides rules under which a certain percentage of charges under a revolving credit plan will be treated as sales on the installment plan. For purposes of arriving at this percentage, these rules, in general, treat as sales on the plan those sales under a revolving installment credit plan:

(i) Which are of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments and

(ii) Which are charged to accounts on which subsequent payments indicate that such sales are being paid for in two or more installments.

(2)(i) The percentage of charges under a revolving credit plan which will be treated as sales on the installment plan shall be computed by making an actual segregation of charges in a probability sample of the revolving credit accounts and by applying the rules contained in paragraph (c)(3) of this section to determine what percentage of charges in the sample is to be treated as sales on the installment plan. (See paragraph (c)(5) of this section for rules to be used if some of the sales under a revolving credit plan are nonpersonal property sales (as defined in paragraph (c)(6)(iv) of this section).) Such segregation shall be made of charges which make up the balances in the sample accounts as of the end of each customer's last billing-month ending within the taxable year. (See paragraph (c)(6)(v) of this section for rules to be used in determining which charges make up the balance of an account.) However, in making such segregation, any account to which a sale is charged during the taxable year on which no payment is credited after the billing-month within which the sale is made (hereinafter called the ''billing-month of sale'') and on or before the end of the first billing-month ending in the taxpayer's next taxable year shall be disregarded and not taken into account in the determination of what percentage of charges in the sample is to be treated as sales on the installment plan. In order to obtain a probability sample, the accounts shall be selected in accordance with generally accepted probability sampling techniques. The appropriateness of the sampling technique and the accuracy and reliability of the results obtained must, if requested, be demonstrated to the satisfaction of the district director. If the district director is not satisfied that the taxpayer's sample is appropriate or that the results obtained are accurate and reliable, the taxpayer shall recompute the sample percentage or make appropriate adjustments to the original computations in a manner satisfactory to the district director. The taxpayer shall maintain records in sufficient detail to show the method of computing and applying the sample.

(ii) For taxable years ending before January 31, 1964, a taxpayer who has reported for income tax purposes all or a portion of sales under a revolving credit plan as sales on the installment method may apply the percentage obtained for the first taxable year ending on or after such date in determining the percentage of charges under a revolving credit plan for such prior taxable year (or years) which will be treated as sales on the installment plan. However, in computing the percentage to be applied in determining the percentage of charges under a revolving credit plan which will be treated as sales on the installment plan for such prior taxable year (or years), the rule stated in § 1.453A–1(e)(3) shall not apply. See paragraph (c)(6)(v) of this section for rules relating to the application of payments to finance charges for such prior taxable years.

(3) For the purpose of determining the percentage described in paragraph (c)(2) of this section, a charge under a revolving credit plan will be treated as a sale on the installment plan only if such charge is a sale (as defined in paragraph (c)(6) of this section) and meets the following requirements:

(i) The sale must be of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments. If the aggregate of sales charged during a billing-month to an account under a revolving credit plan exceeds the required monthly payment, then all sales during such billing-month shall be considered to be of the type which the terms and conditions of such plan contemplate will be paid for in two or more installments. The required monthly payment shall be the amount of the payment which the terms and conditions of the revolving credit contract require the customer to make with respect to a billing-month. If the amount of such payment is not fixed at the date the contract is entered into, but is dependent upon the balance of the account, then such amount shall be the amount that the customer is required to pay (but not including any past-due payments) as shown on the statement either:

(A) For the last billing-month ending within the taxpayer's taxable year or

(B) For the billing-month of sale, whichever method the taxpayer adopts for all accounts. A taxpayer shall not change such method of determining the required monthly payment based upon the balance of the account without obtaining the consent of the district director. In any case where the required monthly payment is not set in accordance with a consistent method used during the entire taxable year, the district director may determine the required monthly payment in accordance with the method used during the major portion of such taxable year if the use of such method is necessary in order to reflect properly the income from sales under a revolving credit plan. The requirements stated in this paragraph (c)(3)(i) may be illustrated by the following examples:

Example 1. Under the terms of a revolving credit plan the required monthly payment to be made by customer A is $20. During the billing-month ending in December, sales aggregating $80 are charged to customer A's account, and during the next billing-month, ending in January, sales aggregating $19.95 and finance charges of $.60 are charged to A's account. Since the aggregate of sales charged to customer A's account during the billing-month ending in December ($80) exceeds the required monthly payment ($20), the terms and conditions of the plan contemplate that the sales charged during such billing-month are of the type which will be paid for in two or more installments. Since the aggregate of sales charged to customer A's account during the billing-month ending in January ($19.95) does not exceed the required monthly payment, the sales making up the aggregate of sales in such billing-month are not of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments.

Example 2. The terms of a revolving credit plan require a payment of 20 percent of the balance of the customer's account as of the end of the billing-month for which the statement is rendered. A customer makes purchases aggregating $25 in the customer's next to the last billing-month ending within the taxpayer's taxable year, and the balance at the end of that month is $150. At the end of the customer's last billing-month ending within the taxpayer's taxable year, the balance of the account has decreased to $110. If the taxpayer determines the required monthly payment by reference to the payment required on the statement for the last billing-month ending within the taxable year and applies such method consistently to all accounts, then the sales making up the $25 aggregate of sales are of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments. Although such aggregate was less than the $30 payment (20% × $150) required on the statement rendered for the billing-month of sales. It was more than the $22 (20% × $110) that the customer was required to pay on the statement rendered for his last billing-month ending within the taxable year, and thus meets the requirements of this paragraph (c)(3)(i). If, however, the taxpayer determines the required monthly payment by reference to the payment required on the statement for the billing-month of sale, then the sales making up the aggregate of sales during such billing-month do not meet the requirements of this paragraph (c)(3)(i) because such aggregate was less than the $30 payment required on the statement rendered for such month.

(ii) The sale must be charged to an account on which the first payment after the billing-month of sale indicates that the sale is being paid in installments. The first payment after the billing-month of sale indicates that the sale is being paid in installments if, and only if, such payment is an amount which is less than the balance of the account as of the close of the billing-month of sale. For purposes of this paragraph (c)(3)(ii), such balance shall be reduced by any return or allowance credited to the account after the close of the billing-month of sale and before the close of the billing-month within which the first payment after the billing-month of sale is credited to the account, unless the taxpayer demonstrates that the return or allowance was attributable to a charge made in a month subsequent to the billing-month of sale. The requirements stated in this paragraph (c)(3)(ii) may be illustrated by the following examples, in which it is assumed that the taxpayer's annual accounting period ends on January 31.

Example 1. Customer A's revolving credit account shows the following sales and payments:

Month ending	Aggregate sales in month	Payments	Balance
December 20	$150	0	$150
January 20	75	$30	195
February 20	0	195	0

All sales made in the billing-month ending December 20 meet the requirements of this paragraph (c)(3)(ii) because the first payment on the account after such billing-month ($30) was less than the balance of the account as of the close of such billing-month ($150); and none of the sales made in the billing-month ending January 20 meets the requirements of this paragraph (c)(3)(ii) because the balance of the account as of the end of such billing-month was liquidated in one payment. By application of the rules of paragraph (c)(6)(v) of this section, the balance in the account as of the last billing-month ending in the taxable year ($195) consists of $120 of the $150 of sales made in the billing-month ending December 20 and all of the $75 of sales made in the billing-month ending January 20. Therefore, $120 of the account balance meets the requirements of this paragraph (c)(3)(ii) and $75 does not.

Example 2. Customer B's revolving credit account shows the following sales and payments:

Month ending	Aggregate sales in month	Payments	Balance
December 20	$ 50	0	$ 50
January 20	100	0	150
February 20	0	$50	100

None of the sales made in the billing-month ending December 20 meets the requirements of this paragraph (c)(3)(ii) because the first payment credited to the account after such billing-month ($50) is not less than the balance of the account as of the close of such month ($50). All of the sales made in the billing-month ending January 20 meet the requirements of this paragraph (c)(3)(ii) because the first payment after such billing-month ($50) is less than the balance of the account as of the close of such month ($150).

Example 3. Customer C's revolving credit account shows the following purchases and credits:

Month ending	Item	Charges	Credits	Balance
January 20	Coat	$55		
	Dress	40		
	Shirt	5		$100
February 20	Return		$5	
	Payments		95	0

None of the sales made in the billing-month ending January 20 meets the requirements of this paragraph (c)(3)(ii) because the first payment credited to the account after such billing-month ($95) was equal to the balance of the account as of the end of such billing-month, $95. For this purpose, the balance of $100 is reduced by the $5 return which was credited to the account after the close of the billing-month of sale and before the close of the billing-month within which the first payment after the billing-month of sale is credited.

(4) The provisions of paragraphs (c)(2) and (3) of this section may be illustrated by the following examples in which it is assumed that the taxpayer is a dealer whose annual accounting period ends on January 31.

Example 1. Customer A's revolving credit ledger account shows the following:

Month ending	Aggregate sales in month[1]	Returns and allowances	Payments	Finance charges	Balance
January 20	$15.00	0	0	0	$15.00
February 20	0	0	0	$0.15	15.15

[1] Including sales of personal property and nonpersonal property sales.

For purposes of the segregation provided for in paragraph (c)(2)(i) of this section, customer A's account will be disregarded and not taken into account in the determination of what percentage of charges in the sample is to be treated as sales on the installment plan because no payment was credited to that account after the billing-month of sale and on or before February 20.

Example 2. This example is applicable with respect to sales made during taxable years beginning before January 1, 1964. Under the terms of corporation X's revolving credit plan, payments are required in accordance with the following schedule:

	Required monthly payment
Unpaid balance:	
0 to $99.99	$20
$100 to $199.99	40
$200 to $299.99	60

Customer B's revolving credit ledger account for the period beginning on September 21, 1963, and ending February 20, 1964, shows the following:

Month ending	Aggregate sales in month[1]	Returns and allowances	Payments	Finance charges	Balances
October 20	$55.00	0	0	0	$55.00
November 20	45.00	0	$20.00	$0.35	80.35
December 20	20.00	0	20.00	.60	80.95
January 20	26.00	$5.00	20.00	.61	82.56
February 20	0	10.00	72.56	0	0

[1] Including sales of personal property and nonpersonal property sales.

The three $20 payments and the $5 return or allowance made in the billing-months ending in the taxable year are applied under the rules in paragraph (c)(6)(v) of this section to liquidate the earliest outstanding charges, first to the $55 aggregate of sales in the billing-month ending October 20 and next to $10 of the aggregate of sales made in the billing-month ending November 20. Thus, the balance of the account as of the close of the billing-month ending January 20, $82.56, is made up as follows:

Remainder of sales in billing-month ending Nov. 20 ($45 − $10)	$35.00
Finance charges for billing-month ending Nov. 20	0.35
Sales for billing-month ending Dec. 20	20.00
Finance charge for billing-month ending Dec. 20	0.60
Sales for billing-month ending Jan. 20	26.00
Finance charge for billing-month ending Jan. 20	0.61
Total	82.56

The sales of $35 remaining from the aggregate of sales for the billing-month ending November 20 meet the requirements of paragraph (c)(3)(i) of this section because the aggregate of sales charged during such billing-month ($45) exceeds the required monthly payment ($20), and such sales meet the requirements of paragraph (c)(3)(ii) of this section because the first payment after the billing-month of sale ($20) is an amount less than the balance of the account as of the close of such month ($80.35). Therefore, $35 of sales will be treated as sales on the installment plan. The $20 aggregate of sales charged during the billing-month ending December 20 does not meet the requirements of paragraph (c)(3)(i) of this section because it is in an amount which does not exceed the required monthly payment ($20). (The finance charge of $0.60 added in the billing-month does not enter into the determination of the aggregate of sales for the month because the term ''sales'' (as defined in paragraph (c)(6)(i) of this section does not include finance charges). The $26 aggregate of sales for the billing-month ending January 20 does not meet the requirements of paragraph (c)(3)(ii) of this section because the first payment after such billing-month ($72.56) was equal to the balance of the account as of the close of such billing-month ($72.56). For this purpose, the balance of $82.56 is reduced by the $10 return or allowance which was credited after the billing-month of sale and before February 20. Thus, of the $82.56 balance of B's account as of the close of the last billing-month ending within corporation X's taxable year, $35 will be treated as sales on the installment plan for purposes of determining the percentage provided for paragraph (c)(2) of this section.

Example 3. This example is applicable with respect to sales made during taxable years beginning after December 31, 1963. Assume the facts in Example 2, except that Customer B's revolving credit ledger account is for the period beginning on September 21, 1964 and ending February 20, 1965. Since payments received are first used to liquidate any outstanding finance charges under the rule in paragraph (c)(6)(v) of this section, the $20 payment in December liquidated the $0.35 finance charge accrued at the end of the November billing-month and the $20 payment in January liquidated the $0.60 finance charge accrued at the end of the December billing-month. The balance of the three $20 payments ($59.05) and the $5 return or allowance are applied (under the rules in paragraph (c)(6)(v) of this section) to liquidate the earliest outstanding sales, first to the $55 aggregate of sales in the billing-month ending October 20 and next to $9.05 of the aggregate of sales made in the billing-month ending November 20. Thus, the balance of the account as of the close of the billing-month ending January 20, $82.56, is made up as follows:

Remainder of sales in billing-month ending Nov. 20 ($45-$9.05)	$35.95
Sales for billing-month ending Dec. 20	20.00
Sales for billing-month ending Jan. 20	26.00
Finance charge for billing-month ending Jan. 20	0.61
Total	82.56

The sales of $35.95 remaining from the aggregate of sales for the billing-month ending November 20 meet the requirements of paragraph (c)(3)(i) of this section because the aggregate of sales charged during such billing-month ($45) exceeds the required monthly payment ($20), and such sales meet the requirements of paragraph (c)(3)(ii) of this section because the first payment after the billing-month of sale ($20) is an amount less than the balance of the account as of the close of such month ($80.35). Therefore, $35.95 of sales will be treated as sales on the installment plan. The $20 aggregate of sales charged during the billing-month ending December 20 does not meet the requirements of paragraph (c)(3)(i) of this section because it is in an amount which does not exceed the required monthly payment ($20). The $26 aggregate of sales for the billing-month ending January 20 does not meet the requirements of paragraph (c)(3)(ii) of this section because the first payment after such billing-month ($72.56) was equal to the balance of the account as of the close of such billing-month ($72.56). For this purpose, the balance of $82.56 is reduced by the $10 return or allowance which was credited after the billing-month of sale and before February 20. Thus, of the $82.56 balance of B's account as of the close of the last billing-month ending within corporation X's taxable year $35.95 will be treated as sales on the installment plan for purposes of determining the percentage provided for in paragraph (c)(2) of this section.

(5) Sales under a revolving credit plan which are nonpersonal property sales (as defined in paragraph (c)(6)(iv) of this section) do not constitute sales on the installment plan. Therefore, the charges under a revolving credit plan must be reduced by the nonpersonal property sales, if any, under such plan, before application of the sample percentage as provided for in paragraph (c)(2)(i) of this section. The taxpayer may treat as the nonpersonal property sales under the plan for the taxable year an amount which bears the same ratio to the total sales under the revolving credit plan made in the taxable year as the total nonpersonal property sales made in such year bears to the total sales made in such year.

(6) For purposes of this paragraph (c)—

(i) The term ''sales'' includes sales of services, such as a charge for watch repair, as well as sales of property, but does not include finance or service charges.

(ii) The term ''charges'' includes sales of services and property as well as finance or service charges.

(iii) A billing-month is that period of time for which a periodic statement of charges and credits is rendered to a customer.

(iv) The term ''nonpersonal property sales'' means all sales which are not sales of personal property made by the taxpayer. Thus, sales of a department leased by the taxpayer to another are nonpersonal property sales. Likewise, charges for services rendered by the taxpayer are nonpersonal property sales unless such services are incidental to and rendered contemporaneously with the sale of personal property, in which case such charges shall be considered as constituting part of the selling price of such property.

(v) Except as otherwise provided in this paragraph (c)(6)(v), each payment received from a customer under a revolving credit plan before the close of the last billing-month ending in the taxable year shall be applied to liquidate the earliest outstanding charges under such plan, notwithstanding any rule of law or contract provision to the contrary. For purposes of determining which charges remain in the balance of an account at the end of the last billing-month ending in the taxable year, the taxpayer may apply returns and allowances which are credited before the close of the last billing-month ending in the taxable year either (A) to liquidate or reduce the charge for the specific item so returned or for which an allowance is permitted, or (B) to liquidate or reduce the earliest outstanding charges. The method so selected for applying returns and allowances shall be followed on a consistent basis from year to year unless the district director consents to a change. Additionally, finance or service charges which are computed on the basis of the balance of the account at the end of the previous billing-month (usually reduced by payments during the current billing-month) are accrued at the end of the current billing-month and are therefore considered, for purposes of determining the earliest outstanding charges, as charged to the account after any sales made during the current billing month. However, for purposes of determining which charges remain in the balance of an account at the end of the last billing-month ending in a taxable year which began after December 31, 1963, payments received during such year shall be applied first against any finance or service charges which were outstanding at the time such payment was received. The preceding sentence shall not apply with respect to a computation made for purposes of applying the rule described in paragraph (c)(2)(ii) of this section.

(vi) The taxpayer shall allocate those sales under a revolving credit plan which are treated as sales on the installment plan to the proper year of sale in order to apply the appropriate gross profit percentage as provided for in §1.453A–1(e). This allocation shall be made on the basis of the percentages of charges treated as sales on the installment plan which are attributable to each taxable year as determined in the sample of accounts described in paragraph (c)(2) of this section. However, if the taxpayer demonstrates to the satisfaction of the district director that income from sales on the installment plan is clearly reflected, all sales may be considered as being made in the taxable year for purposes of applying the gross profit percentage.

(7) The provisions of this paragraph (c) may be illustrated by the following example:

Example. Corporation X is a dealer and has elected to report on the installment method those sales under its revolving credit plan which may be treated as sales on the installment plan. Corporation X's taxable year ends on January 31, and the total balance of all its revolving credit accounts as of January 31, 1964, is $2,000,000. The total sales made in the taxable year are $10,000,000 of which $500,000 are nonpersonal property sales. The gross profit percentage realized or to be realized on all sales made in the taxable year is 40 percent. The amount of the gross profit contained in the year-end balance of $2,000,000 which may be deferred to succeeding years is computed as follows:

(i) In order to reduce the charges appearing in the year-end balance of revolving credit accounts receivable by the nonpersonal property sales contained therein, corporation X determines the amount of such nonpersonal property sales under the method permitted in paragraph (c)(5) of this section. Corporation X first determines the ratio which total nonpersonal property sales made during the year ($500,000) bears to total sales made during the year ($10,000,000), and then applies the percentage (5 percent) thus obtained to the year-end balance of revolving credit accounts receivable ($2,000,000). The nonpersonal property sales thus determined ($100,000) is subtracted from such year-end balance to obtain the charges under the revolving credit plan appearing in the year-end balance ($1,900,000) to which the sample percentage is to be applied.

(ii) In accordance with generally accepted sampling techniques, the taxpayer selects a probability sample of all revolving credit accounts having balances for billing-months ending in January 1964. The technique employed results in a random selection of accounts with total balances of $100,000.

(iii) Analysis of these sample accounts discloses that of the $100,000 of balances, $10,000 of balances are in accounts on which no payment was credited after a billing-month of sale and on or before the end of the first billing-month ending in the taxable year beginning February 1, 1964. These balances are, therefore, disregarded and not taken into account in the determination of what percentage of sales in the sample is to be treated as sales on the installment plan. Of the remaining $90,000 of balances, the taxpayer determines, by analyzing the ledger cards in the sample, that $63,000 of balances are composed of sales which meet the requirements of paragraphs (c)(3) (i) and (ii) of this section and are thus treated as sales on the installment plan. The remaining $27,000 of balances either did not meet the requirements of paragraphs (c)(3) (i) and (ii) of this section or were not sales (as defined in paragraph (c)(6)(i) of this section). The percentage of charges in the sample treated as sales on the installment plan is, therefore, 70 percent ($63,000 ÷ $90,000).

(iv) The charges in the year-end balance which are to be treated as sales on the installment plan, $1,330,000, are computed by multiplying the charges to which the sample percentage is applied ($1,900,000) by the sample percentage (70 percent).

(v) The deferred gross profit attributable to sales under the revolving credit plan for the taxable year, $532,000, is determined by multiplying the amount treated as sales on the installment plan ($1,330,000), by the gross profit percentage (40 percent). (Corporation X will be able to demonstrate to the satisfaction of the district director that (A) since the gross profit percentage for all sales does not vary materially from the gross profit percentage for all sales made under the revolving credit plan, (B) since only an insubstantial amount of sales included in year-end account balances was made prior to the taxable year, and (C) since the prior year's gross profit percentage does not vary materially from the gross profit percentage for the taxable year, income from sales on the installment plan will be clearly reflected by applying the current year's gross profit percentage for all sales under the revolving credit plan treated as sales on the installment plan.)

(d) *Effective date.* This section applies for taxable years beginning after December 31, 1953, and ending after August 16, 1954, but does not apply for any taxable year beginning after December 31, 1986. For taxable years beginning after December 31, 1986, sales under a revolving credit plan shall not be treated as sales on the installment plan.

[T.D. 8269, 54 FR 46375, Nov. 3, 1989]

§ 1.453A–3 Requirements for adoption of or change to installment method by dealers in personal property.

(a) *In general.* A dealer (within the meaning of §1.453A–1(c)(1)) may adopt or change to the installment method for a type or types of sales on the installment plan (within the meaning of §1.453A–1(c)(3) and (d)) in the manner prescribed in this section. This section applies only to dealers and only with respect to their sales on the installment plan.

(b) *Time and manner of electing installment method reporting*—(1) *Time for election.* An election to adopt or change to the installment method for a type or types of sales must be made on an income tax return for the taxable year of the election, filed on or before the time specified (including extensions thereof) for filing such return.

(2) *Adoption of installment method.* A taxpayer who adopts the installment method for the first taxable year in which sales are made on an installment plan of any kind must indicate in the income tax return for that taxable year that the installment method of accounting is being adopted and specify the type or types of sales included within the election. If a taxpayer in the year of the initial election made only one type of sale on the installment plan, but during a subsequent taxable year makes another type of sale on the installment plan and adopts the installment method for that other type of sale, the taxpayer must indicate in the income tax return for the subsequent year that an election is being made to adopt the installment method of accounting for the additional type of sale.

(3) *Change to installment method.* A taxpayer who changes to the installment method for a particular type or types of sales on the installment plan in acordance with this section must, for each type of sale on the installment plan for which the installment method is to be used, attach a separate statement to the income tax return for the taxable year with respect to which the change is made. Each statement must show the method of accounting used in computing taxable income before the change and the type of sale on the installment plan for which the installment method is being elected.

(4) *Deemed elections.* A dealer (including a person who is a dealer as a result of the recharacterization of transactions as sales) is deemed to have elected the installment method if the dealer treats a sale on the installment plan as a transaction other than a sale and fails to report the full amount of gain in the year of the sale. For example, if a transaction treated by a dealer as a lease is recharacterized by the Internal Revenue Service as a sale on the installment plan, the dealer will be deemed to have elected the installment

method assuming the dealer failed to report the full amount of gain in the year of the transaction.

(c) *Consent.* A dealer may adopt or change to the installment method for sales on the installment plan without the consent of the Commissioner. However, a dealer may not change from the installment method to the accrual method of accounting or to any other method of accounting without the consent of the Commissioner.

(d) *Cut-off method for amounts previously accrued.* An election to change to the installment method for a type of sale applies only with respect to sales made on or after the first day of the taxable year of change. Thus, payments received in the taxable year of the change, or in subsequent years, in respect of an installment obligation which arose in a taxable year prior to the taxable year of change are not taken into account on the installment method, but rather must be accounted for under the taxpayer's method of accounting in use in the prior year.

(e) *Effective date.* This section applies to sales by dealers in taxable years ending after October 19, 1980, but generally does not apply to sales made after December 31, 1987. For sales made after December 31, 1987, sales by a dealer in personal or real property shall not be treated as sales on the installment plan. (However, see section 453(l)(2) for certain exceptions to this rule.) For rules relating to sales by dealers in taxable years ending before October 20, 1980, see 26 CFR 1.453–7 and 1.453–8 (rev. as of April 1, 1987).

[T.D. 8269, 54 FR 46375, Nov. 3, 1989]

§ 1.454–1 Obligations issued at discount.

(a) *Certain non-interest-bearing obligations issued at discount*—(1) *Election to include increase in income currently.* If a taxpayer owns—

(i) A non-interest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals (other than an obligation issued by a corporation after May 27, 1969, as to which ratable inclusion of original issue discount is required under section 1232(a)(3)), or

(ii) An obligation of the United States, other than a current income obligation, in which he retains his investment in a matured series E U.S. savings bond, or

(iii) A nontransferable obligation (whether or not a current income obligation) of the United States for which a series E U.S. savings bond was exchanged (whether or not at final maturity) in an exchange upon which gain is not recognized because of section 1037(a) (or so much of section 1031(b) as relates to section 1037),

and if the increase, if any, in redemption price of such obligation described in subdivision (i), (ii), or (iii) of this subparagraph during the taxable year (as described in subparagraph (2) of this paragraph) does not constitute income for such year under the method of accounting used in computing his taxable income, then the taxpayer may, at his election, treat the increase as constituting income for the year in which such increase occurs. If the election is not made and section 1037 (or so much of section 1031 as relates to section 1037) does not apply, the taxpayer shall treat the increase as constituting income for the year in which the obligation is redeemed or disposed of, or finally matures, whichever is earlier. Any such election must be made in the taxpayer's return and may be made for any taxable year. If an election is made with respect to any such obligation described in subdivision (i), (ii), or (iii) of this subparagraph, it shall apply also to all other obligations of the type described in such subdivisions owned by the taxpayer at the beginning of the first taxable year to which the election applies, and to those thereafter acquired by him, and shall be binding for the taxable year for which the return is filed and for all subsequent taxable years, unless the Commissioner permits the taxpayer to change to a different method of reporting income from such obligations. See section 446(e) and paragraph (e) of §1.446–1, relating to requirement respecting a change of accounting method. Although the election once made is binding upon the taxpayer, it does not apply to a transferee of the taxpayer.

(2) *Amount of increase in case of non-interest-bearing obligations.* In any case in which an election is made under section 454, the amount which accrues in

any taxable year to which the election applies is measured by the actual increase in the redemption price occurring in that year. This amount does not accrue ratably between the dates on which the redemption price changes. For example, if two dates on which the redemption price increases (February 1 and August 1) fall within a taxable year and if the redemption price increases in the amount of 50 cents on each such date, the amount accruing in that year would be $1 ($0.50 on February 1 and $0.50 on August 1). If the taxpayer owns a non-interest-bearing obligation of the character described in subdivision (i), (ii), or (iii) of subparagraph (1) of this paragraph acquired prior to the first taxable year to which his election applies, he must also include in gross income for such first taxable year (i) the increase in the redemption price of such obligation occurring between the date of acquisition of the obligation and the first day of such first taxable year and (ii), in a case where a series E bond was exchanged for such obligation, the increase in the redemption price of such series E bond occurring between the date of acquisition of such series E bond and the date of the exchange.

(3) *Amount of increase in case of current income obligations.* If an election is made under section 454 and the taxpayer owns, at the beginning of the first taxable year to which the election applies, a current income obligation of the character described in subparagraph (1)(iii) of this paragraph acquired prior to such taxable year, he must also include in gross income for such first taxable year the increase in the redemption price of the series E bond which was surrendered to the United States in exchange for such current income obligation; the amount of the increase is that occurring between the date of acquisition of the series E bond and the date of the exchange.

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

Example 1. Throughout the calendar year 1954, a taxpayer who uses the cash receipts and disbursements method of accounting holds series E U.S. savings bonds having a maturity value of $5,000 and a redemption value at the beginning of the year 1954 of $4,050 and at the end of the year 1954 of $4,150. He purchased the bonds on January 1, 1949, for $3,750, and holds no other obligation of the type described in this section. If the taxpayer exercises the election in his return for the calendar year 1954, he is required to include $400 in taxable income with respect to such bonds. Of this amount, $300 represents the increase in the redemption price before 1954 and $100 represents the increase in the redemption price in 1954. The increases in redemption value occurring in subsequent taxable years are includible in gross income for such taxable years.

Example 2. In 1958 B, a taxpayer who uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year, purchased for $7,500 a series E United States savings bond with a face value of $10,000. In 1965, when the stated redemption value of the series E bond is $9,760, B surrenders it to the United States in exchange solely for a $10,000 series H U.S. current income savings bond in an exchange qualifying under section 1037(a), after paying $240 additional consideration. On the exchange of the series E bond for the series H bond in 1965, B realizes a gain of $2,260 ($9,760 less $7,500), none of which is recognized for that year by reason of section 1037(a). B retains the series H bond and redeems it at maturity in 1975 for $10,000, but in 1966 he exercises the election under section 454(a) in his return for that year with respect to five series E bonds he purchased in 1960. B is required to include in gross income for 1966 the increase in redemption price occurring before 1966 and in 1966 with respect to the series E bonds purchased in 1960; he is also required to include in gross income for 1966 the $2,260 increase in redemption price of the series E bond which was exchanged in 1965 for the series H bond.

(b) *Short-term obligations issued on a discount basis.* In the case of obligations of the United States or any of its possessions, or of a State, or Territory, or any political subdivision thereof, or of the District of Columbia, issued on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation originally sold does not accrue until the date on which such obligation is redeemed, sold, or otherwise disposed of. This rule applies regardless of the method of accounting used by the taxpayer. For examples illustrating rules for computation of income from sale or other disposition of certain obligations of the type described in this paragraph, see section 1221 and the regulations thereunder.

(c) *Matured U.S. savings bonds*—(1) *Inclusion of increase in income upon redemption or final maturity*. If a taxpayer (other than a corporation) holds—

(i) A matured series E U.S. savings bond,

(ii) An obligation of the United States, other than a current income obligation, in which he retains his investment in a matured series E U.S. savings bond, or

(iii) A nontransferable obligation (whether or not a current income obligation) of the United States for which a series E U.S. savings bond was exchanged (whether or not at final maturity) in an exchange upon which gain is not recognized because of section 1037(a) (or so much of section 1031(b) as relates to section 1037(a)),

the increase in redemption price of the series E bond in excess of the amount paid for such series E bond shall be included in the gross income of such taxpayer for the taxable year in which the obligation described in subdivision (i), (ii), or (iii) of this subparagraph is redeemed or disposed of, or finally matures, whichever is earlier, but only to the extent such increase has not previously been includible in the gross income of such taxpayer or any other taxpayer. If such obligation is partially redeemed before final maturity, or partially disposed of by being partially reissued to another owner, such increase in redemption price shall be included in the gross income of such taxpayer for such taxable year on a basis proportional to the total denomination of obligations redeemed or disposed of. The provisions of section 454 (c) and of this subparagraph shall not apply in the case of any taxable year for which the taxpayer's taxable income is computed under an accrual method of accounting or for a taxable year for which an election made by the taxpayer under section 454(a) and paragraph (a) of this section applies. For rules respecting the character of the gain realized upon the disposition or redemption of an obligation described in subdivision (iii) of this subparagraph, see paragraph (b) of §1.1037–1.

(2) *Illustrations*. The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year:

Example 1. On June 1, 1941, A purchased for $375 a series E U.S. savings bond which was redeemable at maturity (10 years from issue date) for $500. At maturity of the bond, A exercised the option of retaining the matured series E bond for the 10-year extended maturity period. On June 2, 1961, A redeemed the series E bond, at which time the stated redemption value was $674.60. A never elected under section 454(a) to include the annual increase in redemption price in gross income currently. Under section 454(c), A is required to include $299.60 ($674.60 less $375) in gross income for 1961 by reason of his redemption of the bond.

Example 2. The facts are the same as in Example 2 in paragraph (a)(4) of this section. On redemption of the series H bond received in the exchange qualifying under section 1037(a), B realizes a gain of $2,260, determined as provided in Example 5 in paragraph (b)(4) of §1.1037–1. None of this amount is includible in B's gross income for 1975, such amount having already been includible in his gross income for 1966 because of his election under section 454(a).

Example 3. C, who had elected under section 454(a) to include the annual increase in the redemption price of his non-interest-bearing obligations in gross income currently, owned a $1,000 series E U.S. savings bond, which was purchased on October 1, 1949, for $750, C died on February 1, 1955, when the redemption value of the bond was $820. The bond was immediately reissued to D, his only heir, who has not made an election under section 454(a). On January 15, 1960, when the redemption value of the bond is $1,000, D surrenders it to the United States in exchange solely for a $1,000 series H U.S. savings bond in an exchange qualifying under the provisions of section 1037(a). For 1960 D properly does not return any income from the exchange of bonds, although he returns the interest payments on the series H bond for the taxable years in which they are received. On September 1, 1964, prior to maturity of the series H bond, D redeems it for $1,000. For 1964, D must include $180 in gross income under section 454(c) from the redemption of the series H bond, that is, the amount of the increase in the redemption price of the series E bond ($1,000 less $820) occurring between February 1, 1955, and January 15, 1960, the period during which he owned the series E bond.

[T.D. 6500, 25 FR 11719, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15820, Nov. 17, 1967; T.D. 7154, 36 FR 24997, Dec. 28, 1971]

§ 1.455–1 Treatment of prepaid subscription income.

Effective with respect to taxable years beginning after December 31, 1957, section 455 permits certain taxpayers to elect with respect to a trade or business in connection with which prepaid subscription income is received, to include such income in gross income for the taxable years during which a liability exists to furnish or deliver a newspaper, magazine, or other periodical. If a taxpayer does not elect to treat prepaid subscription income under the provisions of section 455, such income is includible in gross income for the taxable year in which received by the taxpayer, unless under the method or practice of accounting used in computing taxable income such amount is to be properly accounted for as of a different period.

[T.D. 6591, 27 FR 1798, Feb. 27, 1962]

§ 1.455–2 Scope of election under section 455.

(a) If a taxpayer makes an election under section 455 and § 1.455–6 with respect to a trade or business, all prepaid subscription income from such trade or business shall be included in gross income for the taxable years during which the liability exists to furnish or deliver a newspaper, magazine, or other periodical. Such election shall be applicable to all prepaid subscription income received in connection with the trade or business for which the election is made; except that the taxpayer may further elect to include in gross income for the taxable year of receipt (as described in section 455(d)(3) and paragraph (c) of § 1.455–5) the entire amount of any prepaid subscription income if the liability from which it arose is to end within 12 months after the date of receipt, hereinafter sometimes referred to as ''within 12 months'' election.

(b) If the taxpayer is engaged in more than one trade or business in which a liability is incurred to furnish or deliver a newspaper, magazine, or other periodical, a separate election 455 with respect to each such trade or business. In addition, a taxpayer may make a separate ''within 12 months'' election for each separate trade or business for which it has made an election under section 455.

(c) An election made under section 455 shall be binding for the first taxable year for which the election is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Commissioner to the revocation of such election. Thus, in any case where the taxpayer has elected a method prescribed by section 455 for the inclusion of prepaid subscription income in gross income, such method of reporting income may not be changed without the prior approval of the Commissioner. In order to secure the Commissioner's consent to the revocation of such election, an application must be filed with the Commissioner in accordance with section 446(e) and the regulations thereunder. For purposes of subtitle A of the Code, the computation of taxable income under an election made under section 455 shall be treated as a method of accounting. For adjustments required by changes in method of accounting, see section 481 and the regulations thereunder.

(d) An election made under section 455 shall not apply to any prepaid subscription income received before the first taxable year to which the election applies. For example, Corporation M, which computes its taxable income under an accrual method of accounting and files its income tax returns on the calendar year basis, publishes a monthly magazine and customarily sells subscriptions on a 3-year basis. In 1958 it received $135,000 of 3-year prepaid subscription income for subscriptions beginning during 1958, and in 1959 it received $142,000 of prepaid subscription income for subscriptions beginning after December 31, 1958. In February 1959 it elected, with the consent of the Commissioner, to report its prepaid subscription income under the provisions of section 455 for the year 1959 and subsequent taxable years. The $135,000 received in 1958 from prepaid subscriptions must be included in gross income in full in that year, and no part of such 1958 income shall be allocated to the years 1959, 1960, and 1961 during which M was under a liability to deliver its magazine. The $142,000 received in 1959 from prepaid subscriptions shall be allocated to the years 1959, 1960, 1961, and 1962.

(e) No election may be made under section 455 with respect to a trade or business if, in computing taxable income, the cash receipts and disbursements method of accounting is used with respect to such trade or business. However, if the taxpayer is on a ''combination'' method of accounting under section 446(c)(4) and the regulations thereunder, it may elect the benefits of section 455 if it uses an accrual method of accounting for subscription income

[T.D. 6591, 27 FR 1798, Feb. 27, 1962]

§ 1.455–3 Method of allocation.

(a) Prepaid subscription income to which section 455 applies shall be included in gross income for the taxable years during which the liability to which the income relates is discharged or is deemed to be discharged on the basis of the taxpayer's experience.

(b) For purposes of determining the period or periods over which the liability of the taxpayer extends, and for purposes of allocating prepaid subscription income to such periods, the taxpayer may aggregate similar transactions during the taxable year in any reasonable manner, provided the method of aggregation and allocation is consistently followed.

[T.D. 6591, 27 FR 1798, Feb. 27, 1962]

§ 1.455–4 Cessation of taxpayer's liability.

(a) If a taxpayer has elected to apply the provisions of section 455 to a trade or business in connection with which prepaid subscription income is received, and if its liability to furnish or deliver a newspaper, magazine, or other periodical ends for any reason, then so much of the prepaid subscription income attributable to such liability as was not includible in its gross income under section 455 for preceding taxable years shall be included in its gross income for the taxable year in which such liability ends. A taxpayer's liability may end, for example, because of the cancellation of a subscription. See section 381(c)(4) and the regulations thereunder for the treatment of prepaid subscription income in a transaction to which section 381(a) applies.

(b) If a taxpayer who has elected to apply the provisions of section 455 to a trade or business dies or ceases to exist, then so much of the prepaid subscription income attributable to such trade or business which was not includible in its gross income under section 455 for preceding taxable years shall be included in its gross income for the taxable year in which such death or cessation of existence occurs. See section 381(c)(4) and the regulations thereunder for the treatment of prepaid subscription income in a transaction to which section 381(a) applies.

[T.D. 6591, 27 FR 1799, Feb. 27, 1962]

§ 1.455–5 Definitions and other rules.

(a) *Prepaid subscription income.* (1) The term ''prepaid subscription income'' means any amount includible in gross income which is received in connection with, and is directly attributable to, a liability of the taxpayer which extends beyond the close of the taxable year in which such amount is received and which is income from a newspaper, magazine, or other periodical. For example where Corporation X, a publisher of newspapers, magazines, and other periodicals makes sales on a subscription basis and the purchaser pays the subscription price in advance, prepaid subscription income would include the amounts actually received by X in connection with its liability to furnish or deliver the newspaper, magazine, or other periodical.

(2) For purposes of section 455, prepaid subscription income does not include amounts received by a taxpayer in connection with sales of subscriptions on a prepaid basis where such taxpayer does not have the liability to furnish or deliver a newspaper, magazine, or other periodical. The provisions of this subparagraph may be illustrated by the following example. Corporation D has a contract with each of several large publishers which grants it the right to sell subscriptions to their periodicals. Corporation D collects the subscription price from the subscribers, retains a portion thereof

as its commission and remits the balance to the publishers. The amount retained by Corporation D represents commissions on the sale of subscriptions, and is not prepaid subscription income for purposes of section 455 since the commissions represent compensation for services rendered and are not directly attributable to a liability of Corporation D to furnish or deliver a newspaper, magazine, or other periodical.

(b) *Liability.* The term ''liability'' means a liability of the taxpayer to furnish or deliver a newspaper, magazine, or other periodical.

(c) *Receipt of prepaid subscription income.* For purposes of section 455, prepaid subscription income shall be treated as received during the taxable year for which it is includible in gross income under section 451, relating to general rule for taxable year of inclusion, without regard to section 455.

(d) *Treatment of prepaid subscription income under an established accounting method.* Notwithstanding the provisions of section 455 and §1.455–1, any taxpayer who, for taxable years beginning before January 1, 1958, has reported prepaid subscription income for income tax purposes under an established and consistent method or practice of deferring such income may continue to report such income in accordance with such method or practice for all subsequent taxable years to which section 455 applies without making an election under section 455.

[T.D. 6591, 27 FR 1799, Feb. 27, 1962]

§ 1.455–6 Time and manner of making election.

(a) *Election without consent.* (1) A taxpayer may, without consent, elect to treat prepaid subscription income of a trade or business under section 455 for the first taxable year—

(i) Which begins after December 31, 1957, and

(ii) In which there is received prepaid subscription income from the trade or business for which the election is made. Such an election shall be made not later than the time prescribed by law for filing the income tax return for such year (including extensions thereof), and shall be made by means of a statement attached to such return.

(2) The statement shall indicate that the taxpayer is electing to apply the provisions of section 455 to his trade or business, and shall contain the following information:

(i) The name and a description of the taxpayer's trade or business to which the election is to apply;

(ii) The method of accounting used in such trade or business;

(iii) The total amount of prepaid subscription income from such trade or business for the taxable year;

(iv) The period or periods over which the liability of the taxpayer to furnish or deliver a newspaper, magazine, or other periodical extends;

(v) The amount of prepaid subscription income applicable to each such period; and

(vi) A description of the method used in allocating the prepaid subscription income to each such period.

In any case in which prepaid subscription income is received from more than one trade or business, the statement shall set forth the required information with respect to each trade or business subject to the election.

(3) See paragraph (c) of this section for additional information required to be submitted with the statement if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid subscription income attributable to a liability which is to end within 12 months after the date of receipt.

(b) *Election with consent.* A taxpayer may, with the consent of the Commissioner, elect at any time to apply the provisions of section 455 to any trade or business in which it receives prepaid subscription income. The request for such consent shall be in writing, signed by the taxpayer or its authorized representative, and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R:C, Washington, D.C. 20224. The request must be filed on or before the later of the following dates:

(1) 90 days after the beginning of the first taxable year to which the election is to apply or

(2) May 28, 1962, and must contain the information described in paragraph (a)(2) of this section.

See paragraph (c) of this section for additional information required to be submitted with the request if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid subscription income attributable to a liability which is to end within 12 months after the date of receipt.

(c) *''Within 12 months'' election.* (1) A taxpayer who elects to apply the provisions of section 455 to any trade or business may also elect to include in gross income for the taxable year of receipt (as described in section 455(d)(3) and paragraph (c) of § 1.455–5) the entire amount of any prepaid subscription income from such trade or business if the liability from which it arose is to end within 12 months after the date of receipt. Any such election is binding for the first taxable year for which it is effective and for all subsequent taxable years, unless the taxpayer secures permission from the Commissioner to treat such income differently. Application to revoke or change a ''within 12 months'' election shall be made in accordance with the provisions of section 446(e) and the regulations thereunder.

(2) The ''within 12 months'' election shall be made by including in the statement required by paragraph (a) of this section or the request described in paragraph (b) of this section, whichever is applicable, a declaration that the taxpayer elects to include such income in gross income in the taxable year of receipt, and the amount of such income. If the taxpayer is engaged in more than one trade or business for which the election under section 455 is made, it must include, in such statement or request, a declaration for each trade or business for which it makes the ''within 12 months'' election. See also paragraph (e) of § 1.455–2.

(3) If the taxpayer does not make the ''within 12 months'' election for its trade or business at the time prescribed for making the election to include prepaid subscription income in gross income for the taxable years during which its liability to furnish or deliver a newspaper, magazine, or other periodical exists for such trade or business, but later wishes to make such election, it must apply for permission from the Commissioner. Such application shall be made in accordance with the provisions of section 446(e) and the regulations thereunder.

[T.D. 6591, 27 FR 1799, Feb. 27, 1962]

§ 1.456–1 Treatment of prepaid dues income.

Effective for taxable years beginning after December 31, 1960, a taxpayer which is a membership organization (as described in paragraph (c) of § 1.456–5) and which receives prepaid dues income as described in paragraph (a) of § 1.456–5 in connection with its trade or business of rendering services or making available membership privileges may elect under section 456 to include such income in gross income ratably over the taxable years during which its liability (as described in paragraph (b) of § 1.456–5) to render such services or extend such privileges exists, if such liability does not extend over a period of time in excess of 36 months. If the taxpayer does not elect to treat prepaid dues income under section 456, or if such income may not be reported under section 456, as for example, where the income relates to a liability to render services or make available membership privileges which extends beyond 36 months, then such income is includible in gross income for the taxable year in which it is received (as described in paragraph (d) of § 1.456–5).

[T.D. 6937, 32 FR 16394, Nov. 30, 1967]

§ 1.456–2 Scope of election under section 456.

(a) An election made under section 456 and § 1.456–6, shall be applicable to all prepaid dues income received in connection with the trade or business for which the election is made. However, the taxpayer may further elect to include in gross income for the taxable year of receipt the entire amount of any prepaid dues income attributable to a liability extending beyond the close of the taxable year but ending within 12 months after the date of receipt, hereinafter referred to as the ''within 12 months'' election.

(b) If the taxpayer is engaged in more than one trade or business in connection with which prepaid dues income is received, a separate election may be made under section 456 with respect to each such trade or business. In addition, a taxpayer may make a separate ''within 12 months'' election for each separate trade or business for which it has made an election under section 456.

(c) A section 456 election and a ''within 12 months'' election shall be binding for the first taxable year for which the election is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Commissioner to the revocation of either election. In order to secure the Commissioner's consent to the revocation of the section 456 election or the ''within 12 months'' election, an application must be filed with the Commissioner in accordance with section 446(e) and the regulations thereunder. However, an application for consent to revoke the section 456 election or the ''within 12 months'' election in the case of all taxable years which end before November 30, 1967 must be filed on or before February 28, 1968. For purposes of Subtitle A of the Code, the computation of taxable income under an election made under section 456 or under the ''within 12 months'' election shall be treated as a method of accounting. For adjustments required by changes in method of accounting, see section 481 and the regulations thereunder.

(d) Except as provided in section 456(d) and § 1.456–7, an election made under section 456 shall not apply to any prepaid dues income received before the first taxable year to which the election applies. For example, Corporation X, a membership organization which files its income tax returns on a calendar year basis, customarily sells 3-year memberships, payable in advance. In 1961 it received $160,000 of prepaid dues income for 3-year memberships beginning during 1961, and in 1962 it received $185,000 of prepaid dues income for 3-year memberships beginning on January 1, 1962. In March 1962 it elected, with the consent of the Commissioner, to report its prepaid dues income under the provisions of section 456 for the year 1962 and subsequent taxable years. The $160,000 received in 1961 from prepaid dues must be included in gross income in full in that year, and except as provided in section 456(d) and § 1.456–7, no part of such income shall be allocated to the taxable years 1962, 1963, and 1964 during which X was under a liability to make available its membership privileges. The $185,000 received in 1962 from prepaid dues income shall be allocated to the years 1962, 1963, and 1964.

(e) No election may be made under section 456 with respect to a trade or business if, in computing taxable income, the cash receipts and disbursements method (or a hybrid thereof) of accounting is used with respect to such trade or business, unless the combination of the section 456 election and the taxpayer's hybrid method of accounting does not result in a material distortion of income.

[T.D. 6937, 32 FR 16394, Nov. 30, 1967; 32 FR 17479, Dec. 6, 1967]

§ 1.456–3 Method of allocation.

(a) Prepaid dues income for which an election has been made under section 456 shall be included in gross income over the period of time during which the liability to render services or make available membership privileges exists. The liability to render the services or make available the membership privileges shall be deemed to exist ratably over the period of time such services are required to be rendered, or such membership privileges are required to be made available. Thus, the prepaid dues income shall be included in gross income ratably over the period of the membership contract. For example, Corporation X, a membership organization, which files its income tax returns on a calendar year basis, elects, for its taxable year beginning January 1, 1961, to report its prepaid dues income in accordance with the provisions of section 456. On March 31, 1961, it sells a 2-year membership for $48 payable in advance, the membership to extend from May 1, 1961, to April 30, 1963. X shall include in its gross income for the taxable year 1961 $\frac{8}{24}$ of the $48, or $16, and for the taxable year 1962 $\frac{12}{24}$ of the $48, or $24, and for the taxable year 1963 $\frac{4}{24}$ of the $48, or $8.

(b) For purposes of determining the period or periods over which the liability of the taxpayer exists, and for purposes of allocating prepaid dues income to such periods, the taxpayer may aggregate similar transactions during the taxable year in any reasonable manner, provided the method of aggregation and allocation is consistently followed.

[T.D. 6937, 32 FR 16395, Nov. 30, 1967]

§ 1.456–4 Cessation of liability or existence.

(a) If a taxpayer has elected to apply the provisions of section 456 to a trade or business in connection with which prepaid dues income is received, and if the taxpayer's liability to render services or make available membership privileges ends for any reason, as for example, because of the cancellation of a membership then so much of the prepaid dues income attributable to such liability as was not includible in the taxpayer's gross income under section 456 for preceding taxable years shall be included in gross income for the taxable year in which such liability ends. This paragraph shall not apply to amounts includible in gross income under §1.456–7.

(b) If a taxpayer which has elected to apply the provisions of section 456 ceases to exist, then the prepaid dues income which was not includible in gross income under section 456 for preceding taxable years shall be included in the taxpayer's gross income for the taxable year in which such cessation of existence occurs. This paragraph shall not apply to amounts includible in gross income under §1.456–7.

(c) If a taxpayer is a party to a transaction to which section 381(a) applies and the taxpayer's method of accounting with respect to prepaid dues income is used by the acquiring corporation under the provisions of section 381(c)(4), then neither the liability nor the existence of the taxpayer shall be deemed to have ended or ceased. In such cases see section 381(c)(4) and the regulations thereunder for the treatment of the portion of prepaid dues income which was not included in gross income under section 456 for preceding taxable years.

[T.D. 6937, 32 FR 16395, Nov. 30, 1967]

§ 1.456–5 Definitions and other rules.

(a) *Prepaid dues income.* (1) The term ''prepaid dues income'' means any amount for membership dues includible in gross income which is received by a membership organization in connection with, and is directly attributable to, a liability of the taxpayer to render services or make available membership privileges over a period of time which extends beyond the close of the taxable year in which such amount is received.

(2) For purposes of section 456, prepaid dues income does not include amounts received by a taxpayer in connection with sales of memberships on a prepaid basis where the taxpayer does not have the liability to furnish the services or make available the membership privileges. For example, where a taxpayer has a contract with several membership organizations to sell memberships in such organizations and retains a portion of the amounts received from the sale of such memberships and remits the balance to the membership organizations, the amounts retained by such taxpayer represent commissions and do not constitute prepaid dues income for purposes of section 456.

(b) *Liability.* The term ''liability'' means a liability of the taxpayer to render services or make available membership privileges over a period of time which does not exceed 36 months. Thus, if during the taxable year a taxpayer sells memberships for more than 36 months and also memberships for 36 months or less, section 456 does not apply to the income from the sale of memberships for more than 36 months. For the purpose of determining the duration of a liability, a bona fide renewal of a membership shall not be considered to be a part of the existing membership.

(c) *Membership organization.* (1) The term ''membership organization'' means a corporation, association, federation, or other similar organization meeting the following requirements:

(i) It is organized without capital stock of any kind.

(ii) Its charter, bylaws, or other written agreement or contract expressly prohibits the distribution of any part of the net earnings directly or indirectly, in money, property, or services, to any member, and

(iii) No part of the net earnings of which is in fact distributed to any member either directly or indirectly, in money, property, or services.

(2) For purposes of this paragraph an increase in services or reduction in dues to all members shall generally not be considered distributions of net earnings.

(3) If a corporation, association, federation, or other similar organization subsequent to the time it elects to report its prepaid dues income in accordance with the provisions of section 456, (i) issues any kind of capital stock either to any member or nonmember, (ii) amends its charter, bylaws, or other written agreement or contract to permit distributions of its net earnings to any member or, (iii) in fact, distributes any part of its net earnings either in money, property, or services to any member, then immediately after such event the organization shall not be considered a membership organization within the meaning of section 456(e)(3).

(d) *Receipt of prepaid dues income.* For purposes of section 456, prepaid dues income shall be treated as received during the taxable year for which it is includible in gross income under section 451, relating to the general rule for taxable year of inclusion, without regard to section 456.

[T.D. 6937, 32 FR 16395, Nov. 30, 1967]

§ 1.456–6 Time and manner of making election.

(a) *Election without consent.* A taxpayer may make an election under section 456 without the consent of the Commissioner for the first taxable year beginning after December 31, 1960, in which it receives prepaid dues income in the trade or business for which such election is made. The election must be made not later than the time prescribed by law for filing the income tax return for such year (including extensions thereof). The election must be made by means of a statement attached to such return. In addition, there should be attached a copy of a typical membership contract used by the organization and a copy of its charter, bylaws, or other written agreement or contract of organization or association. The statement shall indicate that the taxpayer is electing to apply the provisions of section 456 to the trade or business, and shall contain the following information:

(1) The taxpayer's name and a description of the trade or business to which the election is to apply.

(2) The method of accounting used for prepaid dues income in the trade or business during the first taxable year for which the election is to be effective and during each of 3 preceding taxable years, and if there was a change in the method of accounting for prepaid dues income during such 3-year period, a detailed explanation of such change including the adjustments necessary to prevent duplications or omissions of income.

(3) Whether any type of deferral method for prepaid dues income has been used during any of the 3 taxable years preceding the first taxable year for which the election is effective. Where any type of such deferral method has been used during this period, an explanation of the method and a schedule showing the amounts received in each such year and the amounts deferred to each succeeding year.

(4) A schedule with appropriate explanations showing:

(i) The total amount of prepaid dues income received in the trade or business in the first taxable year for which the election is effective and the amount of such income to be included in each taxable year in accordance with the election,

(ii) The total amount, if any, of prepayments of dues received in the first taxable year for which the election is effective which are directly attributable to a liability of the taxpayer to render services or make available membership privileges over a period of time in excess of 36 months, and

(iii) The total amount, if any, of prepaid dues income received in the trade or business in—

(*a*) The taxable year preceding the first taxable year for which the election is effective if all memberships sold by the taxpayer are for periods of 1 year or less,

(*b*) Each of the 2 taxable years preceding the first taxable year for which the election is effective if any memberships are sold for periods in excess of 1 year but none are sold for periods in excess of 2 years, or

(*c*) Each of the 3 taxable years preceding the first taxable year for which the election is effective if any memberships are sold for periods in excess of 2 years.

In each case there shall be set forth the amount of such income which would have been includible in each taxable year had the election been effective for the years for which the information is required.

In any case in which prepaid dues income is received from more than one trade or business, the statement shall set forth separately the required information with respect to each trade or business for which the election is made. See paragraph (c) of this section for additional information required to be submitted with the statement if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid dues income attributable to a liability which is to end within 12 months after the date of receipt.

(b) *Election with consent.* A taxpayer may elect with the consent of the Commissioner, to apply the provisions of section 456 to any trade or business in which it receives prepaid dues income. The request for such consent shall be in writing, signed by the taxpayer or its authorized representative, and shall be addressed to the Commissioner of Internal Revenue, Washington, D.C. 20224. The request must be filed on or before the later of the following dates:

(1) 90 days after the beginning of the first taxable year to which the election is to apply, or

(2) February 28, 1968 and should contain the information described in paragraph (a) of this section.

See paragraph (c) of this section for additional information required to be submitted with the request if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid dues income attributable to a liability which is to end within 12 months after the date of receipt.

(c) *''Within 12 months'' election.* (1) The ''within 12 months'' election shall be made by including in the statement required by paragraph (a) of this section or the request described in paragraph (b) of this section, whichever is applicable, a declaration that the taxpayer elects to include such income in gross income in the taxable year of receipt, and the amount of such income for each taxable year to which the election is to apply which has ended prior to the time such statement or request is filed. If the taxpayer is engaged in more than one trade or business for which the election under section 456 is made, it must include, in such statement or request, a declaration for each trade or business for which it wishes to make the ''within 12 months'' election.

(2) If the taxpayer does not make the ''within 12 months'' election for a trade or business at the time it makes the election under paragraph (a) or (b) of this section, but later wishes to make such election, it must apply for permission from the Commissioner. Such application shall be made in accordance with the provisions of section 446(e).

[T.D. 6937, 32 FR 16395, Nov. 30, 1967; 32 FR 17479, Dec. 6, 1967]

§ 1.456–7 Transitional rule.

(a) Under section 456(d)(1), a taxpayer making an election under section 456 shall include in its gross income for the first taxable year to which the election applies and for each of the 2 succeeding taxable years not only that portion of prepaid dues income which is includible in gross income for each such taxable year under section 456(a), but also an additional amount equal to that portion of the total prepaid dues income received in each of the 3 taxable years preceding the first taxable year to which the election applies which would have been includible in gross income for such first taxable year and such 2 succeeding taxable years had the election under section 456 been effective during such 3 preceding taxable years. In computing such additional amounts—

(1) In the case of taxpayers who did not include in gross income for the taxable year preceding the first taxable year for which the election is effective, that portion of the prepaid dues income received in such year attributable to a liability which is to end within 12 months after the date of receipt, no effect shall be given to a ''within 12 months'' election made under paragraph (c) of § 1.456–6, and

(2) There shall be taken into account only prepaid dues income arising from a trade or business with respect to which an election is made under section 456 and § 1.456–6.

Section 481 and the regulations thereunder shall have no application to the additional amounts includible in gross income under section 456(d) and this section, but section 481 and the regulations thereunder shall apply to prevent other amounts from being duplicated or omitted.

(b) A taxpayer who makes an election with respect to prepaid dues income, and who includes in gross income for any taxable year to which the election applies an additional amount computed under section 456(d)(1) and paragraph (a) of this section, shall be permitted under section 456(d)(2) to deduct for such taxable year and for each of the 4 succeeding taxable years an amount equal to one-fifth of such additional amount, but only to the extent that such additional amount was also included in the taxpayer's gross income for any of the 3 taxable years preceding the first taxable year to which such election applies. The taxpayer shall maintain books and records in sufficient detail to enable the district director to determine upon audit that the additional amounts were included in the taxpayer's gross income for any of the 3 taxable years preceding such first taxable year. If, however, the taxpayer ceases to exist, as described in paragraph (b) of § 1.456–4, and there is included in gross income, under such paragraph, of the year of cessation the entire portion of prepaid dues income not previously includible in gross income under section 456 for preceding taxable years (other than for amounts received prior to the first year for which an election was made), all the amounts not previously deducted under this paragraph shall be permitted as a deduction in the year of cessation of existence.

(c) The provisions of this section may be illustrated by the following example:

Example. (1) Assume that X Corporation, a membership organization qualified to make the election under section 456, elects to report its prepaid dues income in accordance with the provisions of section 456 for its taxable year ending December 31, 1961. Assume further that X Corporation receives in the middle of each taxable year $3,000 of prepaid dues income in connection with a liability to render services over a 3-year period beginning with the date of receipt. Under section 456(a), X Corporation will report income received in 1961 and subsequent years as follows:

Year of receipt	Total receipts	1961	1962	1963	1964	1965	1966	1967	1968
1961	$3,000	$500	$1,000	$1,000	$500				
1962	3,000		500	1,000	1,000	$500			
1963	3,000			500	1,000	1,000	$500		
1964	3,000				500	1,000	1,000	$500	
1965	3,000					500	1,000	1,000	$500
1966	3,000						500	1,000	1,000
1967	3,000							500	1,000
1968	3,000								500
Total reportable under section 456(a)		500	1,500	2,500	3,000	3,000	3,000	3,000	3,000

(2) Under section 456(d) (1), X Corporation must include in its gross income for the first taxable year to which the election applies and for each of the 2 succeeding taxable years, the amounts which would have been included in those years had the election been effective 3 years earlier. If the election had been effective in 1958, the following amounts received in 1958, 1959, and 1960 would have been reported in 1961 and subsequent years:

Year of receipt	Amount received	Years of including additional amounts		
		1961	1962	1963
1958	$3,000	$500		
1959	3,000	1,000	$500	
1960	3,000	1,000	1,000	$500
Total additional amounts to be included under section 456(d)(1)	2,500	1,500	500	

(3) Having included the additional amounts as required by section 456(d)(1), and assuming such amounts were actually included in gross income in the 3 taxable years preceding the first taxable year for which the election is effective, X Corporation is entitled to deduct under section 456(d)(2) in the year of inclusion and in each of the succeeding 4 years an amount equal to one-fifth of the amounts included, as follows:

Year of inclusion	Amount	Years of deduction						
		1961	1962	1963	1964	1965	1966	1967
1961	$2,500	$500	$500	$500	$500	$500	....	....
1962	1,500	....	300	300	300	300	$300	....
1963	500	....	....	100	100	100	100	$10
Total amount deductible under section 456(d)(2)	500	800	900	900	900	400	100	

(4) The net result of the inclusions under section 456(d)(1) and the deductions under section 456(d)(2) may be summarized as follows:

	1961	1962	1963	1964	1965	1966	1967	1968
Amount includible under section 456(a)	$500	$1,500	$2,500	$3,000	$3,000	$3,000	$3,000	$3,000
Amount includible under section 456(d)(1)	2,500	1,500	500	....	....	....	....	....
Total	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Amount deductible under section 456(d)(2)	500	800	900	900	900	400	100	....
Net amount reportable under section 456	2,500	2,200	2,100	2,100	2,100	2,600	2,900	3,000

[T.D. 6937, 32 FR 16396, Nov. 30, 1967]

§ 1.457–1 General overviews of section 457.

Section 457 provides rules for nonqualified deferred compensation plans established by eligible employers as defined under § 1.457–2(d). Eligible employers can establish either deferred compensation plans that are eligible plans and that meet the requirements of section 457(b) and §§ 1.457–3 through 1.457–10, or deferred compensation plans or arrangements that do not meet the requirements of section 457(b) and §§ 1.457–3 through 1.457–10 and that are subject to tax treatment under section 457(f) and § 1.457–11.

[T.D. 9075, 68 FR 41234, July 11, 2003]

§ 1.457–2 Definitions.

This section sets forth the definitions that are used under §§ 1.457–1 through 1.457–11.

(a) *Amount(s) deferred. Amount(s) deferred* means the total annual deferrals under an eligible plan in the current and prior years, adjusted for gain or loss. Except as provided at §§ 1.457–4(c)(1)(iii) and 1.457–6(a), amount(s) deferred includes any rollover amount held by an eligible plan as provided under § 1.457–10(e).

(b) *Annual deferral(s)*—(1) *Annual deferral(s)* means, with respect to a taxable year, the amount of compensation deferred under an eligible plan, whether by salary reduction or by nonelective employer contribution. The amount of compensation deferred under an eligible plan is taken into account as an annual deferral in the taxable year of the participant in which deferred, or, if later, the year in which the amount of compensation deferred is no longer subject to a substantial risk of forfeiture.

(2) If the amount of compensation deferred under the plan during a taxable year is not subject to a substantial risk of forfeiture, the amount taken into account as an annual deferral is not adjusted to reflect gain or loss allocable to the compensation deferred. If, however, the amount of compensation deferred under the plan during the taxable year is subject to a substantial risk of forfeiture, the amount of compensation deferred that is taken into account as an annual deferral in the taxable year in which the substantial

risk of forfeiture lapses must be adjusted to reflect gain or loss allocable to the compensation deferred until the substantial risk of forfeiture lapses.

(3) If the eligible plan is a defined benefit plan within the meaning of section 414(j), the annual deferral for a taxable year is the present value of the increase during the taxable year of the participant's accrued benefit that is not subject to a substantial risk of forfeiture (disregarding any such increase attributable to prior annual deferrals). For this purpose, present value must be determined using actuarial assumptions and methods that are reasonable (both individually and in the aggregate), as determined by the Commissioner.

(4) For purposes solely of applying §1.457–4 to determine the maximum amount of the annual deferral for a participant for a taxable year under an eligible plan, the maximum amount is reduced by the amount of any deferral for the participant under a plan described at paragraph (k)(4)(i) of this section (relating to certain plans in existence before January 1, 1987) as if that deferral were an annual deferral under another eligible plan of the employer.

(c) *Beneficiary*. *Beneficiary* means a person who is entitled to benefits in respect of a participant following the participant's death or an alternate payee as described in §1.457–10(c).

(d) *Catch-up*. *Catch-up* amount or *catch-up* limitation for a participant for a taxable year means the annual deferral permitted under section 414(v) (as described in §1.457–4(c)(2)) or section 457(b)(3) (as described in §1.457–4(c)(3)) to the extent the amount of the annual deferral for the participant for the taxable year is permitted to exceed the plan ceiling applicable under section 457(b)(2) (as described in §1.457–4(c)(1)).

(e) *Eligible employer*. *Eligible employer* means an entity that is a State that establishes a plan or a tax-exempt entity that establishes a plan. The performance of services as an independent contractor for a State or local government or a tax-exempt entity is treated as the performance of services for an eligible employer. The term *eligible employer* does not include a church as defined in section 3121(w)(3)(A), a qualified church-controlled organization as defined in section 3121(w)(3)(B), or the Federal government or any agency or instrumentality thereof. Thus, for example, a nursing home which is associated with a church, but which is not itself a church (as defined in section 3121(w)(3)(A)) or a qualified church-controlled organization as defined in section 3121(w)(3)(B)), would be an eligible employer if it is a tax-exempt entity as defined in paragraph (m) of this section.

(f) *Eligible plan*. An *eligible plan* is a plan that meets the requirements of §§1.457–3 through 1.457–10 that is established and maintained by an eligible employer. An *eligible governmental plan* is an eligible plan that is established and maintained by an eligible employer as defined in paragraph (l) of this section. An arrangement does not fail to constitute a single eligible governmental plan merely because the arrangement is funded through more than one trustee, custodian, or insurance carrier. An *eligible plan of a tax-exempt entity* is an eligible plan that is established and maintained by an eligible employer as defined in paragraph (m) of this section.

(g) *Includible compensation*. *Includible compensation* of a participant means, with respect to a taxable year, the participant's compensation, as defined in section 415(c)(3), for services performed for the eligible employer. The amount of includible compensation is determined without regard to any community property laws.

(h) *Ineligible plan*. *Ineligible plan* means a plan established and maintained by an eligible employer that is not maintained in accordance with §§1.457–3 through 1.457–10. A plan that is not established by an eligible employer as defined in paragraph (e) of this section is neither an eligible nor an ineligible plan.

(i) *Nonelective employer contribution*. A *nonelective employer contribution* is a contribution made by an eligible employer for the participant with respect to which the participant does not have the choice to receive the contribution in cash or property. Solely for purposes of section 457 and §§1.457–2 through 1.457–11, the term *nonelective employer* *contribution* includes employer contributions that would be described in section 401(m) if they were contributions to a qualified plan.

(j) *Participant. Participant* in an eligible plan means an individual who is currently deferring compensation, or who has previously deferred compensation under the plan by salary reduction or by nonelective employer contribution and who has not received a distribution of his or her entire benefit under the eligible plan. Only individuals who perform services for the eligible employer, either as an employee or as an independent contractor, may defer compensation under the eligible plan.

(k) *Plan. Plan* includes any agreement or arrangement between an eligible employer and a participant or participants (including an individual employment agreement) under which the payment of compensation is deferred (whether by salary reduction or by nonelective employer contribution). The following types of plans are not treated as agreements or arrangements under which compensation is deferred: a bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan described in section 457(e)(11)(A)(i) and any plan paying length of service awards to bona fide volunteers (and their beneficiaries) on account of qualified services performed by such volunteers as described in section 457(e)(11)(A)(ii). Further, the term *plan* does not include any of the following (and section 457 and §§1.457–2 through 1.457–11 do not apply to any of the following)—

(1) Any nonelective deferred compensation under which all individuals (other than those who have not satisfied any applicable initial service requirement) with the same relationship with the eligible employer are covered under the same plan with no individual variations or options under the plan as described in section 457(e)(12), but only to the extent the compensation is attributable to services performed as an independent contractor;

(2) An agreement or arrangement described in §1.457–11(b);

(3) Any plan satisfying the conditions in section 1107(c)(4) of the Tax Reform Act of 1986 (100 Stat. 2494) (TRA '86) (relating to certain plans for State judges); and

(4) Any of the following plans or arrangements (to which specific transitional statutory exclusions apply)—

(i) A plan or arrangement of a tax-exempt entity in existence prior to January 1, 1987, if the conditions of section 1107(c)(3)(B) of the TRA '86, as amended by section 1011(e)(6) of the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3700) (TAMRA), are satisfied (see §1.457–2(b)(4) for a special rule regarding such plan);

(ii) A collectively bargained nonelective deferred compensation plan in effect on December 31, 1987, if the conditions of section 6064(d)(2) of TAMRA are satisfied;

(iii) Amounts described in section 6064(d)(3) of TAMRA (relating to certain nonelective deferred compensation arrangements in effect before 1989); and

(iv) Any plan satisfying the conditions in section 1107(c)(4) or (5) of TRA '86 (relating to certain plans for certain individuals with respect to which the Service issued guidance before 1977).

(l) *State. State* means a State (treating the District of Columbia as a State as provided under section 7701(a)(10)), a political subdivision of a State, and any agency or instrumentality of a State.

(m) *Tax-exempt entity. Tax-exempt entity* includes any organization exempt from tax under subtitle A of the Internal Revenue Code, except that a governmental unit (including an international governmental organization) is not a tax-exempt entity.

(n) *Trust. Trust* means a trust described under section 457(g) and §1.457–8. Custodial accounts and contracts described in section 401(f) are treated as trusts under the rules described in §1.457–8(a)(2).

[T.D. 9075, 68 FR 41234, July 11, 2003; 68 FR 51446, Aug. 27, 2003]

§1.457–3 General introduction to eligible plans.

(a) *Compliance in form and operation.* An eligible plan is a written plan established and maintained by an eligible employer that is maintained, in both form and operation, in accordance with the requirements of §§1.457–4 through

1.457–10. An eligible plan must contain all the material terms and conditions for benefits under the plan. An eligible plan may contain certain optional features not required for plan eligibility under section 457(b), such as distributions for unforeseeable emergencies, loans, plan-to-plan transfers, additional deferral elections, acceptance of rollovers to the plan, and distributions of smaller accounts to eligible participants. However, except as otherwise specifically provided in §§1.457–4 through 1.457–10, if an eligible plan contains any optional provisions, the optional provisions must meet, in both form and operation, the relevant requirements under section 457 and §§1.457–2 through 1.457–10.

(b) *Treatment as single plan.* In any case in which multiple plans are used to avoid or evade the requirements of §§1.457–4 through 1.457–10, the Commissioner may apply the rules under §§1.457–4 through 1.457–10 as if the plans were a single plan. See also §1.457–4(c)(3)(v) (requiring an eligible employer to have no more than one normal retirement age for each participant under all of the eligible plans it sponsors), the second sentence of §1.457–4(e)(2) (treating deferrals under all eligible plans under which an individual participates by virtue of his or her relationship with a single employer as a single plan for purposes of determining excess deferrals), and §1.457–5 (combining annual deferrals under all eligible plans).

[T.D. 9075, 68 FR 41234, July 11, 2003]

§ 1.457–4 Annual deferrals, deferral limitations, and deferral agreements under eligible plans.

(a) *Taxation of annual deferrals.* Annual deferrals that satisfy the requirements of paragraphs (b) and (c) of this section are excluded from the gross income of a participant in the year deferred or contributed and are not includible in gross income until paid to the participant in the case of an eligible governmental plan, or until paid or otherwise made available to the participant in the case of an eligible plan of a tax-exempt entity. See §1.457–7.

(b) *Agreement for deferral.* In order to be an eligible plan, the plan must provide that compensation may be deferred for any calendar month by salary reduction only if an agreement providing for the deferral has been entered into before the first day of the month in which the compensation is paid or made available. A new employee may defer compensation payable in the calendar month during which the participant first becomes an employee if an agreement providing for the deferral is entered into on or before the first day on which the participant performs services for the eligible employer. An eligible plan may provide that if a participant enters into an agreement providing for deferral by salary reduction under the plan, the agreement will remain in effect until the participant revokes or alters the terms of the agreement. Nonelective employer contributions are treated as being made under an agreement entered into before the first day of the calendar month.

(c) *Maximum deferral limitations*—(1) *Basic annual limitation.* (i) Except as described in paragraphs (c)(2) and (3) of this section, in order to be an eligible plan, the plan must provide that the annual deferral amount for a taxable year (the plan ceiling) may not exceed the lesser of—

(A) The applicable annual dollar amount specified in section 457(e)(15): $11,000 for 2002; $12,000 for 2003; $13,000 for 2004; $14,000 for 2005; and $15,000 for 2006 and thereafter. After 2006, the $15,000 amount is adjusted for cost-of-living in the manner described in paragraph (c)(4) of this section; or

(B) 100 percent of the participant's includible compensation for the taxable year.

(ii) The amount of annual deferrals permitted by the 100 percent of includible compensation limitation under paragraph (c)(1)(i)(B) of this section is determined under section 457(e)(5) and §1.457–2(g).

(iii) For purposes of determining the plan ceiling under this paragraph (c), the annual deferral amount does not include any rollover amounts received by the eligible plan under §1.457–10(e).

(iv) The provisions of this paragraph (c)(1) are illustrated by the following examples:

Example 1. (i) *Facts.* Participant A, who earns $14,000 a year, enters into a salary reduction agreement in 2006 with A's eligible employer and elects to defer $13,000 of A's compensation for that year. A is not eligible for the catch-up described in paragraph (c)(2) or (3) of this section, participates in no other retirement plan, and has no other income exclusions taken into account in computing includible compensation.

(ii) *Conclusion.* The annual deferral limit for A in 2006 is the lesser of $15,000 or 100 percent of includible compensation, $14,000. A's annual deferral of $13,000 is permitted under the plan because it is not in excess of $14,000 and thus does not exceed 100 percent of A's includible compensation.

Example 2. (i) *Facts.* Assume the same facts as in *Example 1,* except that A's eligible employer provides an immediately vested, matching employer contribution under the plan for participants who make salary reduction deferrals under A's eligible plan. The matching contribution is equal to 100 percent of elective contributions, but not in excess of 10 percent of compensation (in A's case, $1,400).

(ii) *Conclusion.* Participant A's annual deferral exceeds the limitations of this paragraph (c)(1). A's maximum deferral limitation in 2006 is $14,000. A's salary reduction deferral of $13,000 combined with A's eligible employer's nonelective employer contribution of $1,400 exceeds the basic annual limitation of this paragraph (c)(1) because A's annual deferrals total $14,400. A has an excess deferral for the taxable year of $400, the amount exceeding A's permitted annual deferral limitation. The $400 excess deferral is treated as described in paragraph (e) of this section.

Example 3. (i) *Facts.* Beginning in year 2002, Eligible Employer X contributes $3,000 per year for five years to B's eligible plan account. B's interest in the account vests in 2006. B has annual compensation of $50,000 in each of the five years 2002 through 2006. B is 41 years old. B is not eligible for the catch-up described in paragraph (c)(2) or (3) of this section, participates in no other retirement plan, and has no other income exclusions taken into account in computing includible compensation. Adjusted for gain or loss, the value of B's benefit when B's interest in the account vests in 2006 is $17,000.

(ii) *Conclusion.* Under this vesting schedule, $17,000 is taken into account as an annual deferral in 2006. B's annual deferrals under the plan are limited to a maximum of $15,000 in 2006. Thus, the aggregate of the amounts deferred, $17,000, is in excess of B's maximum deferral limitation by $2,000. The $2,000 is treated as an excess deferral described in paragraph (e) of this section.

(2) *Age 50 catch-up*—(i) *In general.* In accordance with section 414(v) and the regulations thereunder, an eligible governmental plan may provide for catch-up contributions for a participant who is age 50 by the end of the year, provided that such age 50 catch-up contributions do not exceed the catch-up limit under section 414(v)(2) for the taxable year. The maximum amount of age 50 catch-up contributions for a taxable year under section 414(v) is as follows: $1,000 for 2002; $2,000 for 2003; $3,000 for 2004; $4,000 for 2005; and $5,000 for 2006 and thereafter. After 2006, the $5,000 amount is adjusted for cost-of-living. For additional guidance, see regulations under section 414(v).

(ii) *Coordination with special section 457 catch-up.* In accordance with sections 414(v)(6)(C) and 457(e)(18), the age 50 catch-up described in this paragraph (c)(2) does not apply for any taxable year for which a higher limitation applies under the special section 457 catch-up under paragraph (c)(3) of this section. Thus, for purposes of this paragraph (c)(2)(ii) and paragraph (c)(3) of this section, the special section 457 catch-up under paragraph (c)(3) of this section applies for any taxable year if and only if the plan ceiling taking into account paragraph (c)(1) of this section and the special section 457 catch-up described in paragraph (c)(3) of this section (and disregarding the age 50 catch-up described in this paragraph (c)(2)) is larger than the plan ceiling taking into account paragraph (c)(1) of this section and the age 50 catch-up described in this paragraph (c)(2) (and disregarding the special section 457 catch-up described in paragraph (c)(3) of this section). Thus, if a plan so provides, a participant who is eligible for the age 50 catch-up for a year and for whom the year is also one of the participant's last three taxable years ending before the participant attains normal retirement age is eligible for the larger of—

(A) The plan ceiling under paragraph (c)(1) of this section and the age 50 catch-up described in this paragraph (c)(2) (and disregarding the special section 457 catch-up described in paragraph (c)(3) of this section) or

(B) The plan ceiling under paragraph (c)(1) of this section and the special section 457 catch-up described in paragraph (c)(3) of this section (and disregarding the age 50 catch-up described in this paragraph (c)(2)).

(iii) *Examples*. The provisions of this paragraph (c)(2) are illustrated by the following examples:

Example 1. (i) *Facts*. Participant C, who is 55, is eligible to participate in an eligible governmental plan in 2006. The plan provides a normal retirement age of 65. The plan provides limitations on annual deferrals up to the maximum permitted under paragraphs (c)(1) and (3) of this section and the age 50 catch-up described in this paragraph (c)(2). For 2006, C will receive compensation of $40,000 from the eligible employer. C desires to defer the maximum amount possible in 2006. The applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section is $15,000 for 2006 and the additional dollar amount permitted under the age 50 catch-up is $5,000 for 2006.

(ii) *Conclusion*. C is eligible for the age 50 catch-up in 2006 because C is 55 in 2006. However, C is not eligible for the special section 457 catch-up under paragraph (c)(3) of this section in 2006 because 2006 is not one of the last three taxable years ending before C attains normal retirement age. Accordingly, the maximum that C may defer for 2006 is $20,000.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that, in 2006, C will attain age 62. The maximum amount that C can elect under the special section 457 catch-up under paragraph (c)(3) of this section is $2,000 for 2006.

(ii) *Conclusion*. The maximum that C may defer for 2006 is $20,000. This is the sum of the basic plan ceiling under paragraph (c)(1) of this section equal to $15,000 and the age 50 catch-up equal to $5,000. The special section 457 catch-up under paragraph (c)(3) of this section is not applicable since it provides a smaller plan ceiling.

Example 3. (i) *Facts*. The facts are the same as in *Example 2*, except that the maximum additional amount that C can elect under the special section 457 catch-up under paragraph (c)(3) of this section is $7,000 for 2006.

(ii) *Conclusion*. The maximum that C may defer for 2006 is $22,000. This is the sum of the basic plan ceiling under paragraph (c)(1) of this section equal to $15,000, plus the additional special section 457 catch-up under paragraph (c)(3) of this section equal to $7,000. The additional dollar amount permitted under the age 50 catch-up is not applicable to C for 2006 because it provides a smaller plan ceiling.

(3) *Special section 457 catch-up*—(i) *In general*. Except as provided in paragraph (c)(2)(ii) of this section, an eligible plan may provide that, for one or more of the participant's last three taxable years ending before the participant attains normal retirement age, the plan ceiling is an amount not in excess of the lesser of—

(A) Twice the dollar amount in effect under paragraph (c)(1)(i)(A) of this section; or

(B) The underutilized limitation determined under paragraph (c)(3)(ii) of this section.

(ii) *Underutilized limitation*. The underutilized amount determined under this paragraph (c)(3)(ii) is the sum of—

(A) The plan ceiling established under paragraph (c)(1) of this section for the taxable year; plus

(B) The plan ceiling established under paragraph (c)(1) of this section (or under section 457(b)(2) for any year before the applicability date of this section) for any prior taxable year or years, less the amount of annual deferrals under the plan for such prior taxable year or years (disregarding any annual deferrals under the plan permitted under the age 50 catch-up under paragraph (c)(2) of this section).

(iii) *Determining underutilized limitation under paragraph (c)(3)(ii)(B) of this section*. A prior taxable year is taken into account under paragraph (c)(3)(ii)(B) of this section only if it is a year beginning after December 31, 1978, in which the participant was eligible to participate in the plan, and in which compensation deferred (if any) under the plan during the year was subject to a plan ceiling established under paragraph (c)(1) of this section. This paragraph (c)(3)(iii) is subject to the special rules in paragraph (c)(3)(iv) of this section.

(iv) *Special rules concerning application of the coordination limit for years prior to 2002 for purposes of determining the underutilized limitation*—(A) *General rule*. For purposes of determining the underutilized limitation for years prior to 2002, participants remain subject to the rules in effect prior to the repeal of the coordination limitation under section 457(c)(2). Thus, the applicable basic annual limitation under paragraph (c)(1) of this section and the special section 457 catch-up under this paragraph (c)(3) for years in effect prior to 2002 are reduced, for purposes of determining a participant's underutilized amount under a plan, by amounts excluded from the participant's income for any prior taxable year by reason of a nonelective employer contribution, salary reduction or elective contribution under any other eligible section 457(b) plan, or a salary reduction or elective contribution under any 401(k) qualified cash or deferred arrangement, section 402(h)(1)(B) simplified employee pension (SARSEP), section 403(b) annuity contract, and section 408(p) simple retirement account, or under any plan for which a deduction is allowed because of a contribution to an organization described in section 501(c)(18) (pre-2002 coordination plans). Similarly, in applying the section 457(b)(2)(B) limitation for includible compensation for years prior to 2002, the limitation is 33⅓ percent of the participant's compensation includible in gross income.

(B) *Coordination limitation applied to participant.* For purposes of determining the underutilized limitation for years prior to 2002, the coordination limitation applies to pre-2002 coordination plans of all employers for whom a participant has performed services, whether or not those are plans of the participant's current eligible employer. Thus, for purposes of determining the amount excluded from a participant's gross income in any prior taxable year under paragraph (c)(3)(ii)(B) of this section, the participant's annual deferrals under an eligible plan, and salary reduction or elective deferrals under all other pre-2002 coordination plans, must be determined on an aggregate basis. To the extent that the combined deferrals for years prior to 2002 exceeded the maximum deferral limitations, the amount is treated as an excess deferral under paragraph (e) of this section for those prior years.

(C) *Special rule where no annual deferrals under the eligible plan.* A participant who, although eligible, did not defer any compensation under the eligible plan in any year before 2002 is not subject to the coordinated deferral limit, even though the participant may have deferred compensation under one of the other pre-2002 coordination plans. An individual is treated as not having deferred compensation under an eligible plan for a prior taxable year if all annual deferrals under the plan are distributed in accordance with paragraph (e) of this section. Thus, to the extent that a participant participated solely in one or more of the other pre-2002 coordination plans during a prior taxable year (and not the eligible plan), the participant is not subject to the coordinated limitation for that prior taxable year. However, the participant is treated as having deferred an amount in a prior taxable year, for purposes of determining the underutilized limitation for that prior taxable year under this paragraph (c)(3)(iv)(C), to the extent of the participant's aggregate salary reduction contributions and elective deferrals under all pre-2002 coordination plans up to the maximum deferral limitations in effect under section 457(b) for that prior taxable year. To the extent an employer did not offer an eligible plan to an individual in a prior given year, no underutilized limitation is available to the individual for that prior year, even if the employee subsequently becomes eligible to participate in an eligible plan of the employer.

(D) *Examples.* The provisions of this paragraph (c)(3)(iv) are illustrated by the following examples:

Example 1. (i) *Facts.* In 2001 and in years prior to 2001, Participant D earned $50,000 a year and was eligible to participate in both an eligible plan and a section 401(k) plan. However, D had always participated only in the section 401(k) plan and had always deferred the maximum amount possible. For each year before 2002, the maximum amount permitted under section 401(k) exceeded the limitation of paragraph (c)(3)(i) of this section. In 2002, D is in the 3-year period prior to D's attainment of the eligible plan's normal retirement age of 65, and D now wants to participate in the eligible plan and make annual deferrals of up to $30,000 under the plan's special section 457 catch-up provisions.

(ii) *Conclusion.* Participant D is treated as having no underutilized amount under paragraph (c)(3)(ii)(B) of this section for 2002 for purposes of the catch-up limitation under section 457(b)(3) and paragraph (c)(3) of this section because, in each of the years before 2002, D has deferred an amount equal to or in excess of the limitation of paragraph (c)(3)(i) of this section under all of D's coordinated plans.

Example 2. (i) *Facts.* Assume the same facts as in *Example 1*, except that D only deferred $2,500 per year under the section 401(k) plan for one year before 2002.

(ii) *Conclusion.* D is treated as having an underutilized amount under paragraph (c)(3)(ii)(B) of this section for 2002 for purposes of the special section 457 catch-up limitation. This is because D has deferred an amount for prior years that is less than the limitation of paragraph (c)(1)(i) of this section under all of D's coordinated plans.

Example 3. (i) *Facts.* Participant E, who earned $15,000 for 2000, entered into a salary reduction agreement in 2000 with E's eligible employer and elected to defer $3,000 for that year under E's eligible plan. For 2000, E's eligible employer provided an immediately vested, matching employer contribution under the plan for participants who make salary reduction deferrals under E's eligible plan. The matching contribution was equal to 67 percent of elective contributions, but not in excess of 10 percent of compensation before salary reduction deferrals (in E's case, $1,000). For 2000, E was not eligible for any catch-up contribution, participated in no other retirement plan, and had no other income exclusions taken into account in computing taxable compensation.

(ii) *Conclusion.* Participant E's annual deferral equaled the maximum limitation of section 457(b) for 2000. E's maximum deferral limitation in 2000 was $4,000 because E's includible compensation was $12,000 ($15,000 minus the deferral of $3,000) and the applicable limitation for 2000 was one third of the individual's includible compensation (one-third of $12,000 equals $4,000). E's salary reduction deferral of $3,000 combined with E's eligible employer's matching contribution of $1,000 equals the limitation of section 457(b) for 2000 because E's annual deferrals totaled $4,000. E's underutilized amount for 2000 is zero.

(v) *Normal retirement age*—(A) *General rule.* For purposes of the special section 457 catch-up in this paragraph (c)(3), a plan must specify the normal retirement age under the plan. A plan may define normal retirement age as any age that is on or after the earlier of age 65 or the age at which participants have the right to retire and receive, under the basic defined benefit pension plan of the State or tax-exempt entity (or a money purchase pension plan in which the participant also participates if the participant is not eligible to participate in a defined benefit plan), immediate retirement benefits without actuarial or similar reduction because of retirement before some later specified age, and that is not later than age 70½. Alternatively, a plan may provide that a participant is allowed to designate a normal retirement age within these ages. For purposes of the special section 457 catch-up in this paragraph (c)(3), an entity sponsoring more than one eligible plan may not permit a participant to have more than one normal retirement age under the eligible plans it sponsors.

(B) *Special rule for eligible plans of qualified police or firefighters.* An eligible plan with participants that include qualified police or firefighters as defined under section 415(b)(2)(H)(ii)(I) may designate a normal retirement age for such qualified police or firefighters that is earlier than the earliest normal retirement age designated under the general rule of paragraph (c)(3)(i)(A) of this section, but in no event may the normal retirement age be earlier than age 40. Alternatively, a plan may allow a qualified police or firefighter participant to designate a normal retirement age that is between age 40 and age 70½.

(vi) *Examples.* The provisions of this paragraph (c)(3) are illustrated by the following examples:

Example 1. (i) *Facts.* Participant F, who will turn 61 on April 1, 2006, becomes eligible to participate in an eligible plan on January 1, 2006. The plan provides a normal retirement age of 65. The plan provides limitations on annual deferrals up to the maximum permitted under paragraphs (c)(1) through (3) of this section. For 2006, F will receive compensation of $40,000 from the eligible employer. F desires to defer the maximum amount possible in 2006. The applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section is $15,000 for 2006 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 is $5,000 for 2006.

(ii) *Conclusion.* F is not eligible for the special section 457 catch-up under paragraph (c)(3) of this section in 2006 because 2006 is not one of the last three taxable years ending before F attains normal retirement age. Accordingly, the maximum that F may defer for 2006 is $20,000. See also paragraph (c)(2)(iii) *Example 1* of this section.

Example 2. (i) *Facts.* The facts are the same as in *Example 1* except that, in 2006, F elects to defer only $2,000 under the plan (rather than the maximum permitted amount of $20,000). In addition, assume that the applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section continues to be $15,000 for 2007 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 continues to be $5,000 for 2007. In F's taxable year 2007, which is one of the last three taxable years ending before F attains the plan's normal retirement age of 65, F again receives a salary of $40,000 and elects to defer the maximum amount permissible under the plan's catch-up provisions prescribed under paragraph (c) of this section.

(ii) *Conclusion.* For 2007, which is one of the last three taxable years ending before F attains the plan's normal retirement age of 65, the applicable limit on deferrals for F is the larger of the amount under the special section 457 catch-up or $20,000, which is the basic annual limitation ($15,000) and the age 50 catch-up limit of section 414(v) ($5,000). For 2007, F's special section 457 catch-up amount is the lesser of two times the basic annual limitation ($30,000) or the sum of the basic annual limitation ($15,000) plus the $13,000 underutilized limitation under paragraph (c)(3)(ii) of this section (the $15,000 plan ceiling in 2006, minus the $2,000 contributed for F in 2006), or $28,000. Thus, the maximum amount that F may defer in 2007 is $28,000.

Example 3. (i) *Facts.* The facts are the same as in *Examples 1* and *2*, except that F does not make any contributions to the plan before 2010. In addition, assume that the applicable basic dollar limitation of paragraph (c)(1)(i)(A) of this section continues to be $15,000 for 2010 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 continues to be $5,000 for 2010. In F's taxable year 2010, the year in which F attains age 65 (which is the normal retirement age under the plan), F desires to defer the maximum amount possible under the plan. F's compensation for 2010 is again $40,000.

(ii) *Conclusion.* For 2010, the maximum amount that F may defer is $20,000. The special section 457 catch-up provisions under paragraph (c)(3) of this section are not applicable because 2010 is not a taxable year ending before the year in which F attains normal retirement age.

(4) *Cost-of-living adjustment.* For years beginning after December 31, 2006, the $15,000 dollar limitation in paragraph (c)(1)(i)(A) of this section will be adjusted to take into account increases in the cost-of-living. The adjustment in the dollar limitation is made at the same time and in the same manner as under section 415(d) (relating to qualified plans under section 401(a)), except that the base period is the calendar quarter beginning July 1, 2005 and any increase which is not a multiple of $500 will be rounded to the next lowest multiple of $500.

(d) *Deferrals after severance from employment, including sick, vacation, and back pay under an eligible plan*—(1) *In general.* An eligible plan may provide that a participant who has not had a severance from employment may elect to defer accumulated sick pay, accumulated vacation pay, and back pay under an eligible plan if the requirements of section 457(b) are satisfied. For example, the plan must provide, in accordance with paragraph (b) of this section, that these amounts may be deferred for any calendar month only if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available and the participant is an employee on the date the amounts would otherwise be paid or made available. For purposes of section 457, compensation that would otherwise be paid for a payroll period that begins before severance from employment is treated as an amount that would otherwise be paid or made available before an employee has a severance from employment. In addition, deferrals may be made for former employees with respect to compensation described in § 1.415(c)–2(e)(3)(i) (relating to certain compensation paid by the later of 2½ months after severance from employment or the end of the limitation year that includes the date of severance from employment). For this purpose, the calendar year is substituted for the limitation year. In addition, compensation described in § 1.415(c)–2(e)(4), (g)(4), or (g)(7) (relating to compensation paid to participants who are permanently and totally disabled or compensation relating to qualified military service under section 414(u)), provided those amounts represent compensation described in § 1.415(c)–2(e)(3)(i).

(2) *Examples.* The provisions of this paragraph (d) are illustrated by the following examples:

Example 1. (i) *Facts.* Participant G, who is age 62 in year 2007, is an employee who participates in an eligible plan providing a normal retirement age of 65 and a bona fide sick leave and vacation pay program of the eligible employer. Under the terms of G's employer's eligible plan and the sick leave and vacation pay program, G is permitted to make a one-time election to contribute amounts representing accumulated sick pay to the eligible plan. G has a severance from employment on January 12, 2008, at which time G's accumulated sick and vacation pay that is payable on March 15, 2008, totals

$12,000. G elects, on February 4, 2008, to have the $12,000 of accumulated sick and vacation pay contributed to the eligible plan.

(ii) *Conclusion.* Under the terms of the eligible plan and the sick and vacation pay program, G may elect before March 1, 2008, to defer the accumulated sick and vacation pay because the agreement providing for the deferral is entered into before the beginning of the month in which the amount is currently available and the amount is bona fide accumulated sick and vacation pay, as described in §1.415(c)–2(e)(3)(ii), and that is payable by the later of 2½ months after severance from employment or the end of the calendar year that includes the date of severance from employment by G. Thus, under this section and §1.415(c)–2(e)(3)(ii), the $12,000 is included in G's includible compensation for purposes of determining G's includible compensation in year 2008.

Example 2. (i) *Facts.* Same facts as in *Example 1*, except that G's severance from employment is on May 31, 2008, G's $12,000 of accumulated sick and vacation pay is payable on September 15, 2008 (which is by the later of 2½ months after severance from employment or the end of the calendar year that includes the date of severance from employment by G), and G's election to defer the accumulated sick and vacation pay is made before May 1, 2008.

(ii) *Conclusion.* Under this section and §1.415(c)–2(e)(3)(ii), the $12,000 is included in G's includible compensation for purposes of determining G's includible compensation in year 2008.

Example 3. (i) *Facts.* Employer X maintains an eligible plan and a vacation leave plan. Under the terms of the vacation leave plan, employees generally accrue three weeks of vacation per year. Up to one week's unused vacation may be carried over from one year to the next, so that in any single year an employee may have a maximum of four weeks' vacation time. At the beginning of each calendar year, under the terms of the eligible plan (which constitutes an agreement providing for the deferral), the value of any unused vacation time from the prior year in excess of one week is automatically contributed to the eligible plan, to the extent of the employee's maximum deferral limitations. Amounts in excess of the maximum deferral limitations are forfeited.

(ii) *Conclusion.* The value of the unused vacation pay contributed to X's eligible plan pursuant to the terms of the plan and the terms of the vacation leave plan is treated as an annual deferral to the eligible plan for January of the calendar year. No amounts contributed to the eligible plan will be considered made available to a participant in X's eligible plan.

(e) *Excess deferrals under an eligible plan*—(1) *In general.* Any amount deferred under an eligible plan for the taxable year of a participant that exceeds the maximum deferral limitations set forth in paragraphs (c)(1) through (3) of this section, and any amount that exceeds the individual limitation under §1.457–5, constitutes an excess deferral that is taxable in accordance with §1.457–11 for that taxable year. Thus, an excess deferral is includible in gross income in the taxable year deferred or, if later, the first taxable year in which there is no substantial risk of forfeiture.

(2) *Excess deferrals under an eligible governmental plan other than as a result of the individual limitation.* In order to be an eligible governmental plan, the plan must provide that any excess deferral resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section to amounts deferred under the eligible plan (computed without regard to the individual limitation under §1.457–5) will be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. For purposes of determining whether there is an excess deferral resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section, all plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan (without regard to any differences in funding). An eligible governmental plan does not fail to satisfy the requirements of paragraphs (a) through (d) of this section or §§1.457–6 through 1.457–10 (including the distribution rules under §1.457–6 and the funding rules under §1.457–8) solely by reason of a distribution made under this paragraph (e)(2). If such excess deferrals are not corrected by distribution under this paragraph (e)(2), the plan will be an ineligible plan under which benefits are taxable in accordance with §1.457–11.

(3) *Excess deferrals under an eligible plan of a tax-exempt employer other than as a result of the individual limitation.* If a plan of a tax-exempt employer fails to comply with the limitations of paragraphs (c)(1) through (3) of this section, the plan will be an ineligible plan

under which benefits are taxable in accordance with § 1.457–11. However, a plan may distribute to a participant any excess deferrals (and any income allocable to such amount) not later than the first April 15 following the close of the taxable year of the excess deferrals. In such a case, the plan will continue to be treated as an eligible plan. However, any excess deferral is included in the gross income of a participant for the taxable year of the excess deferral. If the excess deferrals are not corrected by distribution under this paragraph (e)(3), the plan is an ineligible plan under which benefits are taxable in accordance with § 1.457–11. For purposes of determining whether there is an excess deferral resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section, all eligible plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan.

(4) *Excess deferrals arising from application of the individual limitation.* An eligible plan may provide that an excess deferral that is a result solely of a failure to comply with the individual limitation under § 1.457–5 for a taxable year may be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. An eligible plan does not fail to satisfy the requirements of paragraphs (a) through (d) of this section or §§ 1.457–6 through 1.457–10 (including the distribution rules under § 1.457–6 and the funding rules under § 1.457–8) solely by reason of a distribution made under this paragraph (e)(4). Although a plan will still maintain eligible status if excess deferrals are not distributed under this paragraph (e)(4), a participant must include the excess amounts in income as provided in paragraph (e)(1) of this section.

(5) *Examples.* The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. (i) *Facts.* In 2006, the eligible plan of State Employer X in which Participant H participates permits a maximum deferral of the lesser of $15,000 or 100 percent of includible compensation. In 2006, H, who has compensation of $28,000, nevertheless defers $16,000 under the eligible plan. Participant H is age 45 and normal retirement age under the plan is age 65. For 2006, the applicable dollar limit under paragraph (c)(1)(i)(A) of this section is $15,000. Employer X discovers the error in January of 2007 when it completes H's 2006 Form W-2 and promptly distributes $1,022 to H (which is the sum of the $1,000 excess and $22 of allocable net income).

(ii) *Conclusion.* Participant H has deferred $1,000 in excess of the $15,000 limitation provided for under the plan for 2006. The $1,000 excess must be included by H in H's income for 2006. In order to correct the failure and still be an eligible plan, the plan must distribute the excess deferral, with allocable net income, as soon as administratively practicable after determining that the amount exceeds the plan deferral limitations. In this case, $22 of the distribution of $1,022 is included in H's gross income for 2007 (and is not an eligible rollover distribution). If the excess deferral were not distributed, the plan would be an ineligible plan with respect to which benefits are taxable in accordance with § 1.457–11.

Example 2. (i) *Facts.* The facts are the same as in *Example 1,* except that X uses a number of separate arrangements with different trustees and annuity insurers to permit employees to defer and H elects deferrals under several of the funding arrangements none of which exceeds $15,000 for any individual funding arrangement, but which total $16,000.

(ii) *Conclusion.* The conclusion is the same as in *Example 1.*

Example 3. (i) *Facts.* The facts are the same as in *Example 1,* except that H's deferral under the eligible plan is limited to $11,000 and H also makes a salary reduction contribution of $5,000 to an annuity contract under section 403(b) with the same Employer X.

(ii) *Conclusion.* H's deferrals are within the plan deferral limitations of Employer X. Because of the repeal of the application of the coordination limitation under former paragraph (2) of section 457(c), H's salary reduction deferrals under the annuity contract are no longer considered in determining H's applicable deferral limits under paragraphs (c)(1) through (3) of this section.

Example 4. (i) *Facts.* The facts are the same as in *Example 1,* except that H's deferral under the eligible governmental plan is limited to $14,000 and H also makes a deferral of $4,000 to an eligible governmental plan of a different employer. Participant H is age 45 and normal retirement age under both eligible plans is age 65.

(ii) *Conclusion.* Because of the application of the individual limitation under § 1.457–5, H has an excess deferral of $3,000 (the sum of $14,000 plus $4,000 equals $18,000, which is $3,000 in excess of the dollar limitation of $15,000). The $3,000 excess deferral, with allocable net income, may be distributed from either plan as soon as administratively practicable after determining that the combined amount exceeds the deferral limitations. If the $3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the $3,000 must be included by H in H's income for 2006.

Example 5. (i) *Facts.* Assume the same facts as in *Example 3,* except that H's deferral under the eligible governmental plan is limited to $14,000 and H also makes a deferral of $4,000 to an eligible plan of Employer Y, a tax-exempt entity.

(ii) *Conclusion.* The results are the same as in *Example 3,* namely, because of the application of the individual limitation under §1.457–5, H has an excess deferral of $3,000. If the $3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the $3,000 must be included by H in H's income for 2006.

Example 6. (i) *Facts.* Assume the same facts as in *Example 5,* except that X is a tax-exempt entity and thus its plan is an eligible plan of a tax-exempt entity.

(ii) *Conclusion.* The results are the same as in Example 5, namely, because of the application of the individual limitation under §1.457–5, H has an excess deferral of $3,000. If the $3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the $3,000 must be included by H into H's income for 2006.

[T.D. 9075, 68 FR 41234, July 11, 2003; 68 FR 51446, Aug. 27, 2003; T.D. 9319, 72 FR 16930, Apr. 5, 2007]

§ 1.457–5 Individual limitation for combined annual deferrals under multiple eligible plans

(a) *General rule.* The individual limitation under section 457(c) and this section equals the basic annual deferral limitation under §1.457–4(c)(1)(i)(A), plus either the age 50 catch-up amount under §1.457–4(c)(2), or the special section 457 catch-up amount under §1.457–4(c)(3), applied by taking into account the combined annual deferral for the participant for any taxable year under all eligible plans. While an eligible plan may include provisions under which it will limit deferrals to meet the individual limitation under section 457(c) and this section, annual deferrals by a participant that exceed the individual limit under section 457(c) and this section (but do not exceed the limits under §1.457–4(c)) will not cause a plan to lose its eligible status. However, to the extent the combined annual deferrals for a participant for any taxable year exceed the individual limitation under section 457(c) and this section for that year, the amounts are treated as excess deferrals as described in §1.457–4(e).

(b) *Limitation applied to participant.* The individual limitation in this section applies to eligible plans of all employers for whom a participant has performed services, including both eligible governmental plans and eligible plans of a tax-exempt entity and both eligible plans of the employer and eligible plans of other employers. Thus, for purposes of determining the amount excluded from a participant's gross income in any taxable year (including the underutilized limitation under §1.457–4 (c)(3)(ii)(B)), the participant's annual deferral under an eligible plan, and the participant's annual deferrals under all other eligible plans, must be determined on an aggregate basis. To the extent that the combined annual deferral amount exceeds the maximum deferral limitation applicable under §1.457–4 (c)(1)(i)(A), (c)(2), or (c)(3), the amount is treated as an excess deferral under §1.457–4(e).

(c) *Special rules for catch-up amounts under multiple eligible plans.* For purposes of applying section 457(c) and this section, the special section 457 catch-up under §1.457–4 (c)(3) is taken into account only to the extent that an annual deferral is made for a participant under an eligible plan as a result of plan provisions permitted under §1.457–4 (c)(3). In addition, if a participant has annual deferrals under more than one eligible plan and the applicable catch-up amount under §1.457–4 (c)(2) or (3) is not the same for each such eligible plan for the taxable year, section 457(c) and this section are applied using the catch-up amount under whichever plan has the largest catch-up amount applicable to the participant.

(d) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. (i) *Facts.* Participant F is age 62 in 2006 and participates in two eligible plans during 2006, Plans J and K, which are each eligible plans of two different governmental entities. Each plan includes provisions allowing the maximum annual deferral permitted under §1.457–4(c)(1) through (3). For 2006, the underutilized amount under §1.457–4 (c)(3)(ii)(B) is $20,000 under Plan J and is $40,000 under Plan K. Normal retirement age is age 65 under both plans. Participant F defers $15,000 under each plan. Participant F's includible compensation is in each case in excess of the deferral. Neither plan designates the $15,000 contribution as a catch-up permitted under each plan's special section 457 catch-up provisions.

(ii) *Conclusion.* For purposes of applying this section to Participant F for 2006, the maximum exclusion is $20,000. This is equal to the sum of $15,000 plus $5,000, which is the age 50 catch-up amount. Thus, F has an excess amount of $10,000 which is treated as an excess deferral for Participant F for 2006 under § 1.457–4(e).

Example 2. (i) *Facts.* Participant E, who will turn 63 on April 1, 2006, participates in four eligible plans during year 2006: Plan W which is an eligible governmental plan; and Plans X, Y, and Z which are each eligible plans of three different tax-exempt entities. For year 2006, the limitation that applies to Participant E under all four plans under § 1.457–4(c)(1)(i)(A) is $15,000. For year 2006, the additional age 50 catch-up limitation that applies to Participant E under all four plans under § 1.457–4(c)(2) is $5,000. Further, for year 2006, different limitations under § 1.457–4(c)(3) and (c)(3)(ii)(B) apply to Participant E under each of these plans, as follows: under Plan W, the underutilized limitation under § 1.457–4(c)(3)(ii)(B) is $7,000; under Plan X, the underutilized limitation under § 1.457–4(c)(3)(ii)(B) is $2,000; under Plan Y, the underutilized limitation under § 1.457–4(c)(3)(ii)(B) is $8,000; and under Plan Z, § 1.457–4(c)(3) is not applicable since normal retirement age is 62 under Plan Z. Participant E's includible compensation is in each case in excess of any applicable deferral.

(ii) *Conclusion.* For purposes of applying this section to Participant E for year 2006, Participant E could elect to defer $23,000 under Plan Y, which is the maximum deferral limitation under § 1.457–4(c)(1) through (3), and to defer no amount under Plans W, X, and Z. The $23,000 maximum amount is equal to the sum of $15,000 plus $8,000, which is the catch-up amount applicable to Participant E under Plan Y and which is the largest catch-up amount applicable to Participant E under any of the four plans for year 2006. Alternatively, Participant E could instead elect to defer the following combination of amounts: An aggregate total of $15,000 to Plans X, Y, and Z, if no contribution is made to Plan W; an aggregate total of $20,000 to any of the four plans, assuming at least $5,000 is contributed to Plan W; or $22,000 to Plan W and none to any of the other three plans.

(iii) If the underutilized amount under Plans W, X, and Y for year 2006 were in each case zero (because E had always contributed the maximum amount or E was a new participant) or an amount not in excess of $5,000, the maximum exclusion under this section would be $20,000 for Participant E for year 2006 ($15,000 plus the $5,000 age 50 catch-up amount), which Participant E could contribute to any of the plans assuming at least $5,000 is contributed to Plan W.

[T.D. 9075, 68 FR 41240, July 11, 2003; 68 FR 51446, Aug. 26, 2003; T.D. 9319, 72 FR 16930, Apr. 5, 2007; 72 FR 28854, May 23, 2007]

§ 1.457–6 Timing of distributions under eligible plans.

(a) *In general.* Except as provided in paragraph (c) of this section (relating to distributions on account of an unforeseeable emergency), paragraph (e) of this section (relating to distributions of small accounts), § 1.457–10(a) (relating to plan terminations), or § 1.457–10(c) (relating to domestic relations orders), amounts deferred under an eligible plan may not be paid to a participant or beneficiary before the participant has a severance from employment with the eligible employer or when the participant attains age 70½, if earlier. For rules relating to loans, see paragraph (f) of this section. This section does not apply to distributions of excess amounts under § 1.457–4(e). However, except to the extent set forth by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter), this section applies to amounts held in a separate account for eligible rollover distributions maintained by an eligible governmental plan as described in § 1.457–10(e)(2).

(b) *Severance from employment*—(1) *Employees.* An employee has a severance from employment with the eligible employer if the employee dies, retires, or otherwise has a severance from employment with the eligible employer. See regulations under section 401(k) for additional guidance concerning severance from employment.

(2) *Independent contractors*—(i) *In general.* An independent contractor is considered to have a severance from employment with the eligible employer upon the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the eligible employer if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration does not constitute a good faith and

complete termination of the contractual relationship if the eligible employer anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, an eligible employer is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to contract again for the services provided under the expired contract, and neither the eligible employer nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, an eligible employer is considered to intend to contract again for the services provided under an expired contract if the eligible employer's doing so is conditioned only upon incurring a need for the services, the availability of funds, or both.

(ii) *Special rule.* Notwithstanding paragraph (b)(2)(i) of this section, the plan is considered to satisfy the requirement described in paragraph (a) of this section that no amounts deferred under the plan be paid or made available to the participant before the participant has a severance from employment with the eligible employer if, with respect to amounts payable to a participant who is an independent contractor, an eligible plan provides that—

(A) No amount will be paid to the participant before a date at least 12 months after the day on which the contract expires under which services are performed for the eligible employer (or, in the case of more than one contract, all such contracts expire); and

(B) No amount payable to the participant on that date will be paid to the participant if, after the expiration of the contract (or contracts) and before that date, the participant performs services for the eligible employer as an independent contractor or an employee.

(c) *Rules applicable to distributions for unforeseeable emergencies*—(1) *In general.* An eligible plan may permit a distribution to a participant or beneficiary for an unforeseeable emergency. The distribution must satisfy the requirements of paragraph (c)(2) of this section.

(2) *Requirements*—(i) *Unforeseeable emergency defined.* An unforeseeable emergency must be defined in the plan as a severe financial hardship of the participant or beneficiary resulting from an illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse, or the participant's or beneficiary's dependent (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(b)(1), (b)(2), and (d)(1)(B)); loss of the participant's or beneficiary's property due to casualty (including the need to rebuild a home following damage to a home not otherwise covered by homeowner's insurance, such as damage that is the result of a natural disaster); or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or the beneficiary. For example, the imminent foreclosure of or eviction from the participant's or beneficiary's primary residence may constitute an unforeseeable emergency. In addition, the need to pay for medical expenses, including non-refundable deductibles, as well as for the cost of prescription drug medication, may constitute an unforeseeable emergency. Finally, the need to pay for the funeral expenses of a spouse or a dependent (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(b)(1), (b)(2), and (d)(1)(B)) of a participant or beneficiary may also constitute an unforeseeable emergency. Except as otherwise specifically provided in this paragraph (c)(2)(i), the purchase of a home and the payment of college tuition are not unforeseeable emergencies under this paragraph (c)(2)(i).

(ii) *Unforeseeable emergency distribution standard.* Whether a participant or beneficiary is faced with an unforeseeable emergency permitting a distribution under this paragraph (c) is to be determined based on the relevant facts and circumstances of each case, but, in any case, a distribution on account of unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the participant's assets, to the extent the liquidation of such assets would not itself cause severe financial hardship, or by cessation of deferrals under the plan.

(iii) *Distribution necessary to satisfy emergency need.* Distributions because of an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include any amounts necessary to pay for any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution).

(d) *Minimum required distributions for eligible plans.* In order to be an eligible plan, a plan must meet the distribution requirements of section 457(d)(1) and (2). Under section 457(d)(2), a plan must meet the minimum distribution requirements of section 401(a)(9). See section 401(a)(9) and the regulations thereunder for these requirements. Section 401(a)(9) requires that a plan begin lifetime distributions to a participant no later than April 1 of the calendar year following the later of the calendar year in which the participant attains age 70½ or the calendar year in which the participant retires.

(e) *Distributions of smaller accounts*—(1) *In general.* An eligible plan may provide for a distribution of all or a portion of a participant's benefit if this paragraph (e)(1) is satisfied. This paragraph (e)(1) is satisfied if the participant's total amount deferred (the participant's total account balance) which is not attributable to rollover contributions (as defined in section 411(a)(11)(D)) is not in excess of the dollar limit under section 411(a)(11)(A), no amount has been deferred under the plan by or for the participant during the two-year period ending on the date of the distribution, and there has been no prior distribution under the plan to the participant under this paragraph (e). An eligible plan is not required to permit distributions under this paragraph (e).

(2) *Alternative provisions possible.* Consistent with the provisions of paragraph (e)(1) of this section, a plan may provide that the total amount deferred for a participant or beneficiary will be distributed automatically to the participant or beneficiary if the requirements of paragraph (e)(1) of this section are met. Alternatively, if the requirements of paragraph (e)(1) of this section are met, the plan may provide for the total amount deferred for a participant or beneficiary to be distributed to the participant or beneficiary only if the participant or beneficiary so elects. The plan is permitted to substitute a specified dollar amount that is less than the total amount deferred. In addition, these two alternatives can be combined; for example, a plan could provide for automatic distributions for up to $500, but allow a participant or beneficiary to elect a distribution if the total account balance is above $500.

(f) *Loans from eligible plans*—(1) *Eligible plans of tax-exempt entities.* If a participant or beneficiary receives (directly or indirectly) any amount deferred as a loan from an eligible plan of a tax-exempt entity, that amount will be treated as having been paid or made available to the individual as a distribution under the plan, in violation of the distribution requirements of section 457(d).

(2) *Eligible governmental plans.* The determination of whether the availability of a loan, the making of a loan, or a failure to repay a loan made from a trustee (or a person treated as a trustee under section 457(g)) of an eligible governmental plan to a participant or beneficiary is treated as a distribution (directly or indirectly) for purposes of this section, and the determination of whether the availability of the loan, the making of the loan, or a failure to repay the loan is in any other respect a violation of the requirements of section 457(b) and the regulations, depends on the facts and circumstances. Among the facts and circumstances are whether the loan has a fixed repayment schedule and bears a reasonable rate of interest, and whether there are repayment safeguards to which a prudent lender would adhere. Thus, for example, a loan must bear a reasonable rate of interest in order to satisfy the exclusive benefit requirement of section 457(g)(1) and §1.457–8(a)(1). See also §1.457–7(b)(3) relating to the application of section 72(p) with respect to the taxation of a loan made under an eligible governmental plan, and §1.72(p)-1 relating to section 72(p)(2).

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

Example. (i) *Facts.* Eligible Plan X of State Y is funded through Trust Z. Plan X permits an employee's account balance under Plan X to be paid in a single sum at severance from employment with State Y. Plan X includes a loan program under which any active employee with a vested account balance may receive a loan from Trust Z. Loans are made pursuant to plan provisions regarding loans that are set forth in the plan under which loans bear a reasonable rate of interest and are secured by the employee's account balance. In order to avoid taxation under §1.457–7(b)(3) and section 72(p)(1), the plan provisions limit the amount of loans and require loans to be repaid in level installments as required under section 72(p)(2). Participant J's vested account balance under Plan X is $50,000. J receives a loan from Trust Z in the amount of $5,000 on December 1, 2003, to be repaid in level installments made quarterly over the 5-year period ending on November 30, 2008. Participant J makes the required repayments until J has a severance from employment from State Y in 2005 and subsequently fails to repay the outstanding loan balance of $2,250. The $2,250 loan balance is offset against J's $80,000 account balance benefit under Plan X, and J elects to be paid the remaining $77,750 in 2005.

(ii) *Conclusion.* The making of the loan to J will not be treated as a violation of the requirements of section 457(b) or the regulations. The cancellation of the loan at severance from employment does not cause Plan X to fail to satisfy the requirements for plan eligibility under section 457. In addition, because the loan satisfies the maximum amount and repayment requirements of section 72(p)(2), J is not required to include any amount in income as a result of the loan until 2005, when J has income of $2,250 as a result of the offset (which is a permissible distribution under this section) and income of $77,750 as a result of the distribution made in 2005.

[T.D. 9075, 68 FR 41240, July 11, 2003; 68 FR 51446, Aug. 27, 2003; T.D. 9319, 72 FR 16930, Apr. 5, 2007]

§ 1.457–7 Taxation of Distributions Under Eligible Plans.

(a) *General rules for when amounts are included in gross income.* The rules for determining when an amount deferred under an eligible plan is includible in the gross income of a participant or beneficiary depend on whether the plan is an eligible governmental plan or an eligible plan of a tax-exempt entity. Paragraph (b) of this section sets forth the rules for an eligible governmental plan. Paragraph (c) of this section sets forth the rules for an eligible plan of a tax-exempt entity.

(b) *Amounts included in gross income under an eligible governmental plan*—(1) *Amounts included in gross income in year paid under an eligible governmental plan.* Except as provided in paragraphs (b)(2) and (3) of this section (or in §1.457–10(c) relating to payments to a spouse or former spouse pursuant to a qualified domestic relations order), amounts deferred under an eligible governmental plan are includible in the gross income of a participant or beneficiary for the taxable year in which paid to the participant or beneficiary under the plan.

(2) *Rollovers to individual retirement arrangements and other eligible retirement plans.* A trustee-to-trustee transfer in accordance with section 401(a)(31) (generally referred to as a direct rollover) from an eligible government plan is not includible in gross income of a participant or beneficiary in the year transferred. In addition, any payment made from an eligible government plan in the form of an eligible rollover distribution (as defined in section 402(c)(4)) is not includible in gross income in the year paid to the extent the payment is transferred to an eligible retirement plan (as defined in section 402(c)(8)(B)) within 60 days, including the transfer to the eligible retirement plan of any property distributed from the eligible governmental plan. For this purpose, the rules of section 402(c)(2) through (7) and (9) apply. Any trustee-to-trustee transfer under this paragraph (b)(2) from an eligible government plan is a distribution that is subject to the distribution requirements of §1.457–6.

(3) *Amounts taxable under section 72(p)(1).* In accordance with section 72(p), the amount of any loan from an eligible governmental plan to a participant or beneficiary (including any pledge or assignment treated as a loan under section 72(p)(1)(B)) is treated as having been received as a distribution from the plan under section 72(p)(1), except to the extent set forth in section 72(p)(2) (relating to loans that do not exceed a maximum amount and that are repayable in accordance with certain terms) and §1.72(p)–1. Thus, except

to the extent a loan satisfies section 72(p)(2), any amount loaned from an eligible governmental plan to a participant or beneficiary (including any pledge or assignment treated as a loan under section 72(p)(1)(B)) is includible in the gross income of the participant or beneficiary for the taxable year in which the loan is made. See generally §1.72(p)–1.

(4) *Examples*. The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. (i) *Facts*. Eligible Plan G of a governmental entity permits distribution of benefits in a single sum or in installments of up to 20 years, with such benefits to commence at any date that is after severance from employment (up to the later of severance from employment or the plan's normal retirement age of 65). Effective for participants who have a severance from employment after December 31, 2001, Plan X allows an election—as to both the date on which payments are to begin and the form in which payments are to be made—to be made by the participant at any time that is before the commencement date selected. However, Plan X chooses to require elections to be filed at least 30 days before the commencement date selected in order for Plan X to have enough time to be able to effectuate the election.

(ii) *Conclusion*. No amounts are included in gross income before actual payments begin. If installment payments begin (and the installment payments are payable over at least 10 years so as not to be eligible rollover distributions), the amount included in gross income for any year is equal to the amount of the installment payment paid during the year.

Example 2. (i) *Facts*. Same facts as in *Example 1*, except that the same rules are extended to participants who had a severance from employment before January 1, 2002.

(ii) *Conclusion*. For all participants (that is, both those who have a severance from employment after December 31, 2001, and those who have a severance from employment before January 1, 2002, including those whose benefit payments have commenced before January 1, 2002), no amounts are included in gross income before actual payments begin. If installment payments begin (and the installment payments are payable over at least 10 years so as not to be eligible rollover distributions), the amount included in gross income for any year is equal to the amount of the installment payment paid during the year.

(c) *Amounts included in gross income under an eligible plan of a tax-exempt entity*—(1) *Amounts included in gross income in year paid or made available under an eligible plan of a tax-exempt entity*. Amounts deferred under an eligible plan of a tax-exempt entity are includible in the gross income of a participant or beneficiary for the taxable year in which paid or otherwise made available to the participant or beneficiary under the plan. Thus, amounts deferred under an eligible plan of a tax-exempt entity are includible in the gross income of the participant or beneficiary in the year the amounts are first made available under the terms of the plan, even if the plan has not distributed the amounts deferred. Amounts deferred under an eligible plan of a tax-exempt entity are not considered made available to the participant or beneficiary solely because the participant or beneficiary is permitted to choose among various investments under the plan.

(2) *When amounts deferred are considered to be made available under an eligible plan of a tax-exempt entity*—(i) *General rule*. Except as provided in paragraphs (c)(2)(ii) through (iv) of this section, amounts deferred under an eligible plan of a tax-exempt entity are considered made available (and, thus, are includible in the gross income of the participant or beneficiary under this paragraph (c)) at the earliest date, on or after severance from employment, on which the plan allows distributions to commence, but in no event later than the date on which distributions must commence pursuant to section 401(a)(9). For example, in the case of a plan that permits distribution to commence on the date that is 60 days after the close of the plan year in which the participant has a severance from employment with the eligible employer, amounts deferred are considered to be made available on that date. However, distributions deferred in accordance with paragraphs (c)(2)(ii) through (iv) of this section are not considered made available prior to the applicable date under paragraphs (c)(2)(ii) through (iv) of this section. In addition, no portion of a participant or beneficiary's account is treated as made available (and thus currently includible in income) under an eligible plan of a tax-exempt entity merely because the participant or beneficiary under the plan may elect

to receive a distribution in any of the following circumstances:

(A) A distribution in the event of an unforeseeable emergency to the extent the distribution is permitted under § 1.457–6(c).

(B) A distribution from an account for which the total amount deferred is not in excess of the dollar limit under section 411(a)(11)(A) to the extent the distribution is permitted under § 1.457–6(e).

(ii) *Initial election to defer commencement of distributions*—(A) *In general.* An eligible plan of a tax-exempt entity may provide a period for making an initial election during which the participant or beneficiary may elect, in accordance with the terms of the plan, to defer the payment of some or all of the amounts deferred to a fixed or determinable future time. The period for making this initial election must expire prior to the first time that any such amounts would be considered made available under the plan under paragraph (c)(2)(i) of this section.

(B) *Failure to make initial election to defer commencement of distributions.* Generally, if no initial election is made by a participant or beneficiary under this paragraph (c)(2)(ii), then the amounts deferred under an eligible plan of a tax-exempt entity are considered made available and taxable to the participant or beneficiary in accordance with paragraph (c)(2)(i) of this section at the earliest time, on or after severance from employment (but in no event later than the date on which distributions must commence pursuant to section 401(a)(9)), that distribution is permitted to commence under the terms of the plan. However, the plan may provide for a default payment schedule that applies if no election is made. If the plan provides for a default payment schedule, the amounts deferred are includible in the gross income of the participant or beneficiary in the year the amounts deferred are first made available under the terms of the default payment schedule.

(iii) *Additional election to defer commencement of distribution.* An eligible plan of a tax-exempt entity is permitted to provide that a participant or beneficiary who has made an initial election under paragraph (c)(2)(ii)(A) of this section may make one additional election to defer (but not accelerate) commencement of distributions under the plan before distributions have commenced in accordance with the initial deferral election under paragraph (c)(2)(ii)(A) of this section. Amounts payable to a participant or beneficiary under an eligible plan of a tax-exempt entity are not treated as made available merely because the plan allows the participant to make an additional election under this paragraph (c)(2)(iii). A participant or beneficiary is not precluded from making an additional election to defer commencement of distributions merely because the participant or beneficiary has previously received a distribution under § 1.457–6(c) because of an unforeseeable emergency, has received a distribution of smaller amounts under § 1.457–6(e), has made (and revoked) other deferral or method of payment elections within the initial election period, or is subject to a default payment schedule under which the commencement of benefits is deferred (for example, until a participant is age 65).

(iv) *Election as to method of payment.* An eligible plan of a tax-exempt entity may provide that an election as to the method of payment under the plan may be made at any time prior to the time the amounts are distributed in accordance with the participant or beneficiary's initial or additional election to defer commencement of distributions under paragraph (c)(2)(ii) or (iii) of this section. Where no method of payment is elected, the entire amount deferred will be includible in the gross income of the participant or beneficiary when the amounts first become made available in accordance with a participant's initial or additional elections to defer under paragraphs (c)(2)(ii) and (iii) of this section, unless the eligible plan provides for a default method of payment (in which case amounts are considered made available and taxable when paid under the terms of the default payment schedule). A method of payment means a distribution or a series of periodic distributions commencing on a date determined in accordance with paragraph (c)(2)(ii) or (iii) of this section.

(3) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. (i) *Facts.* Eligible Plan X of a tax-exempt entity provides that a participant's total account balance, representing all amounts deferred under the plan, is payable to a participant in a single sum 60 days after severance from employment throughout these examples, unless, during a 30-day period immediately following the severance, the participant elects to receive the single sum payment at a later date (that is not later than the plan's normal retirement age of 65) or elects to receive distribution in 10 annual installments to begin 60 days after severance from employment (or at a later date, if so elected, that is not later than the plan's normal retirement age of 65). On November 13, 2004, K, a calendar year taxpayer, has a severance from employment with the eligible employer. K does not, within the 30-day window period, elect to postpone distributions to a later date or to receive payment in 10 fixed annual installments.

(ii) *Conclusion.* The single sum payment is payable to K 60 days after the date K has a severance from employment (January 12, 2005), and is includible in the gross income of K in 2005 under section 457(a).

Example 2. (i) *Facts.* The terms of eligible Plan X are the same as described in *Example 1*. Participant L participates in eligible Plan X. On November 11, 2003, L has a severance from the employment of the eligible employer. On November 24, 2003, L makes an initial deferral election not to receive the single-sum payment payable 60 days after the severance, and instead elects to receive the amounts in 10 annual installments to begin 60 days after severance from employment.

(ii) *Conclusion.* No portion of L's account is considered made available in 2003 or 2004 before a payment is made and no amount is includible in the gross income of L until distributions commence. The annual installment payable in 2004 will be includible in L's gross income in 2004.

Example 3. (i) *Facts.* The facts are the same as in *Example 1*, except that eligible Plan X also provides that those participants who are receiving distributions in 10 annual installments may, at any time and without restriction, elect to receive a cash out of all remaining installments. Participant M elects to receive a distribution in 10 annual installments commencing in 2004.

(ii) *Conclusion.* M's total account balance, representing the total of the amounts deferred under the plan, is considered made available and is includible in M's gross income in 2004.

Example 4. (i) *Facts.* The facts are the same as in *Example 3*, except that, instead of providing for an unrestricted cashout of remaining payments, the plan provides that participants or beneficiaries who are receiving distributions in 10 annual installments may accelerate the payment of the amount remaining payable to the participant upon the occurrence of an unforeseeable emergency as described in §1.457–6(c)(1) in an amount not exceeding that described in §1.457–6(c)(2).

(ii) *Conclusion.* No amount is considered made available to participant M on account of M's right to accelerate payments upon the occurrence of an unforeseeable emergency.

Example 5. (i) *Facts.* Eligible Plan Y of a tax-exempt entity provides that distributions will commence 60 days after a participant's severance from employment unless the participant elects, within a 30-day window period following severance from employment, to defer distributions to a later date (but no later than the year following the calendar year the participant attains age 70½). The plan provides that a participant who has elected to defer distributions to a later date may make an election as to form of distribution at any time prior to the 30th day before distributions are to commence.

(ii) *Conclusion.* No amount is considered made available prior to the date distributions are to commence by reason of a participant's right to defer or make an election as to the form of distribution.

Example 6. (i) *Facts.* The facts are the same as in *Example 1*, except that the plan also permits participants who have made an initial election to defer distribution to make one additional deferral election at any time prior to the date distributions are scheduled to commence. Participant N has a severance from employment at age 50. The next day, during the 30-day period provided in the plan, N elects to receive distribution in the form of 10 annual installment payments beginning at age 55. Two weeks later, within the 30-day window period, N makes a new election permitted under the plan to receive 10 annual installment payments beginning at age 60 (instead of age 55). When N is age 59, N elects under the additional deferral election provisions, to defer distributions until age 65.

(ii) *Conclusion.* In this example, N's election to defer distributions until age 65 is a valid election. The two elections N makes during the 30-day window period are not additional deferral elections described in paragraph (c)(2)(iii) of this section because they are made before the first permissible payout date under the plan. Therefore, the plan is not precluded from allowing N to make the additional deferral election. However, N can make no further election to defer distributions beyond age 65 (or accelerate distribution before age 65) because this additional deferral election can only be made once.

[T.D. 9075, 68 FR 41240, July 11, 2003; 68 FR 51447, Aug. 27, 2003]

§ 1.457–8 Funding rules for eligible plans.

(a) *Eligible governmental plans*—(1) *In general*. In order to be an eligible governmental plan, all amounts deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights, must be held in trust for the exclusive benefit of participants and their beneficiaries. A trust described in this paragraph (a) that also meets the requirements of §§ 1.457–3 through 1.457–10 is treated as an organization exempt from tax under section 501(a), and a participant's or beneficiary's interest in amounts in the trust is includible in the gross income of the participants and beneficiaries only to the extent, and at the time, provided for in section 457(a) and §§ 1.457–4 through 1.457–10.

(2) *Trust requirement*. (i) A trust described in this paragraph (a) must be established pursuant to a written agreement that constitutes a valid trust under State law. The terms of the trust must make it impossible, prior to the satisfaction of all liabilities with respect to participants and their beneficiaries, for any part of the assets and income of the trust to be used for, or diverted to, purposes other than for the exclusive benefit of participants and their beneficiaries.

(ii) Amounts deferred under an eligible governmental plan must be transferred to a trust within a period that is not longer than is reasonable for the proper administration of the participant accounts (if any). For purposes of this requirement, the plan may provide for amounts deferred for a participant under the plan to be transferred to the trust within a specified period after the date the amounts would otherwise have been paid to the participant. For example, the plan could provide for amounts deferred under the plan at the election of the participant to be contributed to the trust within 15 business days following the month in which these amounts would otherwise have been paid to the participant.

(3) *Custodial accounts and annuity contracts treated as trusts*—(i) *In general*. For purposes of the trust requirement of this paragraph (a), custodial accounts and annuity contracts described in section 401(f) that satisfy the requirements of this paragraph (a)(3) are treated as trusts under rules similar to the rules of section 401(f). Therefore, the provisions of § 1.401(f)–1(b) will generally apply to determine whether a custodial account or an annuity contract is treated as a trust. The use of a custodial account or annuity contract as part of an eligible governmental plan does not preclude the use of a trust or another custodial account or annuity contract as part of the same plan, provided that all such vehicles satisfy the requirements of section 457(g)(1) and (3) and paragraphs (a)(1) and (2) of this section and that all assets and income of the plan are held in such vehicles.

(ii) *Custodial accounts*—(A) *In general*. A custodial account is treated as a trust, for purposes of section 457(g)(1) and paragraphs (a)(1) and (2) of this section, if the custodian is a bank, as described in section 408(n), or a person who meets the nonbank trustee requirements of paragraph (a)(3)(ii)(B) of this section, and the account meets the requirements of paragraphs (a)(1) and (2) of this section, other than the requirement that it be a trust.

(B) *Nonbank trustee status*. The custodian of a custodial account may be a person other than a bank only if the person demonstrates to the satisfaction of the Commissioner that the manner in which the person will administer the custodial account will be consistent with the requirements of section 457(g)(1) and (3). To do so, the person must demonstrate that the requirements of § 1.408–2(e)(2) through (6) (relating to nonbank trustees) are met. The written application must be sent to the address prescribed by the Commissioner in the same manner as prescribed under § 1.408–2(e). To the extent that a person has already demonstrated to the satisfaction of the Commissioner that the person satisfies the requirements of § 1.408–2(e) in connection with a qualified trust (or custodial account or annuity contract) under section 401(a), that person is deemed to satisfy the requirements of this paragraph (a)(3)(ii)(B).

(iii) *Annuity contracts*. An annuity contract is treated as a trust for purposes of section 457(g)(1) and paragraph (a)(1) of this section if the contract is an annuity contract, as defined in section 401(g), that has been issued by an insurance company qualified to do business in the State, and the contract meets the requirements of paragraphs (a)(1) and (2) of this section, other than the requirement that it be a trust. An annuity contract does not include a life, health or accident, property, casualty, or liability insurance contract.

(4) *Combining assets.* [Reserved]

(b) *Eligible plans maintained by tax-exempt entity*—(1) *General rule.* In order to be an eligible plan of a tax-exempt entity, the plan must be unfunded and plan assets must not be set aside for participants or their beneficiaries. Under section 457(b)(6) and this paragraph (b), an eligible plan of a tax-exempt entity must provide that all amounts deferred under the plan, all property and rights to property (including rights as a beneficiary of a contract providing life insurance protection) purchased with such amounts, and all income attributable to such amounts, property, or rights, must remain (until paid or made available to the participant or beneficiary) solely the property and rights of the eligible employer (without being restricted to the provision of benefits under the plan), subject only to the claims of the eligible employer's general creditors.

(2) *Additional requirements.* For purposes of paragraph (b)(1) of this section, the plan must be unfunded regardless of whether or not the amounts were deferred pursuant to a salary reduction agreement between the eligible employer and the participant. Any funding arrangement under an eligible plan of a tax-exempt entity that sets aside assets for the exclusive benefit of participants violates this requirement, and amounts deferred are generally immediately includible in the gross income of plan participants and beneficiaries. Nothing in this paragraph (b) prohibits an eligible plan from permitting participants and their beneficiaries to make an election among different investment options available under the plan, such as an election affecting the investment of the amounts described in paragraph (b)(1) of this section.

[T.D. 9075, 68 FR 41240, July 11, 2003; 68 FR 51447, Aug. 27, 2003]

§ 1.457–9 Effect on eligible plans when not administered in accordance with eligibility requirements.

(a) *Eligible governmental plans.* A plan of a State ceases to be an eligible governmental plan on the first day of the first plan year beginning more than 180 days after the date on which the Commissioner notifies the State in writing that the plan is being administered in a manner that is inconsistent with one or more of the requirements of §§ 1.457–3 through 1.457–8 or 1.447–10. However, the plan may correct the plan inconsistencies specified in the written notification before the first day of that plan year and continue to maintain plan eligibility. If a plan ceases to be an eligible governmental plan, amounts subsequently deferred by participants will be includible in income when deferred, or, if later, when the amounts deferred cease to be subject to a substantial risk of forfeiture, as provided at § 1.457–11. Amounts deferred before the date on which the plan ceases to be an eligible governmental plan, and any earnings thereon, will be treated as if the plan continues to be an eligible governmental plan and will not be includible in participant's or beneficiary's gross income until paid to the participant or beneficiary.

(b) *Eligible plans of tax-exempt entities.* A plan of a tax-exempt entity ceases to be an eligible plan on the first day that the plan fails to satisfy one or more of the requirements of §§ 1.457–3 through 1.457–8, or § 1.457–10. *See* § 1.457–11 for rules regarding the treatment of an ineligible plan.

[T.D. 9075, 68 FR 41240, July 11, 2003; 68 FR 51447, Aug. 27, 2003]

§ 1.457–10 Miscellaneous provisions.

(a) *Plan terminations and frozen plans*—(1) *In general.* An eligible employer may amend its plan to eliminate future deferrals for existing participants or to limit participation to existing participants and employees. An eligible plan may also contain provisions that permit plan termination and permit amounts deferred to be distributed on termination. In order for a plan to be considered terminated, amounts deferred under an eligible plan must be distributed to all plan participants and beneficiaries as soon as administratively practicable after termination of the eligible plan. The mere provision for, and making of, distributions to participants or beneficiaries upon a plan termination will not cause an eligible plan to cease to satisfy the requirements of section 457(b) or the regulations.

(2) *Employers that cease to be eligible employers*—(i) *Plan not terminated.* An eligible employer that ceases to be an eligible employer may no longer maintain an eligible plan. If the employer was a tax-exempt entity and the plan is not terminated as permitted under paragraph (a)(2)(ii) of this section, the tax consequences to participants and beneficiaries in the previously eligible (unfunded) plan of an ineligible employer are determined in accordance with either section 451 if the employer becomes an entity other than a State or §1.457–11 if the employer becomes a State. If the employer was a State and the plan is neither terminated as permitted under paragraph (a)(2)(ii) of this section nor transferred to another eligible plan of that State as permitted under paragraph (b) of this section, the tax consequences to participants in the previously eligible governmental plan of an ineligible employer, the assets of which are held in trust pursuant to §1.457–8(a), are determined in accordance with section 402(b) (section 403(c) in the case of an annuity contract) and the trust is no longer to be treated as a trust that is exempt from tax under section 501(a).

(ii) *Plan termination.* As an alternative to determining the tax consequences to the plan and participants under paragraph (a)(2)(i) of this section, the employer may terminate the plan and distribute the amounts deferred (and all plan assets) to all plan participants as soon as administratively practicable in accordance with paragraph (a)(1) of this section. Such distribution may include eligible rollover distributions in the case of a plan that was an eligible governmental plan. In addition, if the employer is a State, another alternative to determining the tax consequences under paragraph (a)(2)(i) of this section is to transfer the assets of the eligible governmental plan to an eligible governmental plan of another eligible employer within the same State under the plan-to-plan transfer rules of paragraph (b) of this section.

(3) *Examples.* The provisions of this paragraph (a) are illustrated by the following examples:

Example 1. (i) *Facts.* Employer Y, a corporation that owns a State hospital, sponsors an eligible governmental plan funded through a trust. Employer Y is acquired by a for-profit hospital and Employer Y ceases to be an eligible employer under section 457(e)(1) or §1.457–2(e). Employer Y terminates the plan and, during the next 6 months, distributes to participants and beneficiaries all amounts deferred that were under the plan.

(ii) *Conclusion.* The termination and distribution does not cause the plan to fail to be an eligible governmental plan. Amounts that are distributed as eligible rollover distributions may be rolled over to an eligible retirement plan described in section 402(c)(8)(B).

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that Employer Y decides to continue to maintain the plan.

(ii) *Conclusion.* If Employer Y continues to maintain the plan, the tax consequences to participants and beneficiaries will be determined in accordance with either section 402(b) if the compensation deferred is funded through a trust, section 403(c) if the compensation deferred is funded through annuity contracts, or §1.457–11 if the compensation deferred is not funded through a trust or annuity contract. In addition, if Employer Y continues to maintain the plan, the trust will no longer be treated as exempt from tax under section 501(a).

Example 3. (i) *Facts.* Employer Z, a corporation that owns a tax-exempt hospital, sponsors an unfunded eligible plan. Employer Z is acquired by a for-profit hospital and is no longer an eligible employer under section 457(e)(1) or §1.457–2(e). Employer Z terminates the plan and distributes all amounts deferred under the eligible plan to participants and beneficiaries within a one-year period.

(ii) *Conclusion.* Distributions under the plan are treated as made under an eligible plan of a tax-exempt entity and the distributions of the amounts deferred are includible in the gross income of the participant or beneficiary in the year distributed.

Example 4. (i) *Facts.* The facts are the same as in *Example 3*, except that Employer Z decides to maintain instead of terminate the plan.

(ii) *Conclusion.* If Employer Z maintains the plan, the tax consequences to participants and beneficiaries in the plan will thereafter be determined in accordance with section 451.

(b) *Plan-to-plan transfers*—(1) *General rule.* An eligible governmental plan may provide for the transfer of amounts deferred by a participant or beneficiary to another eligible governmental plan if the conditions in paragraphs (b)(2), (3), or (4) of this section are met. An eligible plan of a tax-exempt entity may provide for transfers of amounts deferred by a participant to another eligible plan of a tax-exempt entity if the conditions in paragraph (b)(5) of this section are met. In addition, an eligible governmental plan may accept transfers from another eligible governmental plan as described in the first sentence of this paragraph (b)(1), and an eligible plan of a tax-exempt entity may accept transfers from another eligible plan of a tax-exempt entity as described in the preceding sentence. However, a State may not transfer the assets of its eligible governmental plan to a tax-exempt entity's eligible plan and the plan of a tax-exempt entity may not accept such a transfer. Similarly, a tax-exempt entity may not transfer the assets of its eligible plan to an eligible governmental plan and an eligible governmental plan may not accept such a transfer. In addition, if the conditions in paragraph (b)(4) of this section (relating to permissive past service credit and repayments under section 415) are met, an eligible governmental plan of a State may provide for the transfer of amounts deferred by a participant or beneficiary to a qualified plan (under section 401(a)) maintained by a State. However, a qualified plan may not transfer assets to an eligible governmental plan or to an eligible plan of a tax-exempt entity, and an eligible governmental plan or the plan of a tax-exempt entity may not accept such a transfer.

(2) *Requirements for post-severance plan-to-plan transfers among eligible governmental plans.* A transfer under paragraph (b)(1) of this section from an eligible governmental plan to another eligible governmental plan is permitted if the following conditions are met—

(i) The transferor plan provides for transfers;

(ii) The receiving plan provides for the receipt of transfers;

(iii) The participant or beneficiary whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer; and

(iv) In the case of a transfer for a participant, the participant has had a severance from employment with the transferring employer and is performing services for the entity maintaining the receiving plan.

(3) *Requirements for plan-to-plan transfers of all plan assets of eligible governmental plan.* A transfer under paragraph (b)(1) of this section from an eligible governmental plan to another eligible governmental plan is permitted if the following conditions are met—

(i) The transfer is from an eligible governmental plan to another eligible governmental plan within the same State;

(ii) All of the assets held by the transferor plan are transferred;

(iii) The transferor plan provides for transfers;

(iv) The receiving plan provides for the receipt of transfers;

(v) The participant or beneficiary whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer; and

(vi) The participants or beneficiaries whose deferred amounts are being transferred are not eligible for additional annual deferrals in the receiving plan unless they are performing services for the entity maintaining the receiving plan.

(4) *Requirements for plan-to-plan transfers among eligible governmental plans of the same employer.* A transfer under paragraph (b)(1) of this section from an eligible governmental plan to another eligible governmental plan is permitted if the following conditions are met—

(i) The transfer is from an eligible governmental plan to another eligible governmental plan of the same employer (and, for this purpose, the employer is not treated as the same employer if the participant's compensation is paid by a different entity);

(ii) The transferor plan provides for transfers;

(iii) The receiving plan provides for the receipt of transfers;

(iv) The participant or beneficiary whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer; and

(v) The participant or beneficiary whose deferred amounts are being transferred is not eligible for additional annual deferrals in the receiving plan unless the participant or beneficiary is performing services for the entity maintaining the receiving plan.

(5) *Requirements for post-severance plan-to-plan transfers among eligible plans of tax-exempt entities.* A transfer under paragraph (b)(1) of this section from an eligible plan of a tax-exempt employer to another eligible plan of a tax-exempt employer is permitted if the following conditions are met—

(i) The transferor plan provides for transfers;

(ii) The receiving plan provides for the receipt of transfers;

(iii) The participant or beneficiary whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer; and

(iv) In the case of a transfer for a participant, the participant has had a severance from employment with the transferring employer and is performing services for the entity maintaining the receiving plan.

(6) *Treatment of amount transferred following a plan-to-plan transfer between eligible plans.* Following a transfer of any amount between eligible plans under paragraphs (b)(1) through (b)(5) of this section—

(i) The transferred amount is subject to the restrictions of §1.457–6 (relating to when distributions are permitted to be made to a participant under an eligible plan) in the receiving plan in the same manner as if the transferred amount had been originally been deferred under the receiving plan if the participant is performing services for the entity maintaining the receiving plan, and

(ii) In the case of a transfer between eligible plans of tax-exempt entities, except as otherwise determined by the Commissioner, the transferred amount is subject to §1.457–7(c)(2) (relating to when amounts are considered to be made available under an eligible plan of a tax-exempt entity) in the same manner as if the elections made by the participant or beneficiary under the transferor plan had been made under the receiving plan.

(7) *Examples.* The provisions of paragraphs (b)(1) through (6) of this section are illustrated by the following examples:

Example 1. (i) *Facts.* Participant A, the president of City X's hospital, has accepted a position with another hospital which is a tax-exempt entity. A participates in the eligible governmental plan of City X. A would like to transfer the amounts deferred under City X's eligible governmental plan to the eligible plan of the tax-exempt hospital.

(ii) *Conclusion.* City X's plan may not transfer A's amounts deferred to the tax-exempt employer's eligible plan. In addition, because the amounts deferred would no longer be held in trust for the exclusive benefit of participants and their beneficiaries, the transfer would violate the exclusive benefit rule of section 457(g) and §1.457–8(a).

Example 2. (i) *Facts.* County M, located in State S, operates several health clinics and maintains an eligible governmental plan for employees of those clinics. One of the clinics operated by County M is being acquired by a hospital operated by State S, and employees of that clinic will become employees of State S. County M permits those employees to transfer their balances under County M's eligible governmental plan to the eligible governmental plan of State S.

(ii) *Conclusion.* If the eligible governmental plans of County M and State S provide for the transfer and acceptance of the transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), then the requirements of paragraph (b)(2) of this section are satisfied and, thus, the transfer will not cause either plan to violate the requirements of section 457 or these regulations.

Example 3. (i) *Facts.* City Employer Z, a hospital, sponsors an eligible governmental plan. City Employer Z is located in State B. All of the assets of City Employer Z are being acquired by a tax-exempt hospital. City Employer Z, in accordance with the plan-to-plan transfer rules of paragraph (b) of this section, would like to transfer the total amount of assets deferred under City Employer Z's eligible governmental plan to the acquiring tax-exempt entity's eligible plan.

(ii) *Conclusion.* City Employer Z may not permit participants to transfer the amounts to the eligible plan of the tax-exempt entity. In addition, because the amounts deferred would no longer be held in trust for the exclusive benefit of participants and their beneficiaries, the transfer would violate the exclusive benefit rule of section 457(g) and §1.457–8(a).

Example 4. (i) *Facts.* The facts are the same as in *Example 3,* except that City Employer Z, instead of transferring all of its assets to the eligible plan of the tax-exempt entity, decides to transfer all of the amounts deferred under City Z's eligible governmental plan to the eligible governmental plan of County B in which City Z is located. County B's eligible plan does not cover employees of City Z, but is willing to allow the assets of City Z's plan to be transferred to County B's plan, a related state government entity, also located in State B.

(ii) *Conclusion.* If City Employer Z's (transferor) eligible governmental plan provides for such transfer and the eligible governmental plan of County B permits the acceptance of such a transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), then the requirements of paragraph (b)(3) of this section are satisfied and, thus, City Employer Z may transfer the total amounts deferred under its eligible governmental plan, prior to termination of that plan, to the eligible governmental plan maintained by County B. However, the participants of City Employer Z whose deferred amounts are being transferred are not eligible to participate in the eligible governmental plan of County B, the receiving plan, unless they are performing services for County B.

Example 5. (i) *Facts.* State C has an eligible governmental plan. Employees of City U in State C are among the eligible employees for State C's plan and City U decides to adopt another eligible governmental plan only for its employees. State C decides to allow employees to elect to transfer all of the amounts deferred for an employee under State C's eligible governmental plan to City U's eligible governmental plan.

(ii) Conclusion. If State C's (transferor) eligible governmental plan provides for such transfer and the eligible governmental plan of City U permits the acceptance of such a transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), then the requirements of paragraph (b)(4) of this section are satisfied and, thus, State C may transfer the total amounts deferred under its eligible governmental plan to the eligible governmental plan maintained by City U.

(8) *Purchase of permissive service credit by plan-to-plan transfers from an eligible governmental plan to a qualified plan*—(i) *General rule.* An eligible governmental plan of a State may provide for the transfer of amounts deferred by a participant or beneficiary to a defined benefit governmental plan (as defined in section 414(d)), and no amount shall be includible in gross income by reason of the transfer, if the conditions in paragraph (b)(8)(ii) of this section are met. A transfer under this paragraph (b)(8) is not treated as a distribution for purposes of §1.457–6. Therefore, such a transfer may be made before severance from employment.

(ii) *Conditions for plan-to-plan transfers from an eligible governmental plan to a qualified plan.* A transfer may be made under this paragraph (b)(8) only if the transfer is either—

(A) For the purchase of permissive service credit (as defined in section 415(n)(3)(A)) under the receiving defined benefit governmental plan; or

(B) A repayment to which section 415 does not apply by reason of section 415(k)(3).

(iii) *Example.* The provisions of this paragraph (b)(8) are illustrated by the following example:

Example. (i) *Facts.* Plan X is an eligible governmental plan maintained by County Y for its employees. Plan X provides for distributions only in the event of death, an unforeseeable emergency, or severance from employment with County Y (including retirement from County Y). Plan S is a qualified defined benefit plan maintained by State T for its employees. County Y is within State T. Employee A is an employee of County Y and is a participant in Plan X. Employee A previously was an employee of State T and is still entitled to benefits under Plan S. Plan S includes provisions allowing participants in certain plans, including Plan X, to transfer assets to Plan S for the purchase of service credit under Plan S and does not permit the amount transferred to exceed the amount necessary to fund the benefit resulting from the service credit. Although not required to do so, Plan X allows Employee A to transfer assets to Plan S to provide a service benefit under Plan S.

(ii) *Conclusion.* The transfer is permitted under this paragraph (b)(8).

(c) *Qualified domestic relations orders under eligible plans*—(1) *General rule.* An eligible plan does not become an ineligible plan described in section 457(f) solely because its administrator or sponsor complies with a qualified domestic relations order as defined in section 414(p), including an order requiring the distribution of the benefits of a participant to an alternate payee in advance of the general rules for eligible plan distributions under §1.457–6. If a distribution or payment is made from an eligible plan to an alternate payee pursuant to a qualified domestic relations order, rules similar to the rules of section 402(e)(1)(A) shall apply to the distribution or payment.

(2) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. (i) *Facts.* Participant C and C's spouse D are divorcing. C is employed by State S and is a participant in an eligible plan maintained by State S. C has an account valued at $100,000 under the plan. Pursuant to the divorce, a court issues a qualified domestic relations order on September 1, 2003 that allocates 50 percent of C's $100,000 plan account to D and specifically provides for an immediate distribution to D of D's share within 6 months of the order. Payment is made to D in January of 2004.

(ii) *Conclusion.* State S's eligible plan does not become an ineligible plan described in section 457(f) and §1.457–11 solely because its administrator or sponsor complies with the qualified domestic relations order requiring the immediate distribution to D in advance of the general rules for eligible plan distributions under §1.457–6. In accordance with section 402(e)(1)(A), D (not C) must include the distribution in gross income. The distribution is includible in D's gross income in 2004. If the qualified domestic relations order were to provide for distribution to D at a future date, amounts deferred attributable to D's share will be includible in D's gross income when paid to D.

Example 2. (i) *Facts.* The facts are the same as in *Example 1,* except that S is a tax-exempt entity, instead of a State.

(ii) *Conclusion.* State S's eligible plan does not become an ineligible plan described in section 457(f) and §1.457–11 solely because its administrator or sponsor complies with the qualified domestic relations order requiring the immediate distribution to D in advance of the general rules for eligible plan distributions under §1.457–6. In accordance with section 402(e)(1)(A), D (not C) must include the distribution in gross income. The distribution is includible in D's gross income in 2004, assuming that the plan did not make the distribution available to D in 2003. If the qualified domestic relations order were to provide for distribution to D at a future date, amounts deferred attributable to D's share would be includible in D's gross income when paid or made available to D.

(d) *Death benefits and life insurance proceeds.* A death benefit plan under section 457(e)(11) is not an eligible plan. In addition, no amount paid or made available under an eligible plan as death benefits or life insurance proceeds is excludable from gross income under section 101.

(e) *Rollovers to eligible governmental plans*—(1) *General rule.* An eligible governmental plan may accept contributions that are eligible rollover distributions (as defined in section 402(c)(4)) made from another eligible retirement plan (as defined in section 402(c)(8)(B)) if the conditions in paragraph (e)(2) of this section are met. Amounts contributed to an eligible governmental plan as eligible rollover distributions are not taken into account for purposes of the annual limit on annual deferrals by a participant in §1.457–4(c) or §1.457–5, but are otherwise treated in the same manner as amounts deferred under section 457 for purposes of §§1.457–3 through 1.457–9 and this section.

(2) *Conditions for rollovers to an eligible governmental plan.* An eligible governmental plan that permits eligible rollover distributions made from another eligible retirement plan to be paid into the eligible governmental plan is required under this paragraph (e)(2) to provide that it will separately account for any eligible rollover distributions it receives. A plan does not fail to satisfy this requirement if it separately accounts for particular types of eligible rollover distributions (for example, if it maintains a separate account for eligible rollover distributions attributable to annual deferrals that were made under other eligible governmental plans and a separate account for amounts attributable to other eligible rollover distributions), but this requirement is not satisfied if any such separate account includes any amount

that is not attributable to an eligible rollover distribution.

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

Example. (i) *Facts*. Plan T is an eligible governmental plan that provides that employees who are eligible to participate in Plan T may make rollover contributions to Plan T from amounts distributed to an employee from an eligible retirement plan. An eligible retirement plan is defined in Plan T as another eligible governmental plan, a qualified section 401(a) or 403(a) plan, or a section 403(b) contract, or an individual retirement arrangement (IRA) that holds such amounts. Plan T requires rollover contributions to be paid by the eligible retirement plan directly to Plan T (a direct rollover) or to be paid by the participant within 60 days after the date on which the participant received the amount from the other eligible retirement plan. Plan T does not take rollover contributions into account for purposes of the plan's limits on amounts deferred that conform to §1.457–4(c). Rollover contributions paid to Plan T are invested in the trust in the same manner as amounts deferred under Plan T and rollover contributions (and earnings thereon) are available for distribution to the participant at the same time and in the same manner as amounts deferred under Plan T. In addition, Plan T provides that, for each participant who makes a rollover contribution to Plan T, the Plan T record-keeper is to establish a separate account for the participant's rollover contributions. The record-keeper calculates earnings and losses for investments held in the rollover account separately from earnings and losses on other amounts held under the plan and calculates disbursements from and payments made to the rollover account separately from disbursements from and payments made to other amounts held under the plan.

(ii) *Conclusion*. Plan T does not lose its status as an eligible governmental plan as a result of the receipt of rollover contributions. The conclusion would not be different if the Plan T record-keeper were to establish two separate accounts, one of which is for the participant's rollover contributions attributable to annual deferrals that were made under an eligible governmental plan and the other of which is for other rollover contributions.

(f) *Deemed IRAs under eligible governmental plans*. See regulations under section 408(q) for guidance regarding the treatment of separate accounts or annuities as individual retirement plans (IRAs).

[T.D. 9075, 68 FR 41240, July 11, 2003; 68 FR 51447, Aug. 27, 2003; T.D. 9319, 72 FR 16931, Apr. 5, 2007]

§ 1.457–11 Tax treatment of participants if plan is not an eligible plan.

(a) *In general*. Under section 457(f), if an eligible employer provides for a deferral of compensation under any agreement or arrangement that is an ineligible plan—

(1) Compensation deferred under the agreement or arrangement is includible in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)) of the rights to such compensation;

(2) If the compensation deferred is subject to a substantial risk of forfeiture, the amount includible in gross income for the first taxable year in which there is no substantial risk of forfeiture includes earnings thereon to the date on which there is no substantial risk of forfeiture;

(3) Earnings credited on the compensation deferred under the agreement or arrangement that are not includible in gross income under paragraph (a)(2) of this section are includible in the gross income of the participant or beneficiary only when paid or made available to the participant or beneficiary, provided that the interest of the participant or beneficiary in any assets (including amounts deferred under the plan) of the entity sponsoring the agreement or arrangement is not senior to the entity's general creditors; and

(4) Amounts paid or made available to a participant or beneficiary under the agreement or arrangement are includible in the gross income of the participant or beneficiary under section 72, relating to annuities.

(b) *Exceptions*. Paragraph (a) of this section does not apply with respect to—

(1) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(2) An annuity plan or contract described in section 403;

(3) That portion of any plan which consists of a transfer of property described in section 83;

(4) That portion of any plan which consists of a trust to which section 402(b) applies; or

(5) A qualified governmental excess benefit arrangement described in section 415(m).

(c) *Amount included in income.* The amount included in gross income on the applicable date under paragraphs (a)(1) and (a)(2) of this section is equal to the present value of the compensation (including earnings to the extent provided in paragraph (a)(2) of this section) on that date. For purposes of applying section 72 on the applicable date under paragraphs (a)(3) and (4) of this section, the participant is treated as having paid investment in the contract (or basis) to the extent that the deferred compensation has been taken into account by the participant in accordance with paragraphs (a)(1) and (a)(2) of this section.

(d) *Coordination of section 457(f) with section 83*—(1) *General rules.* Under paragraph (b)(3) of this section, section 457(f) and paragraph (a) of this section do not apply to that portion of any plan which consists of a transfer of property described in section 83. For this purpose, a transfer of property described in section 83 means a transfer of property to which section 83 applies. Section 457(f) and paragraph (a) of this section do not apply if the date on which there is no substantial risk of forfeiture with respect to compensation deferred under an agreement or arrangement that is not an eligible plan is on or after the date on which there is a transfer of property to which section 83 applies. However, section 457(f) and paragraph (a) of this section apply if the date on which there is no substantial risk of forfeiture with respect to compensation deferred under an agreement or arrangement that is not an eligible plan precedes the date on which there is a transfer of property to which section 83 applies. If deferred compensation payable in property is includible in gross income under section 457(f), then, as provided in section 72, the amount includible in gross income when that property is later transferred or made available to the service provider is the excess of the value of the property at that time over the amount previously included in gross income under section 457(f).

(2) *Examples.* The provisions of this paragraph (d) are illustrated in the following examples:

Example 1. (i) *Facts.* As part of an arrangement for the deferral of compensation, an eligible employer agrees on December 1, 2002 to pay an individual rendering services for the eligible employer a specified dollar amount on January 15, 2005. The arrangement provides for the payment to be made in the form of property having a fair market value equal to the specified dollar amount. The individual's rights to the payment are not subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)).

(ii) *Conclusion.* In this *Example 1*, because there is no substantial risk of forfeiture with respect to the agreement to transfer property in 2005, the present value (as of December 1, 2002) of the payment is includible in the individual's gross income for 2002. Under paragraph (a)(4) of this section, when the payment is made on January 15, 2005, the amount includible in the individual's gross income is equal to the excess of the fair market value of the property when paid, over the amount that was includible in gross income for 2002 (which is the basis allocable to that payment).

Example 2. (i) *Facts.* As part of an arrangement for the deferral of compensation, individuals A and B rendering services for a tax-exempt entity each receive in 2010 property that is subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and within the meaning of section 83(c)(1)). Individual A makes an election to include the fair market value of the property in gross income under section 83(b) and individual B does not make this election. The substantial risk of forfeiture for the property transferred to individual A lapses in 2012 and the substantial risk of forfeiture for the property transferred to individual B also lapses in 2012. Thus, the property transferred to individual A is included in A's gross income for 2010 when A makes a section 83(b) election and the property transferred to individual B is included in B's gross income for 2012 when the substantial risk of forfeiture for the property lapses.

(ii) *Conclusion.* In this *Example 2*, in each case, the compensation deferred is not subject to section 457(f) or this section because section 83 applies to the transfer of property on or before the date on which there is no substantial risk of forfeiture with respect to compensation deferred under the arrangement.

Example 3. (i) *Facts.* In 2004, Z, a tax-exempt entity, grants an option to acquire property to employee C. The option lacks a readily ascertainable fair market value, within the meaning of section 83(e)(3), has a value on the date of grant equal to $100,000, and is not subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and within the meaning of section 83(c)(1)). Z exercises the option in 2012 by paying an exercise price of $75,000 and receives property that has a fair market value (for purposes of section 83) equal to $300,000.

(ii) *Conclusion.* In this *Example 3,* under section 83(e)(3), section 83 does not apply to the grant of the option. Accordingly, C has income of $100,000 in 2004 under section 457(f). In 2012, C has income of $125,000, which is the value of the property transferred in 2012, minus the allocable portion of the basis that results from the $100,000 of income in 2004 and the $75,000 exercise price.

Example 4. (i) *Facts.* In 2010, X, a tax-exempt entity, agrees to pay deferred compensation to employee D. The amount payable is $100,000 to be paid 10 years later in 2020. The commitment to make the $100,000 payment is not subject to a substantial risk of forfeiture. In 2010, the present value of the $100,000 is $50,000. In 2018, X transfers to D property having a fair market value (for purposes of section 83) equal to $70,000. The transfer is in partial settlement of the commitment made in 2010 and, at the time of the transfer in 2018, the present value of the commitment is $80,000. In 2020, X pays D the $12,500 that remains due.

(ii) *Conclusion.* In this *Example 4,* D has income of $50,000 in 2010. In 2018, D has income of $30,000, which is the amount transferred in 2018, minus the allocable portion of the basis that results from the $50,000 of income in 2010. (Under section 72(e)(2)(B), income is allocated first. The income is equal to $30,000 ($80,000 minus the $50,000 basis), with the result that the allocable portion of the basis is equal to $40,000 ($70,000 minus the $30,000 of income).) In 2020, D has income of $2,500 ($12,500 minus $10,000, which is the excess of the original $50,000 basis over the $40,000 basis allocated to the transfer made in 2018).

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

§ 1.457–12 Effective dates.

(a) *General effective date.* Except as otherwise provided in this section, §§ 1.457–1 through 1.457–11 apply for taxable years beginning after December 31, 2001.

(b) *Transition period for eligible plans to comply with EGTRRA.* For taxable years beginning after December 31, 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 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.

(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*—(i) *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)(ii)(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.* 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 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:

	Years Ending December 31					
	1977	1978	1979	1980 [1]	1981	1982
Facts:						
Qualifying returns during merchandise return period for the taxable year	$5	$8	$6	$5	$7	$10
Adjustment to suspense account:						
Opening balance	....	....	....	$8	$5	$7
Addition to account [2]	....	....	....	....	2	1
Reduction to account [3]	....	....	....	(3)		
Opening balance for next year	....	....	....	$5	$7	$8
Amount excludable from income:						
Initial year adjustment	....	....	....	$(2)		
Amount excludable as qualifying returns in merchandise return period	....	....	....	5	$7	$10
Adjustment for increase in suspense account	....	....	....	....	(2)	(1)
Adjustment for decrease in suspense account	....	....	....	3		
Net amount excludable for the year	....	....	....	$6	$5	$9

[1] Year of Change.

[2] Applies when qualifying returns during the merchandise return period exceed the opening balance; the addition is not to cause the suspense account to exceed the initial opening balance.

[3] Applies when qualifying returns during the merchandise return period are less than the opening balance.

(f) *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 not only its own experience but also the transferor's experience when the transferor held the assets in its trade or business. Furthermore, the transferor is not allowed a deduction or exclusion for merchandise returned after the date of the transfer attributable to sales made by the transferor before the date of the transfer. Such returns shall be considered to be received by the acquiring corporation.

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

Example. Corporation S, a calendar year taxpayer, is a wholly owned subsidiary of Corporation P, a calendar year taxpayer. On December 31, 1982, S acquires from P substantially all of the assets used in a trade or business in which records are sold. P had not made an election under section 458 with respect to the qualified sale of records made in connection with that trade or business. S makes an election to use section 458 for its taxable year ending December 31, 1983, for the trade or business in which the acquired assets are used. P's qualified record returns within the 4 month and 15 day merchandise return period following the 1980 and 1981 taxable years were $150 and $170, respectively. S's qualified record returns during the merchandise return period following 1982 were $160. S must establish a suspense account by taking into account both P's and S'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. P is not entitled to a deduction or exclusion for merchandise received after the date of the transfer (December 31, 1982) attributable to sales made by the transferor before the date of transfer. Thus, P is not entitled to a deduction or exclusion for the $160 of 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 and is unable to resell, provided the merchandise is returned to P within four months following the original sale. The agreement constitutes a legal obligation. The agreement provides that D's return of the covers of paperback books within the first four months following their sale constitutes satisfactory evidence that D has not resold and will not resell the paperback books. During P's 1989 taxable year, pursuant to the agreement, P sells D 500 paperback books for $1 each. In 1990, during the merchandise return period, D returns covers from 100 unsold paperback books representing $100 of P's 1989 sales of paperback books. P's cost attributable to the returned books is $25. No adjustment to cost of goods sold is required under paragraph (g)(1) of this section because P is not holding returned merchandise for resale. P's proper amount excluded from its 1989 gross income under section 458 is $100.

(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 P's cost attributable to the returned merchandise. The proper amount excluded from P's 1989 gross income under section 458 is $75, resulting from adjustments to sales and cost of sales [$(100 \times \$1)$—$25].

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 four 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 also have agreed that the merchandise must be returned to D within four months following the original sale. The agreement constitutes a legal obligation. D is similarly entitled to a full refund from P, the publisher, for the same paperback books. In 1990, during the merchandise return period, R returns paperback books to D representing $100 of 1989 sales. D's cost relating to these sales is $50. Under paragraph (g)(1) of this section, D must decrease its costs of goods sold by $50. D's proper amount excluded from its 1989 gross income under section 458 is $50 resulting from adjustments to sales and costs of sales ($100—$50).

(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).

[T.D. 8426, 57 FR 38596, Aug. 26, 1992; 57 FR 45879, Oct. 5, 1992]

§ 1.458–2 Manner of and time for making election.

(a) *Scope.* For taxable years beginning after September 30, 1979, section 458 provides a special method of accounting for taxpayers who account for sales of magazines, paperbacks, or records using an accrual method of accounting. In order to use the special method of accounting under section 458, a taxpayer must make an election in the manner prescribed in this section. The election does not require the prior consent of the Internal Revenue Service. The election is effective for the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the prior consent of the Internal Revenue Service to revoke such election.

(b) *Separate election for each trade or business.* An election is made with respect to each trade or business of a taxpayer in connection with which qualified sales (as defined in section 458(b)(5)) of a category of merchandise were made. Magazines, paperbacks, and records are each treated as a separate category of merchandise. If qualified sales of two or more categories of merchandise are made in connection with the same trade or business, then solely for purposes of section 458, each category is treated as a separate trade or business. For example, if a taxpayer makes qualified sales of both magazines and paperbacks in the same trade or business, then solely for purposes of section 458, the qualified sales relating to magazines are considered one trade or business and the qualified sales relating to paperbacks are considered a separate trade or business. Thus, if the taxpayer wishes to account under section 458 for the qualified sales of both magazines and paperbacks, such taxpayer must make a separate election for each category.

(c) *Manner of, and time for, making election.* An election is made under section 458 and this section by filing a statement of election containing the information described in paragraph (d) of this section with the taxpayer's income tax return for first taxable year for which the election is made. The election must be made no later than the time prescribed by law (including extensions) for filing the income tax return for the first taxable year for which the election is made. Thus, the election may not be filed with an amended income tax return after the prescribed date (including extensions) for filing the original return for such year.

(d) *Required information.* The statement of election required by paragraph (c) of this section must indicate that an election is being made under section 458(c) and must set forth the following information:

(1) The taxpayer's name, address, and identification number;

(2) A description of each trade or business for which an election is made;

(3) The first taxable year for which an election is made for each trade or business;

(4) The merchandise return period (as defined in section 458(b)(7)) for each trade or business for which an election is made;

(5) With respect to an election that applies to magazines, the amount of the adjustment computed under section 481(a) resulting from the change to the method of accounting described in section 458; and

(6) With respect to an election that applies to paperbacks or records, the initial opening balance (computed in accordance with section 458(e)) in the suspense account for each trade or business for which an election is made.

The statement of election should be made on a Form 3115 which need contain no information other than that required by this paragraph.

[T.D. 7628, 44 FR 33398, June 11, 1979. Redesignated by T.D. 8426, 57 FR 38599, Aug. 26, 1992]

§ 1.460–0 Outline of regulations under section 460.

This section lists the paragraphs contained in § 1.460–1 through § 1.460–6.

§ 1.460–1 Long-term contracts.

(a) Overview.
(1) In general.
(2) Exceptions to required use of PCM.
(i) Exempt construction contract.
(ii) Qualified ship or residential construction contract.

§ 1.460–2 Long-term manufacturing contracts.

§ 1.460–3 Long-term construction contracts.

§ 1.460–4 Methods of accounting for long-term contracts.

(4) Contracts with disputed claims.
(i) In general.
(ii) Taxpayer assured of profit or loss.
(iii) Taxpayer unable to determine profit or loss.
(iv) Dispute resolved.
(e) Percentage-of-completion/capitalized-cost method.
(f) Alternative minimum taxable income.
(1) In general.
(2) Election to use regular completion factors.
(g) Method of accounting.
(h) Examples.
(i) [Reserved]
(j) Consolidated groups and controlled groups.
(1) Intercompany transactions.
(i) In general.
(ii) Definitions and nomenclature.
(2) Example.
(3) Effective dates.
(i) In general.
(ii) Prior law.
(4) Consent to change method of accounting.
(k) Mid-contract change in taxpayer.
(1) In general.
(2) Constructive completion transactions.
(i) Scope.
(ii) Old taxpayer.
(iii) New taxpayer.
(iv) Special rules relating to distributions of certain contracts by a partnership.
(A) In general.
(B) Old taxpayer.
(C) New taxpayer.
(D) Basis rules.
(E) Section 751.
(*1*) In general.
(*2*) Ordering rules.
(3) Step-in-the-shoes transactions.
(i) Scope.
(ii) Old taxpayer.
(A) In general.
(B) Gain realized on the transaction.
(iii) New taxpayer.
(A) Method of accounting.
(B) Contract price.
(C) Contract costs.
(iv) Special rules related to certain corporate and partnership transactions.
(A) Old taxpayer—basis adjustment.
(*1*) In general.
(*2*) Basis adjustment in excess of stock or partnership interest basis.
(*3*) Subsequent dispositions of certain contracts.
(B) New taxpayer.
(*1*) Contract price adjustment.
(*2*) Basis in contract.
(C) Definition of old taxpayer and new taxpayer for certain partnership transactions.
(D) Exceptions to step-in-the-shoes rules for S corporations.
(v) Special rules relating to certain partnership transactions.
(A) Section 704(c).
(*1*) Contributions of contracts.
(*2*) Revaluations of partnership property.
(*3*) Allocation methods.
(B) Basis adjustments under sections 743(b) and 734(b).
(C) Cross reference.
(D) Exceptions to step-in-the-shoes rules.
(4) Anti-abuse rule.
(5) Examples.
(6) Effective date.

§ 1.460–5 Cost allocation rules.

(a) Overview.
(b) Cost allocation method for contracts subject to PCM.
(1) In general.
(2) Special rules.
(i) Direct material costs.
(ii) Components and subassemblies.
(iii) Simplified production methods.
(iv) Costs identified under cost-plus long-term contracts and federal long-term contracts.
(v) Interest.
(A) In general.
(B) Production period.
(C) Application of section 263A(f).
(vi) Research and experimental expenses.
(vii) Service costs.
(A) Simplified service cost method.
(*1*) In general.
(*2*) Example.
(B) Jobsite costs.
(C) Limitation on other reasonable cost allocation methods.
(c) Simplified cost-to-cost method for contracts subject to the PCM.
(1) In general.
(2) Election.
(d) Cost allocation rules for exempt construction contracts reported using CCM.
(1) In general.
(2) Indirect costs.
(i) Indirect costs allocable to exempt construction contracts.
(ii) Indirect costs not allocable to exempt construction contracts.
(3) Large homebuilders.
(e) Cost allocation rules for contracts subject to the PCCM.
(f) Special rules applicable to costs allocated under this section.
(1) Nondeductible costs.
(2) Costs incurred for non-long-term contract activities.
(g) Method of accounting.

§ 1.460–6 Look-back method.

(a) In general.
(1) Introduction.
(2) Overview.
(b) Scope of look-back method.
(1) In general.
(2) Exceptions from section 460.
(3) De minimis exception.

[T.D. 9315, 55 FR 41670, Oct. 15, 1990, as amended by T.D. 8597, 60 FR 36683, July 18, 1995; T.D. 8756, 63 FR 1918, Jan. 13, 1998; T.D. 8775, 63 FR 36181, July 2, 1998; T.D. 8929, 66 FR 2224, Jan. 11, 2001; T.D. 8995, 67 FR 34605, May 15, 2002; T.D. 9137, 69 FR 42553, July 16, 2004]

§ 1.460–1 Long-term contracts.

(a) *Overview*—(1) *In general*. This section provides rules for determining whether a contract for the manufacture, building, installation, or construction of property is a long-term contract under section 460 and what activities must be accounted for as a single long-term contract. Specific rules for long-term manufacturing and construction contracts are provided in

§§ 1.460–2 and 1.460–3, respectively. A taxpayer generally must determine the income from a long-term contract using the percentage-of-completion method described in § 1.460–4(b) (PCM) and the cost allocation rules described in § 1.460–5(b) or (c). In addition, after a contract subject to the PCM is completed, a taxpayer generally must apply the look-back method described in § 1.460-6 to determine the amount of interest owed on any hypothetical underpayment of tax, or earned on any hypothetical overpayment of tax, attributable to accounting for the long-term contract under the PCM.

(2) *Exceptions to required use of PCM*—(i) *Exempt construction contract.* The requirement to use the PCM does not apply to any exempt construction contract described in § 1.460–3(b). Thus, a taxpayer may determine the income from an exempt construction contract using any accounting method permitted by § 1.460–4(c) and, for contracts accounted for using the completed-contract method (CCM), any cost allocation method permitted by § 1.460–5(d). Exempt construction contracts that are not subject to the PCM or CCM are not subject to the cost allocation rules of § 1.460–5 except for the production-period interest rules of § 1.460–5(b)(2)(v). Exempt construction contractors that are large homebuilders described in § 1.460–5(d)(3) must capitalize costs under section 263A. All other exempt construction contractors must account for the cost of construction using the appropriate rules contained in other sections of the Internal Revenue Code or regulations.

(ii) *Qualified ship or residential construction contract.* The requirement to use the PCM applies only to a portion of a *qualified ship contract* described in § 1.460–2(d) or *residential construction contract* described in § 1.460–3(c). A taxpayer generally may determine the income from a qualified ship contract or residential construction contract using the percentage-of-completion/capitalized-cost method (PCCM) described in § 1.460–4(e), but must use a cost allocation method described in § 1.460–5(b) for the entire contract.

(b) *Terms*—(1) *Long-term contract. A long-term contract* generally is any contract for the manufacture, building, installation, or construction of property if the contract is not completed within the contracting year, as defined in paragraph (b)(5) of this section. However, a contract for the manufacture of property is a long-term contract only if it also satisfies either the unique item or 12-month requirements described in § 1.460–2. A contract for the manufacture of personal property is a *manufacturing contract.* In contrast, a contract for the building, installation, or construction of real property is a *construction contract.*

(2) *Contract for the manufacture, building, installation, or construction of property*—(i) *In general.* A contract is a *contract for the manufacture, building, installation, or construction of property* if the manufacture, building, installation, or construction of property is necessary for the taxpayer's contractual obligations to be fulfilled and if the manufacture, building, installation, or construction of that property has not been completed when the parties enter into the contract. If a taxpayer has to manufacture or construct an item to fulfill its obligations under the contract, the fact that the taxpayer is not required to deliver that item to the customer is not relevant. Whether the customer has title to, control over, or bears the risk of loss from, the property manufactured or constructed by the taxpayer also is not relevant. Furthermore, how the parties characterize their agreement (*e.g.*, as a contract for the sale of property) is not relevant.

(ii) *De minimis construction activities.* Notwithstanding paragraph (b)(2)(i) of this section, a contract is not a construction contract under section 460 if the contract includes the provision of land by the taxpayer and the estimated total allocable contract costs, as defined in paragraph (b)(3) of this section, attributable to the taxpayer's construction activities are less than 10 percent of the contract's total contract price, as defined in § 1.460–4(b)(4)(i). For the purposes of this paragraph (b)(2)(ii), the allocable contract costs attributable to the taxpayer's construction activities do not include the cost of the land provided to the customer. In addition, a contract's estimated total allocable contract costs include a proportionate share of the estimated cost of any common improvement that benefits the subject matter of the contract if the taxpayer is contractually obligated, or required by law, to construct the common improvement.

(3) *Allocable contract costs. Allocable contract costs* are costs that are allocable to a long-term contract under §1.460–5.

(4) *Related party.* A *related party* is a person whose relationship to a taxpayer is described in section 707(b) or 267(b), determined without regard to section 267(f)(1)(A) and determined by replacing ''at least 80 percent'' with ''more than 50 percent'' for the purposes of determining the ownership of the stock of a corporation in sections 267(b)(2), (8), (10)(A), and (12).

(5) *Contracting year.* The *contracting year* is the taxable year in which a taxpayer enters into a contract as described in paragraph (c)(2) of this section.

(6) *Completion year.* The *completion year* is the taxable year in which a taxpayer completes a contract as described in paragraph (c)(3) of this section.

(7) *Contract commencement date.* The *contract commencement date* is the date that a taxpayer or related party first incurs any allocable contract costs, such as design and engineering costs, other than expenses attributable to bidding and negotiating activities. Generally, the contract commencement date is relevant in applying §1.460–6(b)(3) (concerning the de minimis exception to the look-back method under section 460(b)(3)(B)); §1.460–5(b)(2)(v)(B)(*1*)(*i*) (concerning the production period subject to interest allocation); §1.460–2(d) (concerning qualified ship contracts); and §1.460–3(b)(1)(ii) (concerning the construction period for exempt construction contracts).

(8) *Incurred. Incurred* has the meaning given in §1.461–1(a)(2) (concerning the taxable year a liability is incurred under the accrual method of accounting), regardless of a taxpayer's overall method of accounting. See §1.461–4(d)(2)(ii) for economic performance rules concerning the PCM.

(9) *Independent research and development expenses. Independent research and development expenses* are any expenses incurred in the performance of research or development, except that this term does not include any expenses that are directly attributable to a particular long-term contract in existence when the expenses are incurred and this term does not include any expenses under an agreement to perform research or development.

(10) *Long-term contract methods of accounting. Long-term contract methods of accounting,* which include the PCM, the CCM, the PCCM, and the exempt-contract percentage-of-completion method (EPCM), are methods of accounting that may be used only for long-term contracts.

(c) *Entering into and completing long-term contracts*—(1) *In general.* To determine when a contract is entered into under paragraph (c)(2) of this section and completed under paragraph (c)(3) of this section, a taxpayer must consider all relevant allocable contract costs incurred and activities performed by itself, by related parties on its behalf, and by the customer, that are incident to or necessary for the long-term contract. In addition, to determine whether a contract is completed in the contracting year, the taxpayer may not consider when it expects to complete the contract.

(2) *Date contract entered into*—(i) *In general.* A taxpayer enters into a contract on the date that the contract binds both the taxpayer and the customer under applicable law, even if the contract is subject to unsatisfied conditions not within the taxpayer's control (such as obtaining financing). If a taxpayer delays entering into a contract for a principal purpose of avoiding section 460, however, the taxpayer will be treated as having entered into a contract not later than the contract commencement date.

(ii) *Options and change orders.* A taxpayer enters into a new contract on the date that the customer exercises an option or similar provision in a contract if that option or similar provision must be severed from the contract under paragraph (e) of this section. Similarly, a taxpayer enters into a new contract on the date that it accepts a change order or other similar agreement if the change order or other similar agreement must be severed from the contract under paragraph (e) of this section.

(3) *Date contract completed*—(i) *In general*. A taxpayer's contract is completed upon the earlier of—

(A) Use of the subject matter of the contract by the customer for its intended purpose (other than for testing) and at least 95 percent of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer; or

(B) Final completion and acceptance of the subject matter of the contract.

(ii) *Secondary items*. The date a contract accounted for using the CCM is completed is determined without regard to whether one or more secondary items have been used or finally completed and accepted. If any secondary items are incomplete at the end of the taxable year in which the primary subject matter of a contract is completed, the taxpayer must separate the portion of the gross contract price and the allocable contract costs attributable to the incomplete secondary item(s) from the completed contract and account for them using a permissible method of accounting. A permissible method of accounting includes a long-term contract method of accounting only if a separate contract for the secondary item(s) would be a long-term contract, as defined in paragraph (b)(1) of this section.

(iii) *Subcontracts*. In the case of a subcontract, a subcontractor's customer is the general contractor. Thus, the subject matter of the subcontract is the relevant subject matter under paragraph (c)(3)(i) of this section.

(iv) *Final completion and acceptance*—(A) *In general*. Except as otherwise provided in this paragraph (c)(3)(iv), to determine whether final completion and acceptance of the subject matter of a contract have occurred, a taxpayer must consider all relevant facts and circumstances. Nevertheless, a taxpayer may not delay the completion of a contract for the principal purpose of deferring federal income tax.

(B) *Contingent compensation*. Final completion and acceptance is determined without regard to any contractual term that provides for additional compensation that is contingent on the successful performance of the subject matter of the contract. A taxpayer must account for all contingent compensation that is not includible in total contract price under §1.460–4(b)(4)(i), or in gross contract price under §1.460–4(d)(3), using a permissible method of accounting. For application of the look-back method for contracts accounted for using the PCM, see §1.460–6(c)(1)(ii) and (2)(vi).

(C) *Assembly or installation*. Final completion and acceptance is determined without regard to whether the taxpayer has an obligation to assist or supervise assembly or installation of the subject matter of the contract where the assembly or installation is not performed by the taxpayer or a related party. A taxpayer must account for the gross receipts and costs attributable to such an obligation using a permissible method of accounting, other than a long-term contract method.

(D) *Disputes*. Final completion and acceptance is determined without regard to whether a dispute exists at the time the taxpayer tenders the subject matter of the contract to the customer. For contracts accounted for using the CCM, see §1.460–4(d)(4). For application of the look-back method for contracts accounted for using the PCM, see §1.460–6(c)(1)(ii) and (2)(vi).

(d) *Allocation among activities*—(1) *In general*. Long-term contract methods of accounting apply only to the gross receipts and costs attributable to long-term contract activities. Gross receipts and costs attributable to long-term contract activities means amounts included in total contract price or gross contract price, whichever is applicable, as determined under §1.460–4, and costs allocable to the contract, as determined under §1.460–5. Gross receipts and costs attributable to non-long-term contract activities (as defined in paragraph (d)(2) of this section) generally must be taken into account using a permissible method of accounting other than a long-term contract method. See section 446(c) and §1.446–

1(c). However, if the performance of a non-long-term contract activity is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, the gross receipts and costs attributable to that activity must be allocated to the long-term contract(s) benefitted as provided in §§1.460–4(b)(4)(i) and 1.460–5(f)(2), respectively. Similarly, if a single long-term contract requires a taxpayer to perform a non-long-term contract activity that is not incident to or necessary for the manufacture, building, installation, or construction of the subject matter of the long-term contract, the gross receipts and costs attributable to that non-long-term contract activity must be separated from the contract and accounted for using a permissible method of accounting other than a long-term contract method. But see paragraph (g) of this section for related party rules.

(2) *Non-long-term contract activity. Non-long-term contract activity* means the performance of an activity other than manufacturing, building, installation, or construction, such as the provision of architectural, design, engineering, and construction management services, and the development or implementation of computer software. In addition, performance under a guaranty, warranty, or maintenance agreement is a non-long-term contract activity that is never incident to or necessary for the manufacture or construction of property under a long-term contract.

(e) *Severing and aggregating contracts*—(1) *In general.* After application of the allocation rules of paragraph (d) of this section, the severing and aggregating rules of this paragraph (e) may be applied by the Commissioner or the taxpayer as necessary to clearly reflect income (*e.g.*, to prevent the unreasonable deferral (or acceleration) of income or the premature recognition (or deferral) of loss). Under the severing and aggregating rules, one agreement may be treated as two or more contracts, and two or more agreements may be treated as one contract. Except as provided in paragraph (e)(3)(ii) of this section, a taxpayer must determine whether to sever an agreement or to aggregate two or more agreements based on the facts and circumstances known at the end of the contracting year.

(2) *Facts and circumstances.* Whether an agreement should be severed, or two or more agreements should be aggregated, depends on the following factors:

(i) *Pricing.* Independent pricing of items in an agreement is necessary for the agreement to be severed into two or more contracts. In the case of an agreement for similar items, if the price to be paid for the items is determined under different terms or formulas (e.g., if some items are priced under a cost-plus incentive fee arrangement and later items are to be priced under a fixed-price arrangement), then the difference in the pricing terms or formulas indicates that the items are independently priced. Similarly, interdependent pricing of items in separate agreements is necessary for two or more agreements to be aggregated into one contract. A single price negotiation for similar items ordered under one or more agreements indicates that the items are interdependently priced.

(ii) *Separate delivery or acceptance.* An agreement may not be severed into two or more contracts unless it provides for separate delivery or separate acceptance of items that are the subject matter of the agreement. However, the separate delivery or separate acceptance of items by itself does not necessarily require an agreement to be severed.

(iii) *Reasonable businessperson.* Two or more agreements to perform manufacturing or construction activities may not be aggregated into one contract unless a reasonable businessperson would not have entered into one of the agreements for the terms agreed upon without also entering into the other agreement(s). Similarly, an agreement to perform manufacturing or construction activities may not be severed into two or more contracts if a reasonable businessperson would not have entered into separate agreements containing terms allocable to each severed contract. Analyzing the reasonable businessperson standard requires an analysis of all the facts and circumstances of the business arrangement between the taxpayer and the customer. For purposes of this paragraph (e)(2)(iii), a taxpayer's expectation that the parties would enter into another agreement, when agreeing to the terms contained in the first agreement, is not relevant.

(3) *Exceptions*—(i) *Severance for PCM*. A taxpayer may not sever under this paragraph (e) a long-term contract that would be subject to the PCM without obtaining the Commissioner's prior written consent.

(ii) *Options and change orders*. Except as provided in paragraph (e)(3)(i) of this section, a taxpayer must sever an agreement that increases the number of units to be supplied to the customer, such as through the exercise of an option or the acceptance of a change order, if the agreement provides for separate delivery or separate acceptance of the additional units.

(4) *Statement with return*. If a taxpayer severs an agreement or aggregates two or more agreements under this paragraph (e) during the taxable year, the taxpayer must attach a statement to its original federal income tax return for that year. This statement must contain the following information—

(i) The legend NOTIFICATION OF SEVERANCE OR AGGREGATION UNDER SEC. 1.460–1(e);

(ii) The taxpayer's name; and

(iii) The taxpayer's employer identification number or social security number.

(f) *Classifying contracts*—(1) *In general*. After applying the severing and aggregating rules of paragraph (e) of this section, a taxpayer must determine the classification of a contract (*e.g.*, as a long-term manufacturing contract, long-term construction contract, non-long-term contract) based on all the facts and circumstances known no later than the end of the contracting year. Classification is determined on a contract-by-contract basis. Consequently, a requirement to manufacture a single unique item under a long-term contract will subject all other items in that contract to section 460.

(2) *Hybrid contracts*—(i) *In general*. A long-term contract that requires a taxpayer to perform both manufacturing and construction activities (hybrid contract) generally must be classified as two contracts, a manufacturing contract and a construction contract. A taxpayer may elect, on a contract-by-contract basis, to classify a hybrid contract as a long-term construction contract if at least 95 percent of the estimated total allocable contract costs are reasonably allocable to construction activities. In addition, a taxpayer may elect, on a contract-by-contract basis, to classify a hybrid contract as a long-term manufacturing contract subject to the PCM.

(ii) *Elections*. A taxpayer makes an election under this paragraph (f)(2) by using its method of accounting for similar construction contracts or for manufacturing contracts, whichever is applicable, to account for a hybrid contract entered into during the taxable year of the election on its original federal income tax return for the election year. If an electing taxpayer's method is the PCM, the taxpayer also must use the PCM to apply the look-back method under §1.460–6 and to determine alternative minimum taxable income under §1.460–4(f).

(3) *Method of accounting*. Except as provided in paragraph (f)(2)(ii) of this section, a taxpayer's method of classifying contracts is a method of accounting under section 446 and, thus, may not be changed without the Commissioner's consent. If a taxpayer's method of classifying contracts is unreasonable, that classification method is an impermissible accounting method.

(4) *Use of estimates*—(i) *Estimating length of contract*. A taxpayer must use a reasonable estimate of the time required to complete a contract when necessary to classify the contract (e.g., to determine whether the five-year completion rule for qualified ship contracts under §1.460–2(d), or the two-year completion rule for exempt construction contracts under §1.460–3(b), is satisfied, but not to determine whether a contract is completed within the contracting year under paragraph (b)(1) of this section). To be considered reasonable, an estimate of the time required to complete the contract must include anticipated time for delay, rework, change orders, technology or design problems, or other problems that reasonably can be anticipated considering

the nature of the contract and prior experience. A contract term that specifies an expected completion or delivery date may be considered evidence that the taxpayer reasonably expects to complete or deliver the subject matter of the contract on or about the date specified, especially if the contract provides bona fide penalties for failing to meet the specified date. If a taxpayer classifies a contract based on a reasonable estimate of completion time, the contract will not be reclassified based on the actual (or another reasonable estimate of) completion time. A taxpayer's estimate of completion time will not be considered unreasonable if a contract is not completed within the estimated time primarily because of unforeseeable factors not within the taxpayer's control, such as third-party litigation, extreme weather conditions, strikes, or delays in securing permits or licenses.

(ii) *Estimating allocable contract costs.* A taxpayer must use a reasonable estimate of total allocable contract costs when necessary to classify the contract (e.g., to determine whether a contract is a home construction contract under §1.460–(3)(b)(2)). If a taxpayer classifies a contract based on a reasonable estimate of total allocable contract costs, the contract will not be reclassified based on the actual (or another reasonable estimate of) total allocable contract costs.

(g) *Special rules for activities benefitting long-term contracts of a related party*—(1) *Related party use of PCM*—(i) *In general.* Except as provided in paragraph (g)(1)(ii) of this section, if a related party and its customer enter into a long-term contract subject to the PCM, and a taxpayer performs any activity that is incident to or necessary for the related party's long-term contract, the taxpayer must account for the gross receipts and costs attributable to this activity using the PCM, even if this activity is not otherwise subject to section 460(a). This type of activity may include, for example, the performance of engineering and design services, and the production of components and subassemblies that are reasonably expected to be used in the production of the subject matter of the related party's contract.

(ii) *Exception for components and subassemblies.* A taxpayer is not required to use the PCM under this paragraph (g) to account for a component or subassembly that benefits a related party's long-term contract if more than 50 percent of the average annual gross receipts attributable to the sale of this item for the 3-taxable-year-period ending with the contracting year comes from unrelated parties.

(2) *Total contract price.* If a taxpayer is required to use the PCM under paragraph (g)(1)(i) of this section, the total contract price (as defined in §1.460–4(b)(4)(i)) is the fair market value of the taxpayer's activity that is incident to or necessary for the performance of the related party's long-term contract. The related party also must use the fair market value of the taxpayer's activity as the cost it incurs for the activity. The fair market value of the taxpayer's activity may or may not be the same as the amount the related party pays the taxpayer for that activity.

(3) *Completion factor.* To compute a contract's completion factor (as described in §1.460–4(b)(5)), the related party must take into account the fair market value of the taxpayer's activity that is incident to or necessary for the performance of the related party's long-term contract when the related party incurs the liability to the taxpayer for the activity, rather than when the taxpayer incurs the costs to perform the activity.

(h) *Effective date*—(1) *In general.* Except as otherwise provided, this section and §§1.460–2 through 1.460–5 are applicable for contracts entered into on or after January 11, 2001.

(2) *Change in method of accounting.* Any change in a taxpayer's method of accounting necessary to comply with this section and §§1.460–2 through 1.460–5 is a change in method of accounting to which the provisions of section 446 and the regulations thereunder apply. For the first taxable year that includes January 11, 2001, a taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with the provisions of this section and §§1.460–2 through 1.460–5 for long-term contracts entered into on or after January 11, 2001. A taxpayer that

wants to change its method of accounting under this paragraph (h)(2) must follow the automatic consent procedures in Rev. Proc. 99–49 (1999–52 I.R.B. 725) (see § 601.601(d)(2) of this chapter), except that the scope limitations in section 4.02 of Rev. Proc. 99–49 do not apply. Because a change under this paragraph (h)(2) is made on a cut-off basis, a section 481(a) adjustment is not permitted or required. Moreover, the taxpayer does not receive audit protection under section 7 of Rev. Proc. 99–49 for a change in method of accounting under this paragraph (h)(2). A taxpayer that wants to change its exempt-contract method of accounting is not granted the consent of the Commissioner under this paragraph (h)(2) and must file a Form 3115, ''Application for Change in Accounting Method,'' to obtain consent. See Rev. Proc. 97–27 (1997–1 C.B. 680) (see § 601.601(d)(2) of this chapter).

(i) [Reserved]

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

Example 1. Contract for manufacture of property. B notifies C, an aircraft manufacturer, that it wants to purchase an aircraft of a particular type. At the time C receives the order, C has on hand several partially completed aircraft of this type; however, C does not have any completed aircraft of this type on hand. C and B agree that B will purchase one of these aircraft after it has been completed. C retains title to and risk of loss with respect to the aircraft until the sale takes place. The agreement between C and B is a contract for the manufacture of property under paragraph (b)(2)(i) of this section, even if labeled as a contract for the sale of property, because the manufacture of the aircraft is necessary for C's obligations under the agreement to be fulfilled and the manufacturing was not complete when B and C entered into the agreement.

Example 2. De minimis construction activity. C, a master developer whose taxable year ends December 31, owns 5,000 acres of undeveloped land with a cost basis of $5,000,000 and a fair market value of $50,000,000. To obtain permission from the local county government to improve this land, a service road must be constructed on this land to benefit all 5,000 acres. In 2001, C enters into a contract to sell a 1,000-acre parcel of undeveloped land to B, a residential developer, for its fair market value, $10,000,000. In this contract, C agrees to construct a service road running through the land that C is selling to B and through the 4,000 adjacent acres of undeveloped land that C has sold or will sell to other residential developers for its fair market value, $40,000,000. C reasonably estimates that it will incur allocable contract costs of $50,000 (excluding the cost of the land) to construct this service road, which will be owned and maintained by the county. C must reasonably allocate the cost of the service road among the benefitted parcels. The portion of the estimated total allocable contract costs that C allocates to the 1,000-acre parcel being sold to B (based upon its fair market value) is $10,000 ($50,000 × ($10,000,000 ÷ $50,000,000)). Construction of the service road is finished in 2002. Because the estimated total allocable contract costs attributable to C's construction activities, $10,000, are less than 10 percent of the contract's total contract price, $10,000,000, C's contract with B is not a construction contract under paragraph (b)(2)(ii) of this section. Thus, C's contract with B is not a long-term contract under paragraph (b)(2)(i) of this section, notwithstanding that construction of the service road is not completed in 2001.

Example 3. Completion—customer use. In 2002, C, whose taxable year ends December 31, enters into a contract to construct a building for B. In November of 2003, the building is completed in every respect necessary for its intended use, and B occupies the building. In early December of 2003, B notifies C of some minor deficiencies that need to be corrected, and C agrees to correct them in January 2004. C reasonably estimates that the cost of correcting these deficiencies will be less than five percent of the total allocable contract costs. C's contract is complete under paragraph (c)(3)(i)(A) of this section in 2003 because in that year, B used the building and C had incurred at least 95 percent of the total allocable contract costs attributable to the building. C must use a permissible method of accounting for any deficiency-related costs incurred after 2003.

Example 4. Completion—customer use. In 2001, C, whose taxable year ends December 31, agrees to construct a shopping center, which includes an adjoining parking lot, for B. By October 2002, C has finished constructing the retail portion of the shopping center. By December 2002, C has graded the entire parking lot, but has paved only one-fourth of it because inclement weather conditions prevented C from laying asphalt on the remaining three-fourths. In December 2002, B opens the retail portion of the shopping center and the paved portion of the parking lot to the general public. C reasonably estimates that the cost of paving the remaining three-fourths of the parking lot when weather permits will exceed five percent of C's total allocable contract costs. Even though B is using the subject matter of the contract, C's contract is not completed in December 2002 under paragraph (c)(3)(i)(A) of this section because C has not incurred at least 95 percent of the total allocable contract costs attributable to the subject matter.

Example 5. Completion—customer use. In 2001, C, whose taxable year ends December 31, agrees to manufacture 100 machines for B. By December 31, 2002, C has delivered 99 of the machines to B. C reasonably estimates that the cost of finishing the related work on the contract will be less than five percent of the total allocable contract costs. C's contract is not complete under paragraph (c)(3)(i)(A) of this section in 2002 because in that year, B is not using the subject matter of the contract (all 100 machines) for its intended purpose.

Example 6. Non-long-term contract activity. On January 1, 2001, C, whose taxable year ends December 31, enters into a single long-term contract to design and manufacture a satellite and to develop computer software enabling B to operate the satellite. At the end of 2001, C has not finished manufacturing the satellite. Designing the satellite and developing the computer software are non-long-term contract activities that are incident to and necessary for the taxpayer's manufacturing of the subject matter of a long-term contract because the satellite could not be manufactured without the design and would not operate without the software. Thus, under paragraph (d)(1) of this section, C must allocate these non-long-term contract activities to the long-term contract and account for the gross receipts and costs attributable to designing the satellite and developing computer software using the PCM.

Example 7. Non-long-term contract activity. C agrees to manufacture equipment for B under a long-term contract. In a separate contract, C agrees to design the equipment being manufactured for B under the long-term contract. Under paragraph (d)(1) of this section, C must allocate the gross receipts and costs related to the design to the long-term contract because designing the equipment is a non-long-term contract activity that is incident to and necessary for the manufacture of the subject matter of the long-term contract.

Example 8. Severance. On January 1, 2001, C, a construction contractor, and B, a real estate investor, enter into an agreement requiring C to build two office buildings in different areas of a large city. The agreement provides that the two office buildings will be completed by C and accepted by B in 2002 and 2003, respectively, and that C will be paid $1,000,000 and $1,500,000 for the two office buildings, respectively. The agreement will provide C with a reasonable profit from the construction of each building. Unless C is required to use the PCM to account for the contract, C is required to sever this contract under paragraph (e)(2) of this section because the buildings are independently priced, the agreement provides for separate delivery and acceptance of the buildings, and, as each building will generate a reasonable profit, a reasonable businessperson would have entered into separate agreements for the terms agreed upon for each building.

Example 9. Severance. C, a large construction contractor whose taxable year ends December 31, accounts for its construction contracts using the PCM and has elected to use the 10-percent method described in §1.460–4(b)(6). In September 2001, C enters into an agreement to construct four buildings in four different cities. The buildings are independently priced and the contract provides a reasonable profit for each of the buildings. In addition, the agreement requires C to complete one building per year in 2002, 2003, 2004, and 2005. As of December 31, 2001, C has incurred 25 percent of the estimated total allocable contract costs attributable to one of the buildings, but only five percent of the estimated total allocable contract costs attributable to all four buildings included in the agreement. C does not request the Commissioner's consent to sever this contract. Using the 10-percent method, C does not take into account any portion of the total contract price or any incurred allocable contract costs attributable to this agreement in 2001. Upon examination of C's 2001 tax return, the Commissioner determines that C entered into one agreement for four buildings rather than four separate agreements each for one building solely to take advantage of the deferral obtained under the 10-percent method. Consequently, to clearly reflect the taxpayer's income, the Commissioner may require C to sever the agreement into four separate contracts under paragraph (e)(2) of this section because the buildings are independently priced, the agreement provides for separate delivery and acceptance of the buildings, and a reasonable businessperson would have entered into separate agreements for these buildings.

Example 10. Aggregation. In 2001, C, a shipbuilder, enters into two agreements with the Department of the Navy as the result of a single negotiation. Each agreement obligates C to manufacture a submarine. Because the submarines are of the same class, their specifications are similar. Because C has never manufactured submarines of this class, however, C anticipates that it will incur substantially higher costs to manufacture the first submarine, to be delivered in 2007, than to manufacture the second submarine, to be delivered in 2010. If the agreements are treated as separate contracts, the first contract probably will produce a substantial loss, while the second contract probably will produce substantial profit. Based upon these facts, aggregation is required under paragraph (e)(2) of this section because the submarines are interdependently priced and a reasonable businessperson would not have entered the first agreement without also entering into the second.

Example 11. Aggregation. In 2001, C, a manufacturer of aircraft and related equipment, agrees to manufacture 10 military aircraft for foreign government B and to deliver the aircraft by the end of 2003. When entering into the agreement, C anticipates that it might receive production orders from B over the next 20 years for as many as 300 more of these aircraft. The negotiated contract price reflects C's and B's consideration of the expected total cost of manufacturing the 10 aircraft, the risks and opportunities associated with the agreement, and the additional factors the parties considered relevant. The negotiated price provides a profit on the sale of the 10 aircraft even if C does not receive any additional production orders from B. It is unlikely, however, that C actually would have wanted to manufacture the 10 aircraft but for the expectation that it would receive additional production orders from B. In 2003, B accepts delivery of the 10 aircraft. At that time, B orders an additional 20 aircraft of the same type for delivery in 2007. When negotiating the price for the additional 20 aircraft, C and B consider the fact that the expected unit cost for this production run of 20 aircraft will be lower than the unit cost of the 10 aircraft completed and accepted in 2003, but substantially higher than the expected unit cost of future production runs. Based upon these facts, aggregation is not permitted under paragraph (e)(2) of this section. Because the parties negotiated the prices of both agreements considering only the expected production costs and risks for each agreement standing alone, the terms and conditions agreed upon for the first agreement are independent of the terms and conditions agreed upon for the second agreement. The fact that the agreement to manufacture 10 aircraft provides a profit for C indicates that a reasonable businessperson would have entered into that agreement without entering into the agreement to manufacture the additional 20 aircraft.

Example 12. Classification and completion. In 2001, C, whose taxable year ends December 31, agrees to manufacture and install an industrial machine for B. C elects under paragraph (f) of this section to classify the agreement as a long-term manufacturing contract and to account for it using the PCM. The agreement requires C to deliver the machine in August 2003 and to install and test the machine in B's factory. In addition, the agreement requires B to accept the machine when the tests prove that the machine's performance will satisfy the environmental standards set by the Environmental Protection Agency (EPA), even if B has not obtained the required operating permit. Because of technical difficulties, C cannot deliver the machine until December 2003, when B conditionally accepts delivery. C installs the machine in December 2003 and then tests it through February 2004. B accepts the machine in February 2004, but does not obtain the operating permit from the EPA until January 2005. Under paragraph (c)(3)(i)(B) of this section, C's contract is finally completed and accepted in February 2004, even though B does not obtain the operating permit until January 2005, because C completed all its obligations under the contract and B accepted the machine in February 2004.

[T.D. 8929, 66 FR 2225, Jan. 11, 2001; 66 FR 18357, Apr. 6, 2001]

§ 1.460–2 Long-term manufacturing contracts.

(a) *In general.* Section 460 generally requires a taxpayer to determine the income from a long-term manufacturing contract using the percentage-of-completion method described in §1.460–4(b) (PCM). A contract not completed in the contracting year is a long-term manufacturing contract if it involves the manufacture of personal property that is—

(1) A unique item of a type that is not normally carried in the finished goods inventory of the taxpayer; or

(2) An item that normally requires more than 12 calendar months to complete (regardless of the duration of the contract or the time to complete a deliverable quantity of the item).

(b) *Unique*—(1) *In general. Unique* means designed for the needs of a specific customer. To determine whether an item is designed for the needs of a specific customer, a taxpayer must consider the extent to which research, development, design, engineering, retooling, and similar activities (customizing activities) are required to manufacture the item and whether the item could be sold to other customers with little or no modification. A contract may require the taxpayer to manufacture more than one unit of a unique item. If a contract requires a taxpayer to manufacture more than one unit of the same item, the taxpayer must determine whether that item is unique by considering the customizing activities that would be needed to produce only the first unit. For the purposes of this paragraph (b), a taxpayer must consider the activities performed on its behalf by a subcontractor.

(2) *Safe harbors.* Notwithstanding paragraph (b)(1) of this section, an item

is not unique if it satisfies one or more of the safe harbors in this paragraph (b)(2). If an item does not satisfy one or more safe harbors, the determination of uniqueness will depend on the facts and circumstances. The safe harbors are:

(i) *Short production period.* An item is not unique if it normally requires 90 days or less to complete. In the case of a contract for multiple units of an item, the item is not unique only if it normally requires 90 days or less to complete each unit of the item in the contract.

(ii) *Customized item.* An item is not unique if the total allocable contract costs attributable to customizing activities that are incident to or necessary for the manufacture of the item do not exceed 10 percent of the estimated total allocable contract costs allocable to the item. In the case of a contract for multiple units of an item, this comparison must be performed on the first unit of the item, and the total allocable contract costs attributable to customizing activities that are incident to or necessary for the manufacture of the first unit of the item must be allocated to that first unit.

(iii) *Inventoried item.* A unique item ceases to be unique no later than when the taxpayer normally includes similar items in its finished goods inventory.

(c) *Normal time to complete*—(1) *In general.* The amount of time normally required to complete an item is the item's reasonably expected *production period*, as described in §1.263A–12, determined at the end of the contracting year. Thus, in general, the expected production period for an item begins when a taxpayer incurs at least five percent of the costs that would be allocable to the item under §1.460–5 and ends when the item is ready to be held for sale and all reasonably expected production activities are complete. In the case of components that are assembled or reassembled into an item or unit at the customer's facility by the taxpayer's employees or agents, the production period ends when the components are assembled or reassembled into an operable item or unit. To the extent that several distinct activities related to the production of the item are expected to occur simultaneously, the period during which these distinct activities occur is not counted more than once. Furthermore, when determining the normal time to complete an item, a taxpayer is not required to consider activities performed or costs incurred that would not be allocable contract costs under section 460 (*e.g.*, independent research and development expenses (as defined in §1.460–1(b)(9)) and marketing expenses). Moreover, the time normally required to design and manufacture the first unit of an item for which the taxpayer intends to produce multiple units generally does not indicate the normal time to complete the item.

(2) *Production by related parties.* To determine the time normally required to complete an item, a taxpayer must consider all relevant production activities performed and costs incurred by itself and by related parties, as defined in §1.460–1(b)(4). For example, if a taxpayer's item requires a component or subassembly manufactured by a related party, the taxpayer must consider the time the related party takes to complete the component or subassembly and, for purposes of determining the beginning of an item's production period, the costs incurred by the related party that are allocable to the component or subassembly. However, if both requirements of the exception for components and subassemblies under §1.460–1(g)(1)(ii) are satisfied, a taxpayer does not consider the activities performed or the costs incurred by a related party when determining the normal time to complete an item.

(d) *Qualified ship contracts.* A taxpayer may determine the income from a long-term manufacturing contract that is a qualified ship contract using either the PCM or the percentage-of-completion/capitalized-cost method (PCCM) of accounting described in §1.460–4(e). A *qualified ship contract* is any contract entered into after February 28, 1986, to manufacture in the United States not more than 5 seagoing vessels if the vessels will not be manufactured directly or indirectly for the United States Government and if the taxpayer reasonably expects to complete the contract within 5 years of the contract commencement date. Under §1.460–1(e)(3)(i), a contract to produce more than 5 vessels for which the PCM would be required cannot be severed in order to be classified as a qualified ship contract.

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

Example 1. Unique item and classification. In December 2001, C enters into a contract with B to design and manufacture a new type of industrial equipment. C reasonably expects the normal production period for this type of equipment to be eight months. Because the new type of industrial equipment requires a substantial amount of research, design, and engineering to produce, C determines that the equipment is a unique item and its contract with B is a long-term contract. After delivering the equipment to B in September 2002, C contracts with B to produce five additional units of that industrial equipment with certain different specifications. These additional units, which also are expected to take eight months to produce, will be delivered to B in 2003. C determines that the research, design, engineering, retooling, and similar customizing costs necessary to produce the five additional units of equipment does not exceed 10 percent of the first unit's share of estimated total allocable contract costs. Consequently, the additional units of equipment satisfy the safe harbor in paragraph (b)(2)(ii) of this section and are not unique items. Although C's contract with B to produce the five additional units is not completed within the contracting year, the contract is not a long-term contract since the additional units of equipment are not unique items and do not normally require more than 12 months to produce. C must classify its second contract with B as a non-long term contract, notwithstanding that it classified the previous contract with B for a similar item as a long-term contract, because the determination of whether a contract is a long-term contract is made on a contract-by-contract basis. A change in classification is not a change in method of accounting because the change in classification results from a change in underlying facts.

Example 2. 12-month rule—related party. C manufactures cranes. C purchases one of the crane's components from R, a related party under §1.460–1(b)(4). Less than 50 percent of R's gross receipts attributable to the sale of this component comes from sales to unrelated parties; thus, the exception for components and subassemblies under §1.460–1(g)(1)(ii) is not satisfied. Consequently, C must consider the activities of R as R incurs costs and performs the activities rather than as C incurs a liability to R. The normal time period between the time that both C and R incur five percent of the costs allocable to the crane and the time that R completes the component is five months. C normally requires an additional eight months to complete production of the crane after receiving the integral component from R. C's crane is an item of a type that normally requires more than 12 months to complete under paragraph (c) of this section because the production period from the time that both C and R incur five percent of the costs allocable to the crane until the time that production of the crane is complete is normally 13 months.

Example 3. 12-month rule—duration of contract. The facts are the same as in *Example 2*, except that C enters into a sales contract with B on December 31, 2001 (the last day of C's taxable year), and delivers a completed crane to B on February 1, 2002. C's contract with B is a long-term contract under paragraph (a)(2) of this section because the contract is not completed in the contracting year, 2001, and the crane is an item that normally requires more than 12 calendar months to complete (regardless of the duration of the contract).

Example 4. 12-month rule—normal time to complete. The facts are the same as in *Example 2*, except that C (and R) actually complete B's crane in only 10 calendar months. The contract is a long-term contract because the normal time to complete a crane, not the actual time to complete a crane, is the relevant criterion for determining whether an item is subject to paragraph (a)(2) of this section.

Example 5. Normal time to complete. C enters into a multi-unit contract to produce four units of an item. C does not anticipate producing any additional units of the item. C expects to perform the research, design, and development that are directly allocable to the particular item and to produce the first unit in the first 24 months. C reasonably expects the production period for each of the three remaining units will be 3 months. This contract is not a contract that involves the manufacture of an item that normally requires more than 12 months to complete because the normal time to complete the item is 3 months. However, the contract does not satisfy the 90-day safe harbor for unique items because the normal time to complete the first unit of this item exceeds 90 days. Thus, the contract might involve the manufacture of a unique item depending on the facts and circumstances.

[T.D. 8929, 66 FR 2230, Jan. 11, 2001; 66 FR 18191, Apr. 6, 2001]

§ 1.460–3 Long-term construction contracts.

(a) *In general*. Section 460 generally requires a taxpayer to determine the income from a long-term construction contract using the percentage-of-completion method described in §1.460–4(b)

(PCM). A contract not completed in the contracting year is a long-term construction contract if it involves the building, construction, reconstruction, or rehabilitation of real property; the installation of an integral component to real property; or the improvement of real property (collectively referred to as construction). *Real property* means land, buildings, and *inherently permanent structures,* as defined in §1.263A–8(c)(3), such as roadways, dams, and bridges. Real property does not include vessels, offshore drilling platforms, or unsevered natural products of land. An *integral component to real property* includes property not produced at the site of the real property but intended to be permanently affixed to the real property, such as elevators and central heating and cooling systems. Thus, for example, a contract to install an elevator in a building is a construction contract because a building is real property, but a contract to install an elevator in a ship is not a construction contract because a ship is not real property.

(b) *Exempt construction contracts*—(1) *In general.* The general requirement to use the PCM and the cost allocation rules described in §1.460–5(b) or (c) does not apply to any long-term construction contract described in this paragraph (b) (exempt construction contract). *Exempt construction contract* means any—

(i) Home construction contract; and

(ii) Other construction contract that a taxpayer estimates (when entering into the contract) will be completed within 2 years of the contract commencement date, provided the taxpayer satisfies the $10,000,000 gross receipts test described in paragraph (b)(3) of this section.

(2) *Home construction contract*—(i) *In general.* A long-term construction contract is a *home construction contract* if a taxpayer (including a subcontractor working for a general contractor) reasonably expects to attribute 80 percent or more of the estimated total allocable contract costs (including the cost of land, materials, and services), determined as of the close of the contracting year, to the construction of—

(A) Dwelling units, as defined in section 168(e)(2)(A)(ii)(I), contained in buildings containing 4 or fewer dwelling units (including buildings with 4 or fewer dwelling units that also have commercial units); and

(B) Improvements to real property directly related to, and located at the site of, the dwelling units.

(ii) *Townhouses and rowhouses.* Each townhouse or rowhouse is a separate building.

(iii) *Common improvements.* A taxpayer includes in the cost of the dwelling units their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units.

(iv) *Mixed use costs.* If a contract involves the construction of both commercial units and dwelling units within the same building, a taxpayer must allocate the costs among the commercial units and dwelling units using a reasonable method or combination of reasonable methods, such as specific identification, square footage, or fair market value.

(3) *$10,000,000 gross receipts test*—(i) *In general.* Except as otherwise provided in paragraphs (b)(3)(ii) and (iii) of this section, the $10,000,000 gross receipts test is satisfied if a taxpayer's (or predecessor's) average annual gross receipts for the 3 taxable years preceding the contracting year do not exceed $10,000,000, as determined using the principles of the gross receipts test for small resellers under §1.263A–3(b).

(ii) *Single employer.* To apply the gross receipts test, a taxpayer is not required to aggregate the gross receipts of persons treated as a single employer solely under section 414(m) and any regulations prescribed under section 414.

(iii) *Attribution of gross receipts.* A taxpayer must aggregate a proportionate share of the construction-related gross receipts of any person that has a five percent or greater interest in the taxpayer. In addition, a taxpayer must aggregate a proportionate share of the construction-related gross receipts of any person in which the taxpayer has a five percent or greater interest. For this purpose, a taxpayer must determine ownership interests as of the first day of the taxpayer's contracting year and must include indirect interests in any corporation, partnership, estate, trust, or sole proprietorship according to principles similar to the constructive ownership rules under sections 1563(e), (f)(2), and (f)(3)(A). However, a taxpayer is not required to aggregate under this paragraph (b)(3)(iii) any construction-related gross receipts required to be aggregated under paragraph (b)(3)(i) of this section.

(c) *Residential construction contracts.* A taxpayer may determine the income from a long-term construction contract that is a residential construction contract using either the PCM or the percentage-of-completion/capitalized-cost method (PCCM) of accounting described in §1.460–4(e). A *residential construction contract* is a home construction contract, as defined in paragraph (b)(2) of this section, except that the building or buildings being constructed contain more than 4 dwelling units.

[T.D. 8929, 66 FR 2231, Jan. 11, 2001]

§1.460–4 Methods of accounting for long-term contracts.

(a) *Overview.* This section prescribes permissible methods of accounting for long-term contracts. Paragraph (b) of this section describes the percentage-of-completion method under section 460(b) (PCM) that a taxpayer generally must use to determine the income from a long-term contract. Paragraph (c) of this section lists permissible methods of accounting for exempt construction contracts described in §1.460–3(b)(1) and describes the exempt-contract percentage-of-completion method (EPCM). Paragraph (d) of this section describes the completed-contract method (CCM), which is one of the permissible methods of accounting for exempt construction contracts. Paragraph (e) of this section describes the percentage-of-completion/capitalized-cost method (PCCM), which is a permissible method of accounting for qualified ship contracts described in §1.460–2(d) and residential construction contracts described in §1.460–3(c). Paragraph (f) of this section provides rules for determining the alternative minimum taxable income (AMTI) from long-term contracts that are not exempted under section 56. Paragraph (g) of this section provides rules concerning consistency in methods of accounting for long-term contracts. Paragraph (h) of this section provides examples illustrating the principles of this section. Paragraph (j) of this section provides rules for taxpayers that file consolidated tax returns. Finally, paragraph (k) of this section provides rules relating to a mid-contract change in taxpayer of a contract accounted for using a long-term contract method of accounting.

(b) *Percentage-of-completion method*—(1) *In general.* Under the PCM, a taxpayer generally must include in income the portion of the *total contract price,* as defined in paragraph (b)(4)(i) of this section, that corresponds to the percentage of the entire contract that the taxpayer has completed during the taxable year. The percentage of completion must be determined by comparing allocable contract costs incurred with estimated total allocable contract costs. Thus, the taxpayer includes a portion of the total contract price in gross income as the taxpayer incurs allocable contract costs.

(2) *Computations.* To determine the income from a long-term contract, a taxpayer—

(i) Computes the *completion factor* for the contract, which is the ratio of the cumulative allocable contract costs that the taxpayer has incurred through the end of the taxable year to the estimated total allocable contract costs that the taxpayer reasonably expects to incur under the contract;

(ii) Computes the amount of *cumulative gross receipts* from the contract by multiplying the completion factor by the total contract price;

(iii) Computes the amount of *current-year gross receipts,* which is the difference between the amount of cumulative gross receipts for the current taxable year and the amount of cumulative gross receipts for the immediately preceding taxable year (the difference can be a positive or negative number); and

(iv) Takes both the current-year gross receipts and the allocable contract costs incurred during the current year into account in computing taxable income.

(3) *Post-completion-year income.* If a taxpayer has not included the total contract price in gross income by the completion year, as defined in §1.460–1(b)(6), the taxpayer must include the remaining portion of the total contract price in gross income for the taxable year following the completion year. For the treatment of post-completion-year costs, see paragraph (b)(5)(v) of this section. See §1.460–6(c)(1)(ii) for application of the look-back method as a result of adjustments to total contract price.

(4) *Total contract price*—(i) *In general*—(A) *Definition. Total contract price* means the amount that a taxpayer reasonably expects to receive under a long-term contract, including holdbacks, retainages, and cost reimbursements. See §1.460–6(c)(1)(ii) and (2)(vi) for application of the look-back method as a result of changes in total contract price.

(B) *Contingent compensation.* Any amount related to a contingent right under a contract, such as a bonus, award, incentive payment, and amount in dispute, is included in total contract price as soon as the taxpayer can reasonably predict that the amount will be earned, even if the all events test has not yet been met. For example, if a bonus is payable to a taxpayer for meeting an early completion date, the bonus is includible in total contract price at the time and to the extent that the taxpayer can reasonably predict the achievement of the corresponding objective. Similarly, a portion of the contract price that is in dispute is includible in total contract price at the time and to the extent that the taxpayer can reasonably predict that the dispute will be resolved in the taxpayer's favor (regardless of when the taxpayer actually receives payment or when the dispute is finally resolved). Total contract price does not include compensation that might be earned under any other agreement that the taxpayer expects to obtain from the same customer (*e.g.*, exercised option or follow-on contract) if that other agreement is not aggregated under §1.460–1(e). For the purposes of this paragraph (b)(4)(i)(B), a taxpayer can reasonably predict that an amount of contingent income will be earned not later than when the taxpayer includes that amount in income for financial reporting purposes under generally accepted accounting principles. If a taxpayer has not included an amount of contingent compensation in total contract price under this paragraph (b)(4)(i) by the taxable year following the completion year, the taxpayer must account for that amount of contingent compensation using a permissible method of accounting. If it is determined after the taxable year following the completion year that an amount included in total contract price will not be earned, the taxpayer should deduct that amount in the year of the determination.

(C) *Non-long-term contract activities.* Total contract price includes an allocable share of the gross receipts attributable to a non-long-term contract activity, as defined in §1.460–1(d)(2), if the activity is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of the long-term contract. Total contract price also includes amounts reimbursed for independent research and development expenses (as defined in §1.460–1(b)(9)), or for bidding and proposal costs, under a federal or cost-plus long-term contract (as defined in section 460(d)), regardless of whether the research and development, or bidding and proposal, activities are incident to or necessary for the performance of that long-term contract.

(ii) *Estimating total contract price.* A taxpayer must estimate the total contract price based upon all the facts and circumstances known as of the last day of the taxable year. For this purpose, an event that occurs after the end of the taxable year must be taken into account if its occurrence was reasonably predictable and its income was subject to reasonable estimation as of the last day of that taxable year.

(5) *Completion factor*—(i) *Allocable contract costs.* A taxpayer must use a cost allocation method permitted under either §1.460–5(b) or (c) to determine the amount of cumulative allocable contract costs and estimated total allocable contract costs that are used to determine a contract's completion factor. Allocable contract costs include a

reimbursable cost that is allocable to the contract.

(ii) *Cumulative allocable contract costs.* To determine a contract's completion factor for a taxable year, a taxpayer must take into account the cumulative allocable contract costs that have been incurred, as defined in §1.460–1(b)(8), through the end of the taxable year.

(iii) *Estimating total allocable contract costs.* A taxpayer must estimate total allocable contract costs for each long-term contract based upon all the facts and circumstances known as of the last day of the taxable year. For this purpose, an event that occurs after the end of the taxable year must be taken into account if its occurrence was reasonably predictable and its cost was subject to reasonable estimation as of the last day of that taxable year. To be considered reasonable, an estimate of total allocable contract costs must include costs attributable to delay, rework, change orders, technology or design problems, or other problems that reasonably can be predicted considering the nature of the contract and prior experience. However, estimated total allocable contract costs do not include any contingency allowance for costs that, as of the end of the taxable year, are not reasonably predicted to be incurred in the performance of the contract. For example, estimated total allocable contract costs do not include any costs attributable to factors not reasonably predictable at the end of the taxable year, such as third-party litigation, extreme weather conditions, strikes, and delays in securing required permits and licenses. In addition, the estimated costs of performing other agreements that are not aggregated with the contract under §1.460–1(e) that the taxpayer expects to incur with the same customer (*e.g.*, follow-on contracts) are not included in estimated total allocable contract costs for the initial contract.

(iv) *Pre-contracting-year costs.* If a taxpayer reasonably expects to enter into a long-term contract in a future taxable year, the taxpayer must capitalize all costs incurred prior to entering into the contract that will be allocable to that contract (*e.g.*, bidding and proposal costs). A taxpayer is not required to compute a completion factor, or to include in gross income any amount, related to allocable contract costs for any taxable year ending before the contracting year or, if applicable, the 10-percent year defined in paragraph (b)(6)(i) of this section. In that year, the taxpayer is required to compute a completion factor that includes all allocable contract costs that have been incurred as of the end of that taxable year (whether previously capitalized or deducted) and to take into account in computing taxable income the related gross receipts and the previously capitalized allocable contract costs. If, however, a taxpayer determines in a subsequent year that it will not enter into the long-term contract, the taxpayer must account for these pre-contracting-year costs in that year (*e.g.*, as a deduction or an inventoriable cost) using the appropriate rules contained in other sections of the Code or regulations.

(v) *Post-completion-year costs.* If a taxpayer incurs an allocable contract cost after the completion year, the taxpayer must account for that cost using a permissible method of accounting. See §1.460–6(c)(1)(ii) for application of the look-back method as a result of adjustments to allocable contract costs.

(6) *10-percent method*—(i) *In general.* Instead of determining the income from a long-term contract beginning with the contracting year, a taxpayer may elect to use the 10-percent method under section 460(b)(5). Under the 10-percent method, a taxpayer does not include in gross income any amount related to allocable contract costs until the taxable year in which the taxpayer has incurred at least 10 percent of the estimated total allocable contract costs (10-percent year). A taxpayer must treat costs incurred before the 10-percent year as pre-contracting-year costs described in paragraph (b)(5)(iv) of this section.

(ii) *Election.* A taxpayer makes an election under this paragraph (b)(6) by using the 10-percent method for all long-term contracts entered into during the taxable year of the election on its original federal income tax return for the election year. This election is a method of accounting and, thus, applies to all long-term contracts entered into during and after the taxable year of the election. An electing taxpayer must use the 10-percent method to apply the look-back method under § 1.460–6 and to determine alternative minimum taxable income under paragraph (f) of this section. This election is not available if a taxpayer uses the simplified cost-to-cost method described in § 1.460-5(c) to compute the completion factor of a long-term contract.

(7) *Terminated contract*—(i) *Reversal of income.* If a long-term contract is terminated before completion and, as a result, the taxpayer retains ownership of the property that is the subject matter of that contract, the taxpayer must reverse the transaction in the taxable year of termination. To reverse the transaction, the taxpayer reports a loss (or gain) equal to the cumulative allocable contract costs reported under the contract in all prior taxable years less the cumulative gross receipts reported under the contract in all prior taxable years.

(ii) *Adjusted basis.* As a result of reversing the transaction under paragraph (b)(7)(i) of this section, a taxpayer will have an adjusted basis in the retained property equal to the cumulative allocable contract costs reported under the contract in all prior taxable years. However, if the taxpayer received and retains any consideration or compensation from the customer, the taxpayer must reduce the adjusted basis in the retained property (but not below zero) by the fair market value of that consideration or compensation. To the extent that the amount of the consideration or compensation described in the preceding sentence exceeds the adjusted basis in the retained property, the taxpayer must include the excess in gross income for the taxable year of termination.

(iii) *Look-back method.* The look-back method does not apply to a terminated contract that is subject to this paragraph (b)(7).

(c) *Exempt contract methods*—(1) *In general.* An *exempt contract method* means the method of accounting that a taxpayer must use to account for all its long-term contracts (and any portion of a long-term contract) that are exempt from the requirements of section 460(a). Thus, an exempt contract method applies to exempt construction contracts, as defined in § 1.460–3(b); the non-PCM portion of a qualified ship contract, as defined in § 1.460–2(d); and the non-PCM portion of a residential construction contract, as defined in § 1.460–3(c). Permissible exempt contract methods include the PCM, the EPCM described in paragraph (c)(2) of this section, the CCM described in paragraph (d) of this section, or any other permissible method. See section 446.

(2) *Exempt-contract percentage-of-completion method*—(i) *In general.* Similar to the PCM described in paragraph (b) of this section, a taxpayer using the EPCM generally must include in income the portion of the total contract price, as described in paragraph (b)(4) of this section, that corresponds to the percentage of the entire contract that the taxpayer has completed during the taxable year. However, under the EPCM, the percentage of completion may be determined as of the end of the taxable year by using any method of cost comparison (such as comparing direct labor costs incurred to date to estimated total direct labor costs) or by comparing the work performed on the contract with the estimated total work to be performed, rather than by using the cost-to-cost comparison required by paragraphs (b)(2)(i) and (5) of this section, provided such method is used consistently and clearly reflects income. In addition, paragraph (b)(3) of this section (regarding post-completion-year income), paragraph (b)(6) of this section (regarding the 10-percent method) and § 1.460–6 (regarding the look-back method) do not apply to the EPCM.

(ii) *Determination of work performed.* For purposes of the EPCM, the criteria used to compare the work performed on a contract as of the end of the taxable year with the estimated total work to be performed must clearly reflect the earning of income with respect to the contract. For example, in the case of a roadbuilder, a standard of completion solely based on miles of roadway completed in a case where the terrain is substantially different may not clearly reflect the earning of income with respect to the contract.

(d) *Completed-contract method*—(1) *In general*. Except as otherwise provided in paragraph (d)(4) of this section, a taxpayer using the CCM to account for a long-term contract must take into account in the contract's completion year, as defined in §1.460–1(b)(6), the gross contract price and all allocable contract costs incurred by the completion year. A taxpayer may not treat the cost of any materials and supplies that are allocated to a contract, but actually remain on hand when the contract is completed, as an allocable contract cost.

(2) *Post-completion-year income and costs*. If a taxpayer has not included an item of contingent compensation (*i.e.*, amounts for which the all events test has not been satisfied) in gross contract price under paragraph (d)(3) of this section by the completion year, the taxpayer must account for this item of contingent compensation using a permissible method of accounting. If a taxpayer incurs an allocable contract cost after the completion year, the taxpayer must account for that cost using a permissible method of accounting.

(3) *Gross contract price*. Gross contract price includes all amounts (including holdbacks, retainages, and reimbursements) that a taxpayer is entitled by law or contract to receive, whether or not the amounts are due or have been paid. In addition, gross contract price includes all bonuses, awards, and incentive payments, such as a bonus for meeting an early completion date, to the extent the all events test is satisfied. If a taxpayer performs a non-long-term contract activity, as defined in §1.460–1(d)(2), that is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, the taxpayer must include an allocable share of the gross receipts attributable to that activity in the gross contract price of the contract(s) benefitted by that activity. Gross contract price also includes amounts reimbursed for independent research and development expenses (as defined in §1.460–1(b)(9)), or bidding and proposal costs, under a federal or cost-plus long-term contract (as defined in section 460(d)), regardless of whether the research and development, or bidding and proposal, activities are incident to or necessary for the performance of that long-term contract.

(4) *Contracts with disputed claims*—(i) *In general*. The special rules in this paragraph (d)(4) apply to a long-term contract accounted for using the CCM with a dispute caused by a customer's requesting a reduction of the gross contract price or the performance of additional work under the contract or by a taxpayer's requesting an increase in gross contract price, or both, on or after the date a taxpayer has tendered the subject matter of the contract to the customer.

(ii) *Taxpayer assured of profit or loss*. If the disputed amount relates to a customer's claim for either a reduction in price or additional work and the taxpayer is assured of either a profit or a loss on a long-term contract regardless of the outcome of the dispute, the gross contract price, reduced (but not below zero) by the amount reasonably in dispute, must be taken into account in the completion year. If the disputed amount relates to a taxpayer's claim for an increase in price and the taxpayer is assured of either a profit or a loss on a long-term contract regardless of the outcome of the dispute, the gross contract price must be taken into account in the completion year. If the taxpayer is assured a profit on the contract, all allocable contract costs incurred by the end of the completion year are taken into account in that year. If the taxpayer is assured a loss on the contract, all allocable contract costs incurred by the end of the completion year, reduced by the amount reasonably in dispute, are taken into account in the completion year.

(iii) *Taxpayer unable to determine profit or loss*. If the amount reasonably in dispute affects so much of the gross contract price or allocable contract costs that a taxpayer cannot determine whether a profit or loss ultimately will be realized from a long-term contract, the taxpayer may not take any of the gross contract price or allocable contract costs into account in the completion year.

(iv) *Dispute resolved*. Any part of the gross contract price and any allocable contract costs that have not been taken into account because of the principles described in paragraph (d)(4)(i), (ii), or (iii) of this section must be taken into account in the taxable year in which the dispute is resolved. If a taxpayer performs additional work under the contract because of the dispute, the term *taxable year in which the dispute is resolved* means the taxable year the additional work is completed, rather than the taxable year in which the outcome of the dispute is determined by agreement, decision, or otherwise.

(e) *Percentage-of-completion/capitalized-cost method*. Under the PCCM, a taxpayer must determine the income from a long-term contract using the PCM for the applicable percentage of the contract and its exempt contract method, as defined in paragraph (c) of this section, for the remaining percentage of the contract. For residential construction contracts described in §1.460–3(c), the applicable percentage is 70 percent, and the remaining percentage is 30 percent. For qualified ship contracts described in §1.460–2(d), the applicable percentage is 40 percent, and the remaining percentage is 60 percent.

(f) *Alternative minimum taxable income*—(1) *In general*. Under section 56(a)(3), a taxpayer (not exempt from the AMT under section 55(e)) must use the PCM to determine its AMTI from any long-term contract entered into on or after March 1, 1986, that is not a home construction contract, as defined in §1.460–3(b)(2). For AMTI purposes, the PCM must include any election under paragraph (b)(6) of this section (concerning the 10-percent method) or under §1.460–5(c) (concerning the simplified cost-to-cost method) that the taxpayer has made for regular tax purposes. For exempt construction contracts described in §1.460–3(b)(1)(ii), a taxpayer must use the simplified cost-to-cost method to determine the completion factor for AMTI purposes. Except as provided in paragraph (f)(2) of this section, a taxpayer must use AMTI costs and AMTI methods, such as the depreciation method described in section 56(a)(1), to determine the completion factor of a long-term contract (except a home construction contract) for AMTI purposes.

(2) *Election to use regular completion factors*. Under this paragraph (f)(2), a taxpayer may elect for AMTI purposes to determine the completion factors of all of its long-term contracts using the methods of accounting and allocable contract costs used for regular federal income tax purposes. A taxpayer makes this election by using regular methods and regular costs to compute the completion factors of all long-term contracts entered into during the taxable year of the election for AMTI purposes on its original federal income tax return for the election year. This election is a method of accounting and, thus, applies to all long-term contracts entered into during and after the taxable year of the election. Although a taxpayer may elect to compute the completion factor of its long-term contracts using regular methods and regular costs, an election under this paragraph (f)(2) does not eliminate a taxpayer's obligation to comply with the requirements of section 55 when computing AMTI. For example, although a taxpayer may elect to use the depreciation methods used for regular tax purposes to compute the completion factor of its long-term contracts for AMTI purposes, the taxpayer must use the depreciation methods permitted by section 56 to compute AMTI.

(g) *Method of accounting*. A taxpayer that uses the PCM, EPCM, CCM, or PCCM, or elects the 10-percent method or special AMTI method (or changes to another method of accounting with the Commissioner's consent) must apply the method(s) consistently for all similarly classified long-term contracts, until the taxpayer obtains the Commissioner's consent under section 446(e) to change to another method of accounting. A taxpayer-initiated change in method of accounting will be permitted only on a cut-off basis (*i.e.*, for contracts entered into on or after the year of change), and thus, a section 481(a) adjustment will not be permitted or required.

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

Example 1. PCM—estimating total contract price. C, whose taxable year ends December 31, determines the income from long-term contracts using the PCM. On January 1, 2001, C enters into a contract to design and manufacture a satellite (a unique item). The contract provides that C will be paid $10,000,000 for delivering the completed satellite by December 1, 2002. The contract also provides that C will receive a $3,000,000 bonus for delivering the satellite by July 1, 2002, and an additional $4,000,000 bonus if the satellite successfully performs its mission for five years. C is unable to reasonably predict if the satellite will successfully perform its mission for five years. If on December 31, 2001, C should reasonably expect to deliver the satellite by July 1, 2002, the estimated total contract price is $13,000,000 ($10,000,000 unit price + $3,000,000 production-related bonus). Otherwise, the estimated total contract price is $10,000,000. In either event, the $4,000,000 bonus is not includible in the estimated total contract price as of December 31, 2001, because C is unable to reasonably predict that the satellite will successfully perform its mission for five years.

Example 2. PCM—computing income. (i) C, whose taxable year ends December 31, determines the income from long-term contracts using the PCM. During 2001, C agrees to manufacture for the customer, B, a unique item for a total contract price of $1,000,000. Under C's contract, B is entitled to retain 10 percent of the total contract price until it accepts the item. By the end of 2001, C has incurred $200,000 of allocable contract costs and estimates that the total allocable contract costs will be $800,000. By the end of 2002, C has incurred $600,000 of allocable contract costs and estimates that the total allocable contract costs will be $900,000. In 2003, after completing the contract, C determines that the actual cost to manufacture the item was $750,000.

(ii) For each of the taxable years, C's income from the contract is computed as follows:

	Taxable Year		
	2001	2002	2003
(A) Cumulative incurred costs	$200,000	$600,000	$750,000
(B) Estimated total costs	800,000	900,000	750,000
(C) Completion factor: (A) ÷ (B)	25.00%	66.67%	100.00%
(D) Total contract price	1,000,000	1,000,000	1,000,000
(E) Cumulative gross receipts: (C) × (D)	250,000	666,667	1,000,000
(F) Cumulative gross receipts (prior year)	(0)	(250,000)	(666,667)
(G) Current-year gross receipts	250,000	416,667	333,333
(H) Cumulative incurred costs	200,000	600,000	750,000
(I) Cumulative incurred costs (prior year)	(0)	(200,000)	(600,000)
(J) Current-year costs	200,000	400,000	150,000
(K) Gross income: (G) − (J)	$50,000	$16,667	$183,333

Example 3. PCM—computing income with cost sharing. (i) C, whose taxable year ends December 31, determines the income from long-term contracts using the PCM. During 2001, C enters into a contract to manufacture a unique item. The contract specifies a target price of $1,000,000, a target cost of $600,000, and a target profit of $400,000. C and B will share the savings of any cost underrun (actual total incurred cost is less than target cost) and the additional cost of any cost overrun (actual total incurred cost is greater than target cost) as follows: 30 percent to C and 70 percent to B. By the end of 2001, C has incurred $200,000 of allocable contract costs and estimates that the total allocable contract costs will be $600,000. By the end of 2002, C has incurred $300,000 of allocable contract costs and estimates that the total allocable contract costs will be $400,000. In 2003, after completing the contract, C determines that the actual cost to manufacture the item was $700,000.

(ii) For each of the taxable years, C's income from the contract is computed as follows (note that the sharing of any cost underrun or cost overrun is reflected as an adjustment to C's target price under paragraph (b)(4)(i) of this section):

	Taxable Year		
	2001	2002	2003
(A) Cumulative incurred costs	$200,000	$300,000	$700,000

	Taxable Year		
	2001	2002	2003
(B) Estimated total costs	600,000	400,000	700,000
(C) Completion factor: (A) ÷ (B)	33.33%	75.00%	100.00%
(D) Target price	$1,000,000	$1,000,000	$1,000,000
(E) Estimated total costs	600,000	400,000	700,000
(F) Target costs	600,000	600,000	600,000
(G) Cost (underrun)/overrun: (E) − (F)	0	(200,000)	100,000
(H) Adjustment rate	70%	70%	70%
(I) Target price adjustment	0	(140,000)	70,000
(J) Total contract price: (D) + (I)	$1,000,000	$860,000	$1,070,000
(K) Cumulative gross receipts: (C) × (J)	$333,333	$645,000	$1,070,000
(L) Cumulative gross receipts (prior year):	(0)	(333,333)	(645,000)
(M) Current-year gross receipts	333,333	311,667	425,000
(N) Cumulative incurred costs	200,000	300,000	700,000
(O) Cumulative incurred costs (prior year):	(0)	(200,000)	(300,000)
(P) Current-year costs	200,000	100,000	400,000
(Q) Gross income: (M) − (P)	$133,333	$211,667	$25,000

Example 4. PCM—10 percent method. (i) C, whose taxable year ends December 31, determines the income from long-term contracts using the PCM. In November 2001, C agrees to manufacture a unique item for $1,000,000. C reasonably estimates that the total allocable contract costs will be $600,000. By December 31, 2001, C has received $50,000 in progress payments and incurred $40,000 of costs. C elects to use the 10 percent method effective for 2001 and all subsequent taxable years. During 2002, C receives $500,000 in progress payments and incurs $260,000 of costs. In 2003, C incurs an additional $300,000 of costs, C finishes manufacturing the item, and receives the final $450,000 payment.

(ii) For each of the taxable years, C's income from the contract is computed as follows:

	Taxable Year		
	2001	2002	2003
(A) Cumulative incurred costs	$40,000	$300,000	$600,000
(B) Estimated total costs	600,000	600,000	600,000
(C) Completion factor (A) ÷ (B)	6.67%	50.00%	100.00%
(D) Total contract price	1,000,000	1,000,000	1,000,000
(E) Cumulative gross receipts: (C) × (D)*	0	500,000	1,000,000
(F) Cumulative gross receipts (prior year):	(0)	(0)	(500,000)
(G) Current-year gross receipts	0	500,000	500,000
(H) Cumulative incurred costs	0	300,000	600,000
(I) Cumulative incurred costs (prior year):	(0)	(0)	(300,000)
(J) Current-year costs	0	300,000	300,000
(K) Gross income: (G) − (J)	$0	$200,000	$200,000

*Unless (C) <10 percent.

Example 5. PCM—contract terminated. C, whose taxable year ends December 31, determines the income from long-term contracts using the PCM. During 2001, C buys land and begins constructing a building that will contain 50 condominium units on that land. C enters into a contract to sell one unit in this condominium to B for $240,000. B gives C a

$5,000 deposit toward the purchase price. By the end of 2001, C has incurred $50,000 of allocable contract costs on B's unit and estimates that the total allocable contract costs on B's unit will be $150,000. Thus, for 2001, C reports gross receipts of $80,000 ($50,000 ÷ $150,000 × $240,000), current-year costs of $50,000, and gross income of $30,000 ($80,000 − $50,000). In 2002, after C has incurred an additional $25,000 of allocable contract costs on B's unit, B files for bankruptcy protection and defaults on the contract with C, who is permitted to keep B's $5,000 deposit as liquidated damages. In 2002, C reverses the transaction with B under paragraph (b)(7) of this section and reports a loss of $30,000 ($50,000 − $80,000). In addition, C obtains an adjusted basis in the unit sold to B of $70,000 ($50,000 (current-year costs deducted in 2001) − $5,000 (B's forfeited deposit) + $25,000 (current-year costs incurred in 2002). C may not apply the look-back method to this contract in 2002.

Example 6. CCM—contracts with disputes from customer claims. In 2001, C, whose taxable year ends December 31, uses the CCM to account for exempt construction contracts. C enters into a contract to construct a bridge for B. The terms of the contract provide for a $1,000,000 gross contract price. C finishes the bridge in 2002 at a cost of $950,000. When B examines the bridge, B insists that C either repaint several girders or reduce the contract price. The amount reasonably in dispute is $10,000. In 2003, C and B resolve their dispute, C repaints the girders at a cost of $6,000, and C and B agree that the contract price is not to be reduced. Because C is assured a profit of $40,000 ($1,000,000 − $10,000 − $950,000) in 2002 even if the dispute is resolved in B's favor, C must take this $40,000 into account in 2002. In 2003, C will earn an additional $4,000 profit ($1,000,000 − $956,000 − $40,000) from the contract with B. Thus, C must take into account an additional $10,000 of gross contract price and $6,000 of additional contract costs in 2003.

Example 7. CCM—contracts with disputes from taxpayer claims. In 2003, C, whose taxable year ends December 31, uses the CCM to account for exempt construction contracts. C enters into a contract to construct a building for B. The terms of the contract provide for a $1,000,000 gross contract price. C finishes the building in 2004 at a cost of $1,005,000. B examines the building in 2004 and agrees that it meets the contract's specifications; however, at the end of 2004, C and B are unable to agree on the merits of C's claim for an additional $10,000 for items that C alleges are changes in contract specifications and B alleges are within the scope of the contract's original specifications. In 2005, B agrees to pay C an additional $2,000 to satisfy C's claims under the contract. Because the amount in dispute affects so much of the gross contract price that C cannot determine in 2004 whether a profit or loss will ultimately be realized, C may not taken any of the gross contract price or allocable contract costs into account in 2004. C must take into account $1,002,000 of gross contract price and $1,005,000 of allocable contract costs in 2005.

Example 8. CCM—contracts with disputes from taxpayer and customer claims. C, whose taxable year ends December 31, uses the CCM to account for exempt construction contracts. C constructs a factory for B pursuant to a long-term contract. Under the terms of the contract, B agrees to pay C a total of $1,000,000 for construction of the factory. C finishes construction of the factory in 2002 at a cost of $1,020,000. When B takes possession of the factory and begins operations in December 2002, B is dissatisfied with the location and workmanship of certain heating ducts. As of the end of 2002, C contends that the heating ducts are constructed in accordance with contract specifications. The amount of the gross contract price reasonably in dispute with respect to the heating ducts is $6,000. As of this time, C is claiming $14,000 in addition to the original contract price for certain changes in contract specifications which C alleges have increased his costs. B denies that these changes have increased C's costs. In 2003, the disputes between C and B are resolved by performance of additional work by C at a cost of $1,000 and by an agreement that the contract price would be revised downward to $996,000. Under these circumstances, C must include in his gross income for 2002, $994,000 (the gross contract price less the amount reasonably in dispute because of B's claim, or $1,000,000 − $6,000). In 2002, C must also take into account $1,000,000 of allocable contract costs (costs incurred less the amounts in dispute attributable to both B's and C's claims, or $1,020,000 − $6,000 − $14,000). In 2003, C must take into account an additional $2,000 of gross contract price ($996,000 − $994,000) and $21,000 of allocable contract costs ($1,021,000 − $1,000,000).

(i) [Reserved]

(j) *Consolidated groups and controlled groups*—(1) *Intercompany transactions*—(i) *In general.* Section 1.1502–13 does not apply to the income, gain, deduction, or loss from an intercompany transaction between members of a consolidated group, and section 267(f) does not apply to these items from an intercompany sale between members of a controlled group, to the extent—

(A) The transaction or sale directly or indirectly benefits, or is intended to benefit, another member's long-term contract with a nonmember;

(B) The selling member is required under section 460 to determine any part of its gross income from the transaction or sale under the percentage-of-completion method (PCM); and

(C) The member with the long-term contract is required under section 460 to determine any part of its gross income from the long-term contract under the PCM.

(ii) *Definitions and nomenclature.* The definitions and nomenclature under §1.1502–13 and §1.267(f)–1 apply for purposes of this paragraph (j).

(2) *Example.* The following example illustrates the principles of paragraph (j)(1) of this section.

Example. Corporations P, S, and B file consolidated returns on a calendar-year basis. In 1996, B enters into a long-term contract with X, a nonmember, to manufacture 5 airplanes for $500 million, with delivery scheduled for 1999. Section 460 requires B to determine the gross income from its contract with X under the PCM. S enters into a contract with B to manufacture for $50 million the engines that B will install on X's airplanes. Section 460 requires S to determine the gross income from its contract with B under the PCM. S estimates that it will incur $40 million of total contract costs during 1997 and 1998 to manufacture the engines. S incurs $10 million of contract costs in 1997 and $30 million in 1998. Under paragraph (j) of this section, S determines its gross income from the long-term contract under the PCM rather than taking its income or loss into account under section 267(f) or §1.1502–13. Thus, S includes $12.5 million of gross receipts and $10 million of contract costs in gross income in 1997 and includes $37.5 million of gross receipts and $30 million of contract costs in gross income in 1998.

(3) *Effective dates*—(i) *In general.* This paragraph (j) applies with respect to transactions and sales occurring pursuant to contracts entered into in years beginning on or after July 12, 1995.

(ii) *Prior law.* For transactions and sales occurring pursuant to contracts entered into in years beginning before July 12, 1995, see the applicable regulations issued under sections 267(f) and 1502, including §§1.267(f)–1T, 1.267(f)–2T, and 1.1502–13(n) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(4) *Consent to change method of accounting.* For transactions and sales to which this paragraph (j) applies, the Commissioner's consent under section 446(e) is hereby granted to the extent any changes in method of accounting are necessary solely to comply with this section, provided the changes are made in the first taxable year of the taxpayer to which the rules of this paragraph (j) apply. Changes in method of accounting for these transactions are to be effected on a cut-off basis.

(k) *Mid-contract change in taxpayer*—(1) *In general.* The rules in this paragraph (k) apply if prior to the completion of a long-term contract accounted for using a long-term contract method by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for accounting for income from the same contract. For purposes of this paragraph (k) and §1.460–6(g), an old taxpayer also includes any old taxpayer(s) (e.g., predecessors) of the old taxpayer. In addition, a change in status from taxable to tax exempt or from domestic to foreign, or vice versa, will be considered a change in taxpayer. Finally, a contract will be treated as the same contract if the terms of the contract are not substantially changed in connection with the transaction, whether or not the customer agrees to release the old taxpayer from any or all of its obligations under the contract. The rules governing constructive completion transactions are provided in paragraph (k)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (k)(3) of this section. Special rules relating to the treatment of certain partnership transactions are provided in paragraphs (k)(2)(iv) and (k)(3)(v) of this section. For application of the look-back method to mid-contract changes in taxpayers for contracts accounted for using the PCM, see §1.460–6(g).

(2) *Constructive completion transactions*—(i) *Scope.* The constructive completion rules in this paragraph (k)(2) apply to transactions (constructive completion transactions) that result in a change in the taxpayer responsible for reporting income from a contract and that are not described in paragraph (k)(3)(i) of this section. Constructive completion transactions generally include, for example, taxable sales under section 1001 and deemed asset sales under section 338.

(ii) *Old taxpayer.* The old taxpayer is treated as completing the contract on the date of the transaction. The total contract price (or, gross contract price in the case of a long-term contract accounted for under the CCM) for the old taxpayer is the sum of any amounts realized from the transaction that are allocable to the contract and any amounts the old taxpayer has received or reasonably expects to receive under the contract. Total contract price (or gross contract price) is reduced by any amount paid by the old taxpayer to the new taxpayer, and by any transaction costs, that are allocable to the contract. Thus, the old taxpayer's allocable contract costs determined under paragraph (b)(5) of this section do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to section 338 or 1060, the amount realized from the transaction allocable to the contract is determined by using the residual method under §§ 1.338–6 and 1.338–7.

(iii) *New taxpayer.* The new taxpayer is treated as entering into a new contract on the date of the transaction. The new taxpayer must evaluate whether the new contract should be classified as a long-term contract within the meaning of § 1.460–1(b) and account for the contract under a permissible method of accounting. For a new taxpayer who accounts for a contract using the PCM, the total contract price is any amount the new taxpayer reasonably expects to receive under the contract consistent with paragraph (b)(4) of this section. Total contract price is reduced by the amount of any consideration paid by the new taxpayer as a result of the transaction, and by any transaction costs, that are allocable to the contract and is increased by the amount of any consideration received by the new taxpayer as a result of the transaction that is allocable to the contract. Similarly, the gross contract price for a contract accounted for using the CCM is all amounts the new taxpayer is entitled by law or contract to receive consistent with paragraph (d)(3) of this section, adjusted for any consideration paid (or received) by the new taxpayer as a result of the transaction, and for any transaction costs, that are allocable to the contract. Thus, the new taxpayer's allocable contract costs determined under paragraph (b)(5) of this section do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to sections 338 or 1060, the amount of consideration paid that is allocable to the contract is determined by using the residual method under §§ 1.338–6 and 1.338–7.

(iv) *Special rules relating to distributions of certain contracts by a partnership*—(A) *In general.* The constructive completion rules of paragraph (k)(2) of this section apply both to the distribution of a contract accounted for under a long-term contract method of accounting by a partnership to a partner and to the distribution of an interest in a partnership (lower-tier partnership) holding (either directly or through other partnerships) one or more contracts accounted for under a long-term contract method of accounting by another partnership (upper-tier partnership). Notwithstanding the previous sentence, the constructive completion rules of paragraph (k)(2) of this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership, under § 1.708–1(b)(4) (relating to terminations under section 708(b)(1)(B)) or § 1.708–1(c)(3)(i) (relating to certain partnership mergers). If a partnership that holds a contract accounted for under a long-term contract method of accounting terminates under section 708(b)(1)(A) because the number of its owners is reduced to one, the entire contract will be treated as being distributed from the partnership for purposes of the constructive completion rules, and the partnership must apply paragraph (k)(2) of this section immediately prior to the transaction or transactions resulting in the termination of the partnership.

(B) *Old taxpayer.* The partnership that distributes the contract is treated as the old taxpayer for purposes of paragraph (k)(2)(ii) of this section. For purposes of determining the total contract price (or gross contract price) under paragraph (k)(2)(ii) of this section, the fair market value of the contract is treated as the amount realized from the transaction. For purposes of determining each partner's distributive share of partnership items, any income or loss resulting from the constructive completion must be allocated among the partners of the old taxpayer as though the partnership closed its books on the date of the distribution.

(C) *New taxpayer.* The partner receiving the distributed contract is treated as the new taxpayer for purposes of paragraph (k)(2)(iii) of this section. For purposes of determining the total contract price (or gross contract price) under paragraph (k)(2)(iii) of this section, the new taxpayer's basis in the contract (including the uncompleted property, if applicable) after the distribution (as determined under section 732) is treated as consideration paid by the new taxpayer that is allocable to the contract. Thus, the total contract price (or gross contract price) of the new contract is reduced by the partner's basis in the contract (including the uncompleted property, if applicable) immediately after the distribution.

(D) *Basis rules.* For purposes of determining the new taxpayer's basis in the contract (including the uncompleted property, if applicable) under section 732, and the amount of any basis adjustment under section 734(b), the partnership's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to—

(*1*) The partnership's allocable contract costs (including transaction costs);

(*2*) Increased (or decreased) by the amount of cumulative taxable income (or loss) recognized by the partnership on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion); and

(*3*) Decreased by the amounts that the partnership has received or reasonably expects to receive under the contract.

(E) *Section 751*—(*1*) *In general.* Contracts accounted for under a long-term contract method of accounting are unrealized receivables within the meaning of section 751(c). For purposes of section 751, the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting is the amount of income or loss that the partnership would take into account under the constructive completion rules of paragraph (k)(2) of this section if the contract were disposed of for its fair market value in a constructive completion transaction, adjusted to account for any income or loss from the contract that is allocated under section 706 to that portion of the taxable year of the partnership ending on the date of the distribution, sale, or exchange.

(*2*) *Ordering rules.* Because the distribution of a contract accounted for under a long-term contract method of accounting is the distribution of an unrealized receivable, section 751(b) may apply to the distribution. A partnership that distributes a contract accounted for under a long-term contract method of accounting must apply paragraph (k)(2)(ii) of this section before applying the rules of section 751(b) to the distribution.

(3) *Step-in-the-shoes transactions*—(i) *Scope.* Except as otherwise provided in paragraph (k)(3)(v)(D) of this section, the step-in-the-shoes rules in this paragraph (k)(3) apply to the following transactions that result in a change in the taxpayer responsible for reporting income from a contract accounted for using a long-term contract method of accounting (step-in-the-shoes transactions)—

(A) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(A), (C) or (F);

(B) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(D) or (G), provided the requirements of section 354(b)(1)(A) and (B) are met;

(C) Distributions to which section 332 applies, provided the contract is transferred to an 80-percent distributee;

(D) Transfers described in section 351;

(E) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met;

(F) Transfers (e.g., sales) of S corporation stock;

(G) Conversion to or from an S corporation;

(H) Members joining or leaving a consolidated group;

(I) Contributions of contracts accounted for under a long-term contract method of accounting to which section 721(a) applies;

(J) Contributions of property (other than contracts accounted for under a long-term contract method of accounting) to a partnership that holds a contract accounted for under a long-term contract method of accounting;

(K) Transfers of partnership interests (other than transfers which cause the partnership to terminate under section 708(b)(1)(A));

(L) Distributions to which section 731 applies (other than the distribution of the contract); and

(M) Any other transaction designated in the Internal Revenue Bulletin by the Internal Revenue Service. See §601.601(d)(2)(ii) of this chapter.

(ii) *Old taxpayer*—(A) *In general.* The new taxpayer will ''step into the shoes'' of the old taxpayer with respect to the contract. Thus, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer, as set forth in paragraph (k)(3)(iii) of this section. As a result, an old taxpayer using the PCM is required to recognize income from the contract based on the cumulative allocable contract costs incurred as of the date of the transaction. Similarly, an old taxpayer using the CCM is not required to recognize any revenue and may not deduct allocable contract costs incurred with respect to the contract.

(B) *Gain realized on the transaction.* The amount of gain the old taxpayer realizes on the transfer of a contract in a step-in-the-shoes transaction must be determined after application of paragraph (k)(3)(ii)(A) of this section using the rules of paragraph (k)(2) of this section that apply to constructive completion transactions. (The amount of gain realized on a transfer of a contract is relevant, for example, in determining the amount of gain recognized with respect to the contract in a section 351 transaction in which the old taxpayer receives from the new taxpayer money or property other than stock of the transferee.)

(iii) *New taxpayer*—(A) *Method of accounting.* Beginning on the date of the transaction, the new taxpayer must account for the long-term contract by using the same method of accounting used by the old taxpayer prior to the transaction. The same method of accounting must be used for such contract regardless of whether the old taxpayer's method is the new taxpayer's principal method of accounting under §1.381(c)(4)–1(b)(3) or whether the new taxpayer is otherwise eligible to use the old taxpayer's method. Thus, if the old taxpayer uses the PCM to account for the contract, the new taxpayer steps into the shoes of the old taxpayer with respect to its completion factor and percentage of completion methods (such as the 10-percent method), even if the new taxpayer has not elected such methods for similarly classified contracts. Similarly, if the old taxpayer uses the CCM, the new taxpayer steps into the shoes of the old taxpayer with respect to the CCM, even if the new taxpayer is not otherwise eligible to use the CCM. However, the new taxpayer is not necessarily bound by the old taxpayer's method for similarly classified contracts entered into by the new taxpayer subsequent to the transaction and must apply general tax principles, including section 381, to determine the appropriate method to account for these subsequent contracts. To the extent that general tax principles allow the taxpayer to account for similarly classified contracts using a method other than the old taxpayer's method, the taxpayer is not required to obtain the consent of the Commissioner to begin using such other method.

(B) *Contract price.* In the case of a long-term contract that has been accounted for under PCM, the total contract price for the new taxpayer is the sum of any amounts the old taxpayer or the new taxpayer has received or reasonably expects to receive under the contract consistent with paragraph (b)(4) of this section. Similarly, the gross contract price in the case of a long-term contract accounted for under the CCM includes all amounts the old taxpayer or the new taxpayer is entitled by law or by contract to receive consistent with paragraph (d)(3) of this section.

(C) *Contract costs.* Total allocable contract costs for the new taxpayer are the allocable contract costs as defined under paragraph (b)(5) of this section incurred by either the old taxpayer prior to, or the new taxpayer after, the transaction. Thus, any payments between the old taxpayer and the new taxpayer with respect to the contract in connection with the transaction are not treated as allocable contract costs.

(iv) *Special rules related to certain corporate and partnership transactions*—(A) *Old taxpayer—basis adjustment*—(*1*) *In general.* Except as provided in paragraph (k)(3)(iv)(A)(*2*) of this section, in the case of a transaction described in paragraph (k)(3)(i)(D), (E), or (I) of this section, the old taxpayer must adjust its basis in the stock or partnership interest of the new taxpayer by—

(*i*) Increasing such basis by the amount of gross receipts the old taxpayer has recognized under the contract; and

(*ii*) Reducing such basis by the amount of gross receipts the old taxpayer has received or reasonably expects to receive under the contract (except to the extent such gross receipts give rise to a liability other than a liability described in section 357(c)(3)).

(*2*) *Basis adjustment in excess of stock or partnership interest basis.* If the old and new taxpayer do not join in the filing of a consolidated Federal income tax return, the old taxpayer may not adjust its basis in the stock or partnership interest of the new taxpayer under paragraph (k)(3)(iv)(A)(*1*) of this section below zero and the old taxpayer must recognize ordinary income to the extent the basis in the stock or partnership interest of the new taxpayer otherwise would be adjusted below zero. If the old and new taxpayer join in the filing of a consolidated Federal income tax return, the old taxpayer must create an (or increase an existing) excess loss account to the extent the basis in the stock of the new taxpayer otherwise would be adjusted below zero under paragraph (k)(3)(iv)(A)(*1*) of this section. See §1.1502–19 and 1.1502–32(a)(3)(ii).

(*3*) *Subsequent dispositions of certain contracts.* If the old taxpayer disposes of a contract in a transaction described in paragraph (k)(3)(i)(D), (E), or (I) of this section that the old taxpayer acquired in a transaction described in paragraph (k)(3)(i)(D), (E), or (I) of this section, the basis adjustment rule of this paragraph (k)(3)(iv)(A) is applied by treating the old taxpayer as having recognized the amount of gross receipts recognized by the previous old taxpayer under the contract and any amount recognized by the previous old taxpayer with respect to the contract in connection with the transaction in which the old taxpayer acquired the contract. In addition, the old taxpayer is treated as having received or as reasonably expecting to receive under the contract any amount the previous old taxpayer received or reasonably expects to receive under the contract. Similar principles will apply in the case of multiple successive transfers described in paragraph (k)(3)(i)(D), (E), or (I) of this section involving the contract.

(B) *New taxpayer*—(*1*) *Contract price adjustment.* Generally, payments between the old taxpayer and the new taxpayer with respect to the contract in connection with the transaction do not affect the contract price. Notwithstanding the preceding sentence and paragraph (k)(3)(iii)(B) of this section, however, in the case of transactions described in paragraph (k)(3)(i)(B), (D), (E), or (I) of this section, the total contract price (or gross contract price) must be reduced to the extent of any amount recognized by the old taxpayer with respect to the contract in connection with the transaction (*e.g.*, any amount recognized under section 351(b) or section 357 that is attributable to the contract and any income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A) of this section).

(*2*) *Basis in contract.* The new taxpayer's basis in a contract (including the uncompleted property, if applicable) acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) or paragraph (k)(3)(i)(I) of this section will be computed under section 362, section 334, or section 723, as applicable. Upon a new taxpayer's completion (actual or constructive) of a CCM or a PCM contract acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) or paragraph (k)(3)(i)(I) of this section, the new taxpayer's basis in the contract (including the uncompleted property, if applicable) is reduced to zero. The new taxpayer is not entitled to a deduction or loss in connection with any basis reduction pursuant to this paragraph (k)(3)(iv)(B)(*2*).

(C) *Definition of old taxpayer and new taxpayer for certain partnership transactions*. For purposes of paragraphs (k)(3)(ii), (iii) and (iv) of this section, in the case of a transaction described in paragraph (k)(3)(i)(I) of this section, the partner contributing the contract to the partnership is treated as the old taxpayer, and the partnership receiving the contract from the partner is treated as the new taxpayer.

(D) *Exceptions to step-in-the-shoes rules for S corporations*. Upon a transfer described in paragraph (k)(3)(i)(F) of this section or a conversion described in paragraph (k)(3)(i)(G) of this section, paragraphs (k)(3)(ii) and (iii) of this section apply to a contract accounted for under a long-term contract method of accounting only if the S corporation's books are closed under section 1362(e)(3), section 1362(e)(6)(C), section 1362(e)(6)(D), section 1377(a)(2), or §1.1502–76 on the date of the transfer or conversion. In these cases, the corporation is treated as both the old taxpayer and the new taxpayer for purposes of paragraphs (k)(3)(ii) and (iii) of this section. In all other cases involving these transfers, the corporation shall compute its income or loss from each contract accounted for under a long-term contract method of accounting for the period that includes the date of the transaction as though no change in taxpayer had occurred with respect to the contract, and must allocate the income or loss from the contract for that period in accordance with the rules generally applicable to transfers of S corporation stock and conversions to or from S corporation status. This paragraph (k)(3)(iv)(D) is applicable for transactions on or after July 16, 2004. In addition, this paragraph (k)(3)(iv)(D) may be relied upon for transactions on or after May 15, 2002.

(v) *Special rules relating to certain partnership transactions*—(A) *Section 704(c)*—(*1*) *Contributions of contracts*. The principles of section 704(c)(1)(A), section 737, and the regulations thereunder apply to income or loss with respect to a contract accounted for under a long-term contract method of accounting that is contributed to a partnership. The amount of built-in income or built-in loss attributable to a contributed contract that is subject to section 704(c)(1)(A) is determined as follows. First, the contributing partner must take into account any income or loss required under paragraph (k)(3)(ii)(A) of this section for the period ending on the date of the contribution. Second, the partnership must determine the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied paragraph (k)(3)(ii)(A) of this section, but before the contribution to the partnership. Finally, this amount is reduced by the amount of income, if any, that the contributing partner is required to recognize as a result of the contribution.

(*2*) *Revaluations of partnership property*. The principles of section 704(c) and §1.704–3 apply to allocations of income or loss with respect to a long-term contract that is revalued by a partnership under §1.704–1(b)(2)(iv)(*f*). The amount of built-in income or built-in loss attributable to such a contract is equal to the amount of income or loss that would be taken into account if, at the time of the revaluation, the contract were disposed of for its fair market value in a constructive completion transaction.

(*3*) *Allocation methods*. In the case of a contract accounted for under the CCM, any built-in income or loss under section 704(c) is taken into account in the year the contract is completed. In the case of a contract accounted for under a long-term contract method of accounting other than the CCM, any built-in income or loss under section 704(c) must be taken into account in a manner that reasonably accounts for the section 704(c) income or loss over the remaining term of the contract.

(B) *Basis adjustments under sections 743(b) and 734(b).* For purposes of §§1.743–1(d), 1.755–1(b), and 1.755–1(c), the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting is the amount of income or loss that the partnership would take into account under the constructive completion rules of paragraph (k)(2) of this section if, at the time of the sale of a partnership interest or the distribution to a partner, the partnership disposed of the contract for its fair market value in a constructive completion transaction. If all or part of the transferee's basis adjustment under section 743(b) or the partnership's basis adjustment under section 734(b) is allocated to a contract accounted for under a long-term contract method of accounting, the basis adjustment shall reduce or increase, as the case may be, the affected party's income or loss from the contract. In the case of a contract accounted for under the CCM, the basis adjustment is taken into account in the year in which the contract is completed. In the case of a contract accounted for under a long-term contract method of accounting other than the CCM, the portion of that basis adjustment that is recovered in each taxable year of the partnership must be determined by the partnership in a manner that reasonably accounts for the adjustment over the remaining term of the contract.

(C) *Cross reference.* See paragraph (k)(2)(iv)(E) of this section for rules relating to the application of section 751 to the transfer of an interest in a partnership holding a contract accounted for under a long-term contract method of accounting.

(D) *Exceptions to step-in-the-shoes rules.* Upon a contribution described in paragraph (k)(3)(i)(J) of this section, a transfer described in paragraph (k)(3)(i)(K) of this section, or a distribution described in paragraph (k)(3)(i)(L) of this section, paragraphs (k)(3)(ii) and (iii) of this section apply to a contract accounted for under a long-term contract method of accounting only if the partnership's books are properly closed with respect to that contract under section 706. In these cases, the partnership is treated as both the old taxpayer and the new taxpayer for purposes of paragraphs (k)(3)(ii) and (iii) of this section. In all other cases involving these transactions, the partnership shall compute its income or loss from each contract accounted for under a long-term contract method of accounting for the period that includes the date of the transaction as though no change in taxpayer had occurred with respect to the contract, and must allocate the income or loss from the contract for that period under a reasonable method complying with section 706.

(4) *Anti-abuse rule.* Notwithstanding this paragraph (k), in the case of a transaction entered into with a principal purpose of shifting the tax consequences associated with a long-term contract in a manner that substantially reduces the aggregate U.S. Federal income tax liability of the parties with respect to that contract, the Commissioner may allocate to the old (or new) taxpayer the income from that contract properly allocable to the old (or new) taxpayer. For example, the Commissioner may reallocate income from a long-term contract in a transaction in which a contract accounted for using the CCM, or using the PCM where the old taxpayer has received advance payments in excess of its contribution to the contract, is transferred to a tax indifferent party (e.g., a foreign person not subject to U.S. Federal income tax).

(5) *Examples.* The following examples illustrate the rules of this paragraph (k). For purposes of these examples, it is assumed that the contract is a long-term construction contract accounted for using the PCM prior to the transaction unless stated otherwise and the contract is not transferred with a principal purpose of shifting the tax consequences associated with a long-term contract in a manner that substantially reduces the aggregate U.S. Federal income tax liability of the parties

with respect to that contract. The examples are as follows:

Example 1. Constructive completion—PCM. (i) *Facts.* In Year 1, X enters into a contract. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, X incurs costs of $200,000. In Year 2, X incurs additional costs of $400,000 before selling the contract as part of a taxable sale of its business in Year 2 to Y, an unrelated party. At the time of sale, X has received $650,000 in progress payments under the contract. The consideration allocable to the contract under section 1060 is $150,000. Pursuant to the sale, the new taxpayer Y immediately assumes X's contract obligations and rights. Y is required to account for the contract using the PCM. In Year 2, Y incurs additional allocable contract costs of $50,000. Y correctly estimates at the end of Year 2 that it will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract.

(ii) *Old taxpayer.* For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000 × $1,000,000)) and costs of $200,000, for a profit of $50,000. X is treated as completing the contract in Year 2 because it sold the contract. For purposes of applying the PCM in Year 2, the total contract price is $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and the total allocable contract costs are $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)). Thus, in Year 2, X reports receipts of $550,000 (total contract price minus receipts already reported ($800,000 − $250,000)) and costs incurred in year 2 of $400,000, for a profit of $150,000.

(iii) *New taxpayer.* Y is treated as entering into a new contract in Year 2. The total contract price is $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 − $650,000 − $150,000)). The estimated total allocable contract costs at the end of Year 2 are $125,000 (the allocable contract costs that Y reasonably expects to incur to complete the contract ($50,000 + $75,000)). In Year 2, Y reports receipts of $80,000 (the completion factor multiplied by the total contract price [($50,000/$125,000) × $200,000] and costs of $50,000 (the costs incurred after the purchase), for a profit of $30,000. For Year 3, Y reports receipts of $120,000 (total contract price minus receipts already reported ($200,000 − $80,000)) and costs of $75,000, for a profit of $45,000.

Example 2. Constructive completion—CCM. (i) *Facts.* The facts are the same as in Example 1, except that X and Y properly account for the contract under the CCM.

(ii) *Old taxpayer.* X does not report any income or costs from the contract in Year 1. In Year 2, the contract is deemed complete for X, and X reports its gross contract price of $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and its total allocable contract costs of $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)) in that year, for a profit of $200,000.

(iii) *New taxpayer.* Y is treated as entering into a new contract in Year 2. Under the CCM, Y reports no gross receipts or costs in Year 2. Y reports its gross contract price of $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 − $650,000 − $150,000)) and its total allocable contract costs of $125,000 (the allocable contract costs that Y incurred to complete the contract ($50,000 + $75,000)) in Year 3, the completion year, for a profit of $75,000.

Example 3. Step-in-the-shoes—PCM. (i) *Facts.* The facts are the same as in Example 1, except that X transfers the contract (including the uncompleted property) to Y in exchange for stock of Y in a transaction that qualifies as a statutory merger described in section 368(a)(1)(A) and does not result in gain or loss to X under section 361(a).

(ii) *Old taxpayer.* For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000 × $1,000,000)) and costs of $200,000, for a profit of $50,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i) of this section, X is not treated as completing the contract in Year 2. In Year 2, X reports receipts of $500,000 (the completion factor multiplied by the total contract price and minus the Year 1 gross receipts [($600,000/$800,000 × $1,000,000)–$250,000]) and costs of $400,000, for a profit of $100,000.

(iii) *New taxpayer.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same methods of accounting used by X prior to the transaction. Total contract price is the sum of any amounts that X and Y have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and Y. Thus, the estimated total allocable contract costs at the end of Year 2 are $725,000 (the cumulative allocable contract costs of X and the estimated total allocable contract costs of Y ($200,000 + $400,000 + $50,000 + $75,000)). In Year 2, Y reports receipts of $146,552 (the completion factor multiplied by the total contract price minus receipts reported by the old taxpayer ([($650,000/$725,000) × $1,000,000]–$750,000) and costs of $50,000, for a profit of $96,552. For Year 3, Y reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000–$896,552)) and costs of $75,000, for a profit of $28,448.

Example 4. Step-in-the-shoes—CCM (i) *Facts.* The facts are the same as in *Example 3,* except that X properly accounts for the contract under the CCM.

(ii) *Old taxpayer.* X reports no income or costs from the contract in Years 1, 2 or 3.

(iii) *New taxpayer.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same method of accounting used by X prior to the transaction. Thus, in Year 3, the completion year, Y reports receipts of $1,000,000 and total contract costs of $725,000, for a profit of $275,000.

Example 5. Step in the shoes—PCM—basis adjustment. The facts are the same as in Example 3, except that X transfers the contract (including the uncompleted property) with a basis of $0 and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. Thus, under section 358(a), X's basis in the Z stock is $125,000. Pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must increase its basis in the Z stock by the amount of gross receipts X recognized under the contract, $750,000 ($250,000 receipts in Year 1 + $500,000 receipts in Year 2), and reduce its basis by the amount of gross receipts X received under the contract, the $650,000 in progress payments. Accordingly, X's basis in the Z stock is $225,000. All other results are the same.

Example 6. Step in the shoes—CCM—basis adjustment. (i) *Facts.* The facts are the same as in *Example 4,* except that X receives progress payments of $800,000 (rather than $650,000) and transfers the contract (including the uncompleted property) with a basis of $600,000 and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. X and Z do not join in filing a consolidated Federal income tax return.

(ii) *Old taxpayer.* X reports no income or costs under the contract in Years 1, 2, or 3. Under section 358(a), X's basis in Z is $725,000. Pursuant to paragraph (k)(3)(iv)(A)(*1*), X must reduce its basis in the stock of Z by $800,000, the progress payments received by X. However, X may not reduce its basis in the Z stock below zero pursuant paragraph (k)(3)(iv)(A)(*2*) of this section. Accordingly, X's basis in the Z stock is reduced by $725,000 to zero and X must recognize ordinary income of $75,000.

(iii) *New taxpayer.* Upon completion of the contract in Year 3, Z reports gross receipts of $925,000 ($1,000,000 original contract price—$75,000 income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A)) and total contract costs of $725,000, for a profit of $200,000.

Example 7. Step in the shoes—PCM—gain recognized in transaction. (i) *Facts.* The facts are the same as in *Example 3,* except that X transfers the contract (including the uncompleted property) with a basis of $0 and an unrelated capital asset with a value of $100,000 and a basis of $0 to a new corporation, Z, in exchange for stock of Z with a value of $200,000 and $50,000 of cash in a section 351 transaction.

(ii) *Old taxpayer.* For year 1, X reports receipts of $250,000 ($200,000/$800,000 × $1,000,000) and costs of $200,000, for a profit of $50,000. X is not treated as completing the contract in Year 2. In Year 2, X reports receipts of $500,000 (($600,000/$800,000 × $1,000,000 = $750,000 cumulative gross receipts)—$250,000 prior year cumulative gross receipts) and costs of $400,000, for a profit of $100,000. Under paragraph (k)(3)(ii)(B) of this section, X determines that the gain realized on the transfer of the contract to Z under the constructive completion rules of paragraph (k)(2)(ii) of this section is $50,000 (total contract price of $800,000 ($150,000 value allocable to the contract + $650,000 progress payments)—$750,000 previously recognized cumulative gross receipts—$0 costs incurred but not recognized). The gain realized on the transfer of the unrelated capital asset to Z is $100,000. The amount of gain X must recognize due to the receipt of $50,000 cash in the exchange is $50,000, of which $30,000 is allocated to the contract ($150,000 value of contract/$250,000 total value of property transferred to Z × $50,000) and is treated as ordinary income, and $20,000 is allocated to the unrelated capital asset ($100,000 value of capital asset/$250,000 total value of property transferred to Z × $50,000). Under section 358(a), X's basis in the Z stock is $0. However, pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must increase its basis in the Z stock by $750,000, the amount of gross receipts recognized under the contract, and must reduce its basis in the Z stock by $650,000, the amount of gross receipts X received under the contract. Therefore, X's basis in the Z stock is $100,000.

(iii) *New taxpayer.* Z must account for the contract using the same PCM method used by X prior to the transaction. Pursuant to paragraph (k)(3)(iv)(B)(1) of this section, the total contract price is $970,000 ($1,000,000 amount X and Z have received or reasonably expect to receive under the contract—$30,000 income recognized by X with respect to the contract as a result of the receipt of $50,000 cash in the transaction). In Year 2, Z reports gross receipts of $119,655 ($650,000/$725,000 × $970,000 = $869,655 current year cumulative gross receipts—$750,000 cumulative gross receipts reported by the old taxpayer) and costs of $50,000, for a profit of $69,655. In Year 3, Z reports gross receipts of $100,345 ($970,000–$869,655) and costs of $75,000, for a profit of $25,345.

Example 8. Step in the shoes—CCM—gain recognized in transaction. (i) *Facts.* The facts are the same as in *Example 4,* except that X transfers the contract (including the uncompleted property) with a basis of

$600,000 and an unrelated capital asset with a value of $125,000 and a basis of $0 to a new corporation, Z, in exchange for all the stock of Z with a value of $175,000 and $100,000 of cash in a section 351 transaction. X and Z do not join in filing a consolidated Federal income tax return.

(ii) *Old taxpayer.* X reports no income or costs under the contract in Years 1, 2, or 3. Under paragraph (k)(3)(ii)(B), X determines that the gain realized on the transfer of the contract to Z under the constructive completion rules of paragraph (k)(2)(ii) of this section is $200,000 ($800,000 total contract price ($150,000 value allocable to the contract + $650,000 progress payments)—$600,000 costs incurred but not recognized). The gain realized on the transfer of the unrelated capital asset to Z is $125,000. The amount of gain X must recognize due to the receipt of $100,000 of cash in the exchange is $100,000, of which $54,545 is allocated to the contract ($150,000 value of the contract/$275,000 total value of property transferred to Z × $100,000) and is treated as ordinary income, and $45,455 is allocated to the unrelated capital asset ($125,000 value of capital asset/$275,000 total value of property transferred to Z × $100,000). Under section 358(a), X's basis in the Z stock is $600,000 ($600,000 basis in the contract and unrelated capital asset transferred—$100,000 cash received + $100,000 gain recognized). Pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must reduce its basis in the stock of Z by $650,000, the progress payments received under the contract. However, X may not reduce its basis in the Z stock below zero pursuant to paragraph (k)(3)(iv)(A)(*2*) of this section. Accordingly, X's basis in the Z stock is reduced by $600,000 to zero and X must recognize income of $50,000.

(iii) *New taxpayer.* Z must account for the contract using the same CCM used by X prior to the transaction. Pursuant to paragraph (k)(3)(iv)(B)(1) of this section, the total contract price is $895,455 ($1,000,000 original contract price—$54,545 income recognized by old taxpayer with respect to the contract as a result of the receipt of cash in the transaction—$50,000 income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A)). Accordingly, upon completion of the contract in Year 3, Z reports gross receipts of $895,455 and total contract costs of $725,000, for a profit of $170,455.

Example 9. Constructive completion—PCM—distribution of contract by partnership. (i) *Facts.* In Year 1, W, X, Y, and Z each contribute $100,000 to form equal partnership PRS. In Year 1, PRS enters into a contract. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, PRS incurs costs of $600,000 and receives $650,000 in progress payments under the contract. Under the contract, PRS performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payments or perform any additional services in order to retain the payments. PRS properly accounts for the contract under the PCM. In Year 2, PRS distributes the contract to X in liquidation of X's interest. PRS incurs no costs and receives no progress payments in Year 2 prior to the distribution. At the time of the distribution, PRS's only asset other than the long-term contract and the partially constructed property is $450,000 cash ($400,000 initially contributed and $50,000 in excess progress payments). The fair market value of the contract is $150,000. Pursuant to the distribution, X assumes PRS's contract obligations and rights. In Year 2, X incurs additional allocable contract costs of $50,000. X correctly estimates at the end of Year 2 that X will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract (rather than $150,000 as originally estimated by PRS). Assume that X properly accounts for the contract under the PCM, that PRS has no income or loss other than income or loss from the contract, and that PRS has an election under section 754 in effect in Year 2.

(ii) *Tax consequences to PRS.* For Year 1, PRS reports receipts of $750,000 (the completion factor multiplied by total contract price ($600,000/$800,000 × $1,000,000)) and costs of $600,000, for a profit of $150,000, which is allocated equally among W, X, Y, and Z ($37,500 each). Immediately prior to the distribution of the contract to X in Year 2, the contract is deemed completed. Under paragraph (k)(2)(iv)(B) of this section, the fair market value of the contract ($150,000) is treated as the amount realized from the transaction. For purposes of applying the PCM in Year 2, the total contract price is $800,000 (the sum of the amounts received under the contract and the amount treated as realized from the transaction ($650,000 + $150,000)) and the total allocable contract costs are $600,000. Thus, in Year 2 PRS reports receipts of $50,000 (total contract price minus receipts already reported ($800,000 − $750,000)), and costs incurred in Year 2 of $0, for a profit of $50,000. Under paragraph (k)(2)(iv)(B) of this section, this profit must be allocated among W, X, Y, and Z as though the partnership closed its books on the date of the distribution. Accordingly, each partner's distributive share of this income is $12,500.

(iii) *Tax consequences to X.* X's basis in its interest in PRS immediately prior to the distribution is $150,000 (X's $100,000 initial contribution, increased by $37,500, X's distributive share of Year 1 income, and $12,500, X's distributive share of Year 2 income). Under paragraph (k)(2)(iv)(D) of this section, PRS's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to

$150,000 (the partnership's allocable contract costs, $600,000, increased by the amount of income recognized by PRS on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), $200,000, decreased by the amounts that the partnership has received or reasonably expects to receive under the contract, $650,000). Under section 732, X's basis in the contract (including the uncompleted property) after the distribution is $150,000. Under paragraph (k)(2)(iv)(C) of this section, X's basis in the contract (including the uncompleted property) is treated as consideration paid by X that is allocable to the contract. X's total contract price is $200,000 (the amount remaining to be paid under the terms of the contract less the consideration allocable to the contract ($350,000–$150,000)). For Year 2, X reports receipts of $80,000 (the completion factor multiplied by the total contract price [($50,000/$125,000) × $200,000]) and costs of $50,000 (the costs incurred after the distribution of the contract), for a profit of $30,000. For Year 3, X reports receipts of $120,000 (the total contract price minus receipts already reported ($200,000 − $80,000)) and costs of $75,000, for a profit of $45,000.

(iv) *Section 734(b)*. Because X's basis in the contract (including the uncompleted property) immediately after the distribution, $150,000, is equal to PRS's basis in the contract (including the uncompleted property) immediately prior to the distribution, there is no basis adjustment under section 734(b).

Example 10. Constructive completion—CCM—distribution of contract by partnership. (i) *Facts*. The facts are the same as in *Example 9*, except that PRS and X properly account for the contract under the CCM.

(ii) *Tax consequences to PRS*. PRS reports no income or costs from the contract in Year 1. Immediately prior to the distribution of the contract to X in Year 2, the contract is deemed completed. Under paragraph (k)(2)(iv)(B) of this section, the fair market value of the contract ($150,000) is treated as the amount realized from the transaction. For purposes of applying the CCM in Year 2, the gross contract price is $800,000 (the sum of the amounts received under the contract and the amount treated as realized from the transaction ($650,000 + $150,000)) and the total allocable contract costs are $600,000. Thus, in Year 2 PRS reports profits of $200,000 ($800,000 − $600,000). This profit must be allocated among W, X, Y, and Z as though the partnership closed its books on the date of the distribution. Accordingly, each partner's distributive share of this income is $50,000.

(iii) *Tax consequences to X*. X's basis in its interest in PRS immediately prior to the distribution is $150,000 ($100,000 initial contribution, increased by $50,000, X's distributive share of Year 2 income). Under paragraph (k)(2)(iv)(D) of this section, PRS's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to $150,000 (the partnership's allocable contract costs, $600,000, increased by the amount of cumulative taxable income recognized by PRS on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), $200,000, decreased by the amounts that the partnership has received or reasonably expects to receive under the contract, $650,000). Under section 732, X's basis in the contract (including the uncompleted property) after the distribution is $150,000. Under paragraph (k)(2)(iv)(C) of this section, X's basis in the contract is treated as consideration paid by X that is allocable to the contract. Under the CCM, X reports no gross receipts or costs in Year 2. For Year 3, the completion year, X reports its gross contract price of $200,000 (the amount remaining to be paid under the terms of the contract less the consideration allocable to the contract ($350,000 − $150,000)) and its total allocable contract costs of $125,000 (the allocable contract costs that X incurred to complete the contract ($50,000 + $75,000)), for a profit of $75,000.

(iv) *Section 734(b)*. The results under section 734(b) are the same as in Example 9.

Example 11. Step-in-the-shoes—PCM—contribution of contract to partnership. (i) *Facts*. In Year 1, X enters into a contract that X properly accounts for under the PCM. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, X incurs costs of $600,000 and receives $650,000 in progress payments under the contract. Under the contract, X performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payments or perform any additional services in order to retain the payments. In Year 2, X contributes the contract (including the uncompleted property) with a basis of $0 and $125,000 of cash to partnership PRS in exchange for a one-fourth partnership interest. X incurs costs of $10,000, and receives no progress payments in Year 2 prior to the contribution of the contract. X and the other three partners of PRS share equally in its capital, profits, and losses. The parties determine that, at the time of the contribution, the fair market value of the contract is $160,000. Following the contribution in Year 2, PRS incurs additional allocable contract costs of $40,000. PRS correctly estimates at the end of Year 2 that it will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract (rather than $150,000 as originally estimated by PRS).

(ii) *Tax consequences to X*. For Year 1, X reports receipts of $750,000 (the completion factor multiplied by the total contract price ($600,000/$800,000 × $1,000,000)) and costs of

$600,000, for a profit of $150,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i)(I) of this section, X is not treated as completing the contract in Year 2. Under paragraph (k)(3)(ii)(A) of this section, for Year 2, X reports receipts of $12,500 (the completion factor multiplied by the total contract price ($610,000/$800,000 × $1,000,000, or $762,500), decreased by receipts already reported, $750,000) and costs of $10,000, for a profit of $2,500. Under section 722, X's initial basis in its interest in PRS is $125,000. Pursuant to paragraph (k)(3)(iv)(A)(1) of this section, X must increase its basis in its interest in PRS by the amount of gross receipts X recognized under the contract, $762,500, and reduce its basis by the amount of gross receipts X received under the contract, the $650,000 in progress payments. Accordingly, X's basis in its interest in PRS is $237,500.

(iii) *Tax consequences to PRS.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, PRS must account for the contract using the same methods of accounting used by X prior to the transaction. The total contract price is the sum of any amounts that X and PRS have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and PRS. For Year 2, PRS reports receipts of $134,052 (the completion factor multiplied by the total contract price [($650,000/$725,000) − $1,000,000], $896,552, decreased by receipts reported by X, $762,500) and costs of $40,000, for a profit of $94,052. For Year 3, PRS reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000 × $896,552)) and costs of $75,000, for a profit of $28,448.

(iv) *Section 704(c).* The principles of section 704(c) and §1.704–3 apply to allocations of income or loss with respect to the contract contributed by X. In this case, the amount of built-in income that is subject to section 704(c) is the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied paragraph (k)(3)(ii)(A) of this section, but before the contribution to the partnership. In a constructive completion transaction, the total contract price would be $810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale ($650,000 + $160,000)). X would report receipts of $47,500 (total contract price minus receipts already reported ($810,000 − $762,500)) and costs of $0, for a profit of $47,500. Thus, the amount of built-in income that is subject to section 704(c) is $47,500. The partnership must apply section 704(c) to this income in a manner that reasonably accounts for the income over the remaining term of the contract. For example, in Year 2, PRS could allocate $26,810 to X under section 704(c) (the amount of built-in income, $47,500, multiplied by a fraction, the numerator of which is the completion factor for the year, $650,000/725,000, less the completion factor for the prior year, $610,000/$800,000, and the denominator of which is 100 percent reduced by the completion factor for the taxable year preceding the event creating the section 704(c) income or loss, $610,000/$800,000). The remaining $67,242 would be allocated equally among all of the partners. In Year 3, the completion year, PRS could allocate $20,690 to X under section 704(c) ($47,500 × [($725,000/$725,000 −$650,000/$725,000) / (100 percent − $610,000/$800,000)]). The remaining $7,758 would be allocated equally among all the partners.

Example 12. Step-in-the-shoes—CCM—contribution of contract to partnership. (i) *Facts.* The facts are the same as in *Example 11*, except that X and PRS properly account for the contract under the CCM, and X has a basis of $610,000 in the contract (including the uncompleted property).

(ii) *Tax consequences to X.* X reports no income or costs from the contract in Years 1 or 2. X is not treated as completing the contract in Year 2. Under section 722, X's initial basis in its interest in PRS is $735,000 (the sum of $125,000 cash and X's basis of $610,000 in the contract (including the uncompleted property)). Pursuant to paragraph (k)(3)(iv)(A)(*1*)(*ii*) of this section, X must reduce its basis in its interest in PRS by the amount of gross receipts X received under the contract, or $650,000. Accordingly, X's basis in its interest in PRS is $85,000.

(iii) *Tax consequences to PRS.* PRS must account for the contract using the same methods of accounting used by X prior to the transaction. Under the CCM, PRS reports no gross receipts or costs in Year 2. For Year 3, the completion year, PRS reports its gross contract price of $1,000,000 (the sum of any amounts that X and PRS have received or reasonably expect to receive under the contract), and total allocable contract costs of $725,000 (the allocable contract costs of X and PRS), for a profit of $275,000.

(iv) *Section 704(c).* In this case, the amount of built-in income that is subject to section 704(c) is the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied paragraph (k)(3)(ii)(A) of this section, but before the contribution to the partnership. In a constructive completion transaction, X would report its gross contract price of $810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale ($650,000 + $160,000)) and its total allocable contract costs of $610,000, for a profit of $200,000. Thus, the amount of built-in income that is subject to section 704(c) is $200,000. Out of PRS's income of $275,000, in Year 3, $200,000 must be allocated to X under section 704(c), and the remaining $75,000 is allocated equally among all of the partners.

Example 13. Step-in-the-shoes—PCM—transfer of a partnership interest. (i) *Facts.* In Year 1, W, X, Y, and Z each contribute $100,000 to form equal partnership PRS. In Year 1, PRS enters into a contract. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, PRS incurs costs of $600,000 and receives $650,000 in progress payments under the contract. Under the contract, PRS performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payment or perform any additional services in order to retain the payments. PRS properly accounts for the contract under the PCM. In Year 2, W transfers W's interest in PRS to T for $150,000. Assume that $10,000 of PRS's Year 2 costs are incurred prior to the transfer, $40,000 are incurred after the transfer; and that PRS receives no progress payments in Year 2. Also assume that the fair market value of the contract on the date of the transfer is $160,000, that PRS closes its books with respect to the contract under section 706 on the date of the transfer, and that PRS correctly estimates at the end of Year 2 that it will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract (rather than $150,000 as originally estimated by PRS).

(ii) *Income reporting for period ending on date of transfer.* For Year 1, PRS reports receipts of $750,000 (the completion factor multiplied by total contract price ($600,000/$800,000 × $1,000,000)) and costs of $600,000, for a profit of $150,000. This profit is allocated equally among W, X, Y, and Z ($37,500 each). Under paragraph (k)(3)(ii)(A) of this section, for the part of Year 2 ending on the date of the transfer of W's interest, PRS reports receipts of $12,500 (the completion factor multiplied by the total contract price ($610,000/$800,000 × $1,000,000) minus receipts already reported ($750,000)) and costs of $10,000 for a profit of $2,500. This profit is allocated equally among W, X, Y, and Z ($625 each).

(iii) *Income reporting for period after transfer.* PRS must continue to use the PCM. For the part of Year 2 beginning on the day after the transfer, PRS reports receipts of $134,052 (the completion factor multiplied by the total contract price decreased by receipts reported by PRS for the period ending on the date of the transfer [($650,000/$725,000 × $1,000,000)—$762,500]) and costs of $40,000, for a profit of $94,052. This profit is shared equally among T, X, Y, and Z ($23,513 each). For Year 3, PRS reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000 − $896,552)) and costs of $75,000, for a profit of $28,448. The profit for Year 3 is shared equally among T, X, Y, and Z ($7,112 each).

(iv) *Tax Consequences to W.* W's amount realized is $150,000. W's adjusted basis in its interest in PRS is $138,125 ($100,000 originally contributed, plus $37,500, W's distributive share of PRS's Year 1 income, and $625, W's distributive share of PRS's Year 2 income prior to the transfer). Accordingly, W's income from the sale of W's interest in PRS is $11,875. Under paragraph (k)(2)(iv)(E) of this section, for purposes of section 751(a), the amount of ordinary income attributable to the contract is determined as follows. First, the partnership must determine the amount of income or loss from the contract that is allocated under section 706 to the period ending on the date of the sale ($625). Second, the partnership must determine the amount of income or loss that the partnership would take into account under the constructive completion rules of paragraph (k)(2) of this section if the contract were disposed of for its fair market value in a constructive completion transaction. Because PRS closed its books under section 706 with respect to the contract on the date of the sale, this calculation is treated as occurring immediately after the partnership has applied paragraph (k)(3)(ii)(A) of this section on the date of the sale. In a constructive completion transaction, the total contract price would be $810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale ($650,000 + $160,000)). PRS would report receipts of $47,500 (total contract price minus receipts already reported ($810,000 − $762,500)) and costs of $0, for a profit of $47,500. Thus, the amount of ordinary income attributable to the contract is $47,500, and W's share of that income is $11,875. Thus, under § 1.751–1(a), all of W's $11,875 of income from the sale of W's interest in PRS is ordinary income.

(v) *Tax Consequences to T.* T's adjusted basis for its interest in PRS is $150,000. Under § 1.743–1(d)(2), the amount of income that would be allocated to T if the contract were disposed of for its fair market value (adjusted to account for income from the contract for the portion of PRS's taxable year that ends on the date of the transfer) is $11,875. Under § 1.743–1(b), the amount of T's basis adjustment under section 743(b) is $11,875. Under paragraph (k)(3)(v)(B) of this section, the portion of T's basis adjustment that is recovered in Year 2 and Year 3 must be determined by PRS in a manner that reasonably accounts for the adjustment over the remaining term of the contract. For example, PRS could recover $6,703 of the adjustment in Year 2 (the amount of the basis adjustment, $11,875, multiplied by a fraction, the numerator of which is the excess of the completion factor for the year, $650,000/

$725,000, less the completion factor for the prior year, $610,000/$800,000, and the denominator of which is 100 percent reduced by the completion factor for the taxable year preceding the transfer, $610,000/$800,000). T's distributive share of income in Year 2 from the contract would be adjusted from $23,513 to $16,810 as a result of the basis adjustment. In Year 3, the completion year, PRS could recover $5,172 of the adjustment ($11,875 × [($725,000/$725,000 − $650,000/$725,000) / (100 percent − $610,000/$800,000)]). T's distributive share of income in Year 3, the completion year, from the contract would be adjusted from $7,112 to $1,940 as a result of the basis adjustment.

(6) *Effective date.* Except as provided in paragraph (k)(3)(iv)(D) of this section, this paragraph (k) is applicable for transactions on or after May 15, 2002. Application of the rules of this paragraph (k) to a transaction that occurs on or after May 15, 2002 is not a change in method of accounting.

[T.D. 8597, 60 FR 36684, July 18, 1995, as amended by T.D. 8929, 66 FR 2232, Jan. 11, 2001; 66 FR 18191, Apr. 6, 2001; T.D. 8995, 67 FR 34605, May 15, 2002; T.D. 9137, 69 FR 42553, July 16, 2004]

§ 1.460–5 Cost allocation rules.

(a) *Overview.* This section prescribes methods of allocating costs to long-term contracts accounted for using the percentage-of-completion method described in §1.460–4(b) (PCM), the completed-contract method described in §1.460–4(d) (CCM), or the percentage-of-completion/capitalized-cost method described in §1.460–4(e) (PCCM). Exempt construction contracts described in §1.460–3(b) accounted for using a method other than the PCM or CCM are not subject to the cost allocation rules of this section (other than the requirement to allocate production-period interest under paragraph (b)(2)(v) of this section). Paragraph (b) of this section describes the regular cost allocation methods for contracts subject to the PCM. Paragraph (c) of this section describes an elective simplified cost allocation method for contracts subject to the PCM. Paragraph (d) of this section describes the cost allocation methods for exempt construction contracts reported using the CCM. Paragraph (e) of this section describes the cost allocation rules for contracts subject to the PCCM. Paragraph (f) of this section describes additional rules applicable to the cost allocation methods described in this section. Paragraph (g) of this section provides rules concerning consistency in method of allocating costs to long-term contracts.

(b) *Cost allocation method for contracts subject to PCM*—(1) *In general.* Except as otherwise provided in paragraph (b)(2) of this section, a taxpayer must allocate costs to each long-term contract subject to the PCM in the same manner that direct and indirect costs are capitalized to property produced by a taxpayer under §1.263A–1(e) through (h). Thus, a taxpayer must allocate to each long-term contract subject to the PCM all direct costs and certain indirect costs properly allocable to the long-term contract (*i.e.*, all costs that directly benefit or are incurred by reason of the performance of the long-term contract). However, see paragraph (c) of this section concerning an election to allocate contract costs using the simplified cost-to-cost method. As in section 263A, the use of the practical capacity concept is not permitted. See §1.263A–2(a)(4).

(2) *Special rules*—(i) *Direct material costs.* The costs of direct materials must be allocated to a long-term contract when dedicated to the contract under principles similar to those in §1.263A–11(b)(2). Thus, a taxpayer dedicates direct materials by associating them with a specific contract, including by purchase order, entry on books and records, or shipping instructions. A taxpayer maintaining inventories under §1.471–1 must determine allocable contract costs attributable to direct materials using its method of accounting for those inventories (*e.g.*, FIFO, LIFO, specific identification).

(ii) *Components and subassemblies.* The costs of a component or subassembly (component) produced by the taxpayer must be allocated to a long-term contract as the taxpayer incurs costs to produce the component if the taxpayer reasonably expects to incorporate the component into the subject matter of the contract. Similarly, the cost of a purchased component (including a component purchased from a related party) must be allocated to a long-term contract as the taxpayer incurs the cost to purchase the component if the taxpayer reasonably expects to incorporate the component into the subject matter of the contract. In all other cases, the cost of a component must be allocated to a long-term contract when the component is dedicated, under principles similar to those in §1.263A–11(b)(2). A taxpayer maintaining inventories under §1.471–1 must determine allocable contract costs attributable to components using its method of accounting for those inventories (*e.g.*, FIFO, LIFO, specific identification).

(iii) *Simplified production methods.* A taxpayer may not determine allocable contract costs using the simplified production methods described in §1.263A–2(b) and (c).

(iv) *Costs identified under cost-plus long-term contracts and federal long-term contracts.* To the extent not otherwise allocated to the contract under this paragraph (b), a taxpayer must allocate any identified costs to a cost-plus long-term contract or federal long-term contract (as defined in section 460(d)). *Identified cost* means any cost, including a charge representing the time-value of money, identified by the taxpayer or related person as being attributable to the taxpayer's cost-plus long-term contract or federal long-term contract under the terms of the contract itself or under federal, state, or local law or regulation.

(v) *Interest*—(A) *In general.* If property produced under a long-term contract is *designated property*, as defined in §1.263A–8(b) (without regard to the exclusion for long-term contracts under §1.263A–8(d)(2)(v)), a taxpayer must allocate interest incurred during the production period to the long-term contract in the same manner as interest is allocated to property produced by a taxpayer under section 263A(f). See §§1.263A–8 to 1.263A–12 generally.

(B) *Production period.* Notwithstanding §1.263A–12(c) and (d), for purposes of this paragraph (b)(2)(v), the production period of a long-term contract—

(*1*) Begins on the later of—

(*i*) The contract commencement date, as defined in §1.460–1(b)(7); or

(*ii*) For a taxpayer using the accrual method of accounting for long-term contracts, the date by which 5 percent or more of the total estimated costs, including design and planning costs, under the contract have been incurred; and

(*2*) Ends on the date that the contract is completed, as defined in §1.460–1(c)(3).

(C) *Application of section 263A(f).* For purposes of this paragraph (b)(2)(v), section 263A(f)(1)(B)(iii) (regarding an estimated production period exceeding 1 year and a cost exceeding $1,000,000) must be applied on a contract-by-contract basis; except that, in the case of a taxpayer using an accrual method of accounting, that section must be applied on a property-by-property basis.

(vi) *Research and experimental expenses.* Notwithstanding §1.263A–1(e)(3)(ii)(P) and (iii)(B), a taxpayer must allocate research and experimental expenses, other than independent research and development expenses (as defined in §1.460–1(b)(9)), to its long-term contracts.

(vii) *Service costs*—(A) *Simplified service cost method*—(*1*) *In general.* To use the simplified service cost method under §1.263A–1(h), a taxpayer must allocate the otherwise capitalizable mixed service costs among its long-term contracts using a reasonable method. For example, otherwise capitalizable mixed service costs may be allocated to each long-term contract based on labor hours or contract costs allocable to the contract. To be considered reasonable, an allocation method must be applied consistently and must not disproportionately allocate service costs to contracts expected to be completed in the near future.

(*2*) *Example.* The following example illustrates the rule of this paragraph (b)(2)(vii)(A):

Example. Simplified service cost method. During 2001, C, whose taxable year ends December 31, produces electronic equipment for inventory and enters into long-term contracts to manufacture specialized electronic equipment. C's method of allocating mixed service costs to the property it produces is the labor-based, simplified service cost method described in §1.263A–1(h)(4). For 2001, C's total mixed service costs are $100,000, C's section 263A labor costs are $500,000, C's section 460 labor costs (*i.e.*, labor costs allocable to C's long-term contracts) are $250,000, and C's total labor costs are $1,000,000. To determine the amount of mixed service costs capitalizable under section 263A for 2001, C multiplies its total mixed service costs by its section 263A allocation ratio (section 263A labor costs ÷ total labor costs). Thus, C's capitalizable mixed service costs for 2001 are $50,000 ($100,000 × $500,000 ÷ $1,000,000). Thereafter, C allocates its capitalizable mixed service costs to produced property remaining in ending inventory using its 263A allocation method (*e.g.*, burden rate, simplified production). Similarly, to determine the amount of mixed service costs that are allocable to C's long-term contracts for 2001, C multiplies its total mixed service costs by its section 460 allocation ratio (section 460 labor ÷ total labor costs). Thus, C's allocable mixed service contract costs for 2001 are $25,000 ($100,000 × $250,000 ÷ $1,000,000). Thereafter, C allocates its allocable mixed service costs to its long-term contracts proportionately based on its section 460 labor costs allocable to each long-term contract.

(B) *Jobsite costs.* If an administrative, service, or support function is performed solely at the jobsite for a specific long-term contract, the taxpayer may allocate all the direct and indirect costs of that administrative, service, or support function to that long-term contract. Similarly, if an administrative, service, or support function is performed at the jobsite solely for the taxpayer's long-term contract activities, the taxpayer may allocate all the direct and indirect costs of that administrative, service, or support function among all the long-term contracts performed at that jobsite. For this purpose, jobsite means a production plant or a construction site.

(C) *Limitation on other reasonable cost allocation methods.* A taxpayer may use any other reasonable method of allocating service costs, as provided in §1.263A–1(f)(4), if, for the taxpayer's long-term contracts considered as a whole, the—

(*1*) Total amount of service costs allocated to the contracts does not differ significantly from the total amount of service costs that would have been allocated to the contracts under §1.263A–1(f)(2) or (3);

(*2*) Service costs are not allocated disproportionately to contracts expected to be completed in the near future because of the taxpayer's cost allocation method; and

(*3*) Taxpayer's cost allocation method is applied consistently.

(c) *Simplified cost-to-cost method for contracts subject to the PCM*—(1) *In general.* Instead of using the cost allocation method prescribed in paragraph (b) of this section, a taxpayer may elect to use the simplified cost-to-cost method, which is authorized under section 460(b)(3)(A), to allocate costs to a long-term contract subject to the PCM. Under the simplified cost-to-cost method, a taxpayer determines a contract's completion factor based upon only direct material costs; direct labor costs; and depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to manufacture or construct the subject matter of the contract. For this purpose, the costs associated with any manufacturing or construction activities performed by a subcontractor are considered either direct material or direct labor costs, as appropriate, and therefore must be allocated to the contract under the simplified cost-to-cost method. An electing taxpayer must use the simplified cost-to-cost method to apply the look-back method under §1.460–6 and to determine alternative minimum taxable income under §1.460–4(f).

(2) *Election.* A taxpayer makes an election under this paragraph (c) by using the simplified cost-to-cost method for all long-term contracts entered into during the taxable year of the election on its original federal income tax return for the election year. This election is a method of accounting and, thus, applies to all long-term contracts entered into during and after the taxable year of the election. This election is not available if a taxpayer does not use the PCM to account for all long-term contracts or if a taxpayer elects to use the 10-percent method described in §1.460–4(b)(6).

(d) *Cost allocation rules for exempt construction contracts reported using the CCM*—(1) *In general.* For exempt construction contracts reported using the CCM, other than contracts described in paragraph (d)(3) of this section (concerning contracts of homebuilders that do not satisfy the $10,000,000 gross receipts test described in §1.460–3(b)(3) or will not be completed within two years of the contract commencement date), a taxpayer must annually allocate the cost of any activity that is incident to or necessary for the taxpayer's performance under a long-term contract.

A taxpayer must allocate to each exempt construction contract all direct costs as defined in §1.263A–1(e)(2)(i) and all indirect costs either as provided in §1.263A–1(e)(3) or as provided in paragraph (d)(2) of this section.

(2) *Indirect costs*—(i) *Indirect costs allocable to exempt construction contracts.* A taxpayer allocating costs under this paragraph (d)(2) must allocate the following costs to an exempt construction contract, other than a contract described in paragraph (d)(3) of this section, to the extent incurred in the performance of that contract—

(A) Repair of equipment or facilities;

(B) Maintenance of equipment or facilities;

(C) Utilities, such as heat, light, and power, allocable to equipment or facilities;

(D) Rent of equipment or facilities;

(E) Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes, and contributions to a supplemental unemployment benefits plan;

(F) Indirect materials and supplies;

(G) Noncapitalized tools and equipment;

(H) Quality control and inspection;

(I) Taxes otherwise allowable as a deduction under section 164, other than state, local, and foreign income taxes, to the extent attributable to labor, materials, supplies, equipment, or facilities;

(J) Depreciation, amortization, and cost-recovery allowances reported for the taxable year for financial purposes on equipment and facilities to the extent allowable as deductions under chapter 1 of the Internal Revenue Code;

(K) Cost depletion;

(L) Administrative costs other than the cost of selling or any return on capital;

(M) Compensation paid to officers other than for incidental or occasional services;

(N) Insurance, such as liability insurance on machinery and equipment; and

(O) Interest, as required under paragraph (b)(2)(v) of this section.

(ii) *Indirect costs not allocable to exempt construction contracts.* A taxpayer allocating costs under this paragraph (d)(2) is not required to allocate the following costs to an exempt construction contract reported using the CCM—

(A) Marketing and selling expenses, including bidding expenses;

(B) Advertising expenses;

(C) Other distribution expenses;

(D) General and administrative expenses attributable to the performance of services that benefit the taxpayer's activities as a whole (*e.g.*, payroll expenses, legal and accounting expenses);

(E) Research and experimental expenses (described in section 174 and the regulations thereunder);

(F) Losses under section 165 and the regulations thereunder;

(G) Percentage of depletion in excess of cost depletion;

(H) Depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle (for this purpose, an asset is not considered to be temporarily idle on non-working days, and an asset used in construction is considered to be idle when it is neither en route to nor located at a job-site), and depreciation, amortization and cost recovery allowances under chapter 1 of the Internal Revenue Code in excess of depreciation, amortization, and cost recovery allowances reported by the taxpayer in the taxpayer's financial reports;

(I) Income taxes attributable to income received from long-term contracts;

(J) Contributions paid to or under a stock bonus, pension, profit-sharing, or annuity plan or other plan deferring the receipt of compensation whether or not the plan qualifies under section 401(a), and other employee benefit expenses paid or accrued on behalf of labor, to the extent the contributions or expenses are otherwise allowable as deductions under chapter 1 of the Internal Revenue Code. Other employee benefit expenses include (but are not limited to): Worker's compensation; amounts deductible or for whose payment reduction in earnings and profits is allowed under section 404A and the regulations thereunder; payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc.;

(K) Cost attributable to strikes, rework labor, scrap and spoilage; and

(L) Compensation paid to officers attributable to the performance of services that benefit the taxpayer's activities as a whole.

(3) *Large homebuilders.* A taxpayer must capitalize the costs of home construction contracts under section 263A and the regulations thereunder, unless the contract will be completed within two years of the contract commencement date and the taxpayer satisfies the $10,000,000 gross receipts test described in §1.460–3(b)(3).

(e) *Cost allocation rules for contracts subject to the PCCM.* A taxpayer must use the cost allocation rules described in paragraph (b) of this section to determine the costs allocable to the entire qualified ship contract or residential construction contract accounted for using the PCCM and may not use the simplified cost-to-cost method described in paragraph (c) of this section.

(f) *Special rules applicable to costs allocated under this section*—(1) *Nondeductible costs.* A taxpayer may not allocate any otherwise allocable contract cost to a long-term contract if any section of the Internal Revenue Code disallows a deduction for that type of payment or expenditure (*e.g.*, an illegal bribe described in section 162(c)).

(2) *Costs incurred for non-long-term contract activities.* If a taxpayer performs a non-long-term contract activity, as defined in §1.460–1(d)(2), that is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, the taxpayer must allocate the costs attributable to that activity to such contract(s).

(g) *Method of accounting.* A taxpayer that adopts or elects a cost allocation method of accounting (or changes to another cost allocation method of accounting with the Commissioner's consent) must apply that method consistently for all similarly classified contracts, until the taxpayer obtains the Commissioner's consent under section 446(e) to change to another cost allocation method. A taxpayer-initiated change in cost allocation method will be permitted only on a cut-off basis (*i.e.*, for contracts entered into on or after the year of change) and thus, a section 481(a) adjustment will not be permitted or required.

[T.D. 8929, 66 FR 2237, Jan. 11, 2001]

§ 1.460–6 Look-back method.

(a) *In general*—(1) *Introduction.* With respect to income from any long-term contract reported under the percentage of completion method, a taxpayer is required to pay or is entitled to receive interest under section 460(b) on the amount of tax liability that is deferred or accelerated as a result of overestimating or underestimating total contract price or contract costs. Under this look-back method, taxpayers are required to pay interest for any deferral of tax liability resulting from the underestimation of the total contract price or the overestimation of total contract costs. Conversely, if the total contract price is overestimated or the total contract costs are underestimated, taxpayers are entitled to receive interest for any resulting acceleration of tax liability. The computation of the amount of deferred or accelerated tax liability under the look-back method is hypothetical; application of the look-back method does not result in an adjustment to the taxpayer's tax liability as originally reported, as reported on an amended return, or as adjusted on examination. Thus, the look-back method does not correct for differences in tax liability that result from over- or under-estimation of contract price and costs and that are permanent because, for example, tax rates change during the term of the contract.

(2) *Overview.* Paragraph (b) explains which situations require application of the look-back method to income from a long-term contract. Paragraph (c) explains the operation of the three computational steps for applying the look-back method. Paragraph (d) provides guidance concerning the simplified marginal impact method. Paragraph (e) provides an elective method to minimize the number of times the look-back method must be reapplied to a single long-term contract. Paragraph (f) describes the reporting requirements for the look-back method and the tax treatment of look-back interest. Paragraph (g) provides rules for applying the look-back method when there is a transaction that changes the taxpayer that reports income from a long-term contract prior to the completion of a contract. Paragraph (h) provides examples illustrating the three computational steps for applying the look-back method. Paragraph (j) of this section provides guidance concerning the election not to apply the look-back method in de minimis cases.

(b) *Scope of look-back method*—(1) *In general.* The look-back method applies to any income from a long-term contract within the meaning of section 460(f) that is required to be reported under the percentage of completion method (as modified by section 460) for regular income tax purposes or for alternative minimum tax purposes. If a taxpayer uses the percentage of completion-capitalized cost method for long-term contracts, the look-back method applies for regular tax purposes only to the portion (40, 70, or 90 percent, whichever applies) of the income from the contract that is reported under the percentage of completion method. To the extent that the percentage-of-completion method is required to be used under §1.460–1(g) with respect to income and expenses that are attributable to activities that benefit a related party's long-term contract, the look-back method also applies to these amounts, even if those activities are not performed under a contract entered into directly by the taxpayer.

(2) *Exceptions from section 460.* The look-back method generally does not apply to the regular taxable income from any long-term construction contract within the meaning of section 460(e)(4) that:

(i) Is a home construction contract within the meaning of section 460(e)(1)(A), or

(ii) Is not a home construction contract but is estimated to be completed within a 2-year period by a taxpayer whose average annual gross receipts for the 3 tax years preceding the tax year the contract is entered into do not exceed $10,000,000 (as provided in section 460(e)(1)(B)). These contracts are not subject to the look-back method for regular tax purposes, even if the taxpayer uses a version of the percentage of completion method permitted under §1.451–3, unless the taxpayer has properly changed its method of accounting for these contracts to the percentage of completion method as modified by section 460(b). The look-back method, however, applies to the alternative minimum taxable income from a contract of this type, unless it is exempt from the required use of the percentage of completion method under section 56(a)(3).

(3) *De minimis exception.* Notwithstanding that the percentage of completion method is otherwise required to be used, the look-back method does not apply to any long-term contract that:

(i) Is completed within 2 years of the contract commencement date, and

(ii) Has a gross contract price (as of the completion of the contract) that does not exceed the lesser of $1,000,000 or 1 percent of the average annual gross receipts of the taxpayer for the 3 tax years preceding the tax year in which the contract is completed.

This de minimis exception is mandatory and, therefore, precludes application of the look-back method to any contract that meets the requirements of the exception. The de minimis exception applies for purposes of computing both regular taxable income and alternative minimum taxable income. Solely for this purpose, the determination of whether a long-term contract meets the gross receipts test for both alternative minimum tax and regular tax purposes is made based only on the taxpayer's regular taxable income.

(4) *Alternative minimum tax.* For purposes of computing alternative minimum taxable income, section 56(a)(3) generally requires long-term contracts within the meaning of section 460(f) (generally without regard to the exceptions in section 460(e)) to be accounted for using only the percentage of completion method as defined in section 460(b), including the look-back method of section 460(b), with respect to tax years beginning after December 31, 1986. However, section 56(a)(3) (and thus the look-back method) does not apply to any long-term contract entered into after June 20, 1988, and before the beginning of the first tax year that begins after September 30, 1990, that meets the conditions of both section 460(e)(1)(A) and clauses (i) and (ii) of section 460(e)(1)(B), and does not apply to any long-term contract entered into in a tax year that begins after September 30, 1990, that meets the conditions of section 460(e)(1)(A). A taxpayer that applies the percentage of completion method (and thus the look-back method) to income from a long-term contract only for purposes of determining alternative minimum taxable income, and not regular taxable income, must apply the look-back method to the alternative minimum taxable income in the year of contract completion and other filing years whether or not the taxpayer was liable for the alternative minimum tax for the filing year or for any prior year. Interest is computed under the look-back method to the extent that the taxpayer's total tax liability (including the alternative minimum tax liability) would have differed if the percentage of completion method had been applied using actual, rather than estimated, contract price and contract costs.

(5) *Effective date.* The look-back method, including the de minimis exception, applies to long-term contracts entered into after February 28, 1986. With respect to activities that are subject to section 460 solely because they benefit a long-term contract of a related party, the look-back method generally applies only if the related party's long-term contract was entered into after June 20, 1988, unless a principal purpose of the related-party arrangement is to avoid the requirements of section 460.

(c) *Operation of the look-back method*—(1) *Overview*—(i) *In general.* The amount of interest charged or credited to a taxpayer under the look-back method is computed in three steps. This paragraph (c) describes the three steps for applying the look-back method. These steps are illustrated by the examples in paragraph (h). The first step is to hypothetically reapply the percentage of completion method to all long-term contracts that are completed or adjusted in the current year (the "filing year"), using the actual, rather than estimated, total contract price and contract costs. Based on this reapplication, the taxpayer determines the amount of taxable income (and alternative minimum taxable income) that would have been reported for each year prior to the filing year that is affected by contracts completed or adjusted in the filing year if the actual, rather than estimated, total contract price and costs had been used in applying the percentage of completion method to these contracts, and to any other contracts completed or adjusted in a year preceding the filing year. If the percentage of completion method only applies to alternative minimum taxable income for contracts completed or adjusted in the filing year, only alternative minimum taxable income is recomputed in the first step. The second step is to compare what the tax liability would have been under the percentage of completion method (as reapplied in the first step) for each tax year for which the tax liability is affected by income from contracts completed or adjusted in the filing year (a "redetermination year") with the most recent determination of tax liability for that year to produce a hypothetical underpayments or overpayment of tax. The third step is to apply the rate of interest on overpayments designated under section 6621 of the Code, compounded daily, to the hypothetical underpayment or overpayment of tax for each redetermination year to compute interest that runs, generally, from the due date (determined without regard to extensions) of the return for the redetermination year to the due date (determined without regard to extensions) of the return for the filing year. The net amount of interest computed under the third step is paid by or credited to the taxpayer for the filing year. Paragraph (d) provides a simplified marginal impact method that simplifies the second step—the computation of hypothetical underpayments or overpayments of tax liability for redetermination years—and, in some cases, the third step—the determination of the time period for computing interest.

(ii) *Post-completion revenue and expenses*—(A) *In general*. Except as otherwise provided in section 460(b)(6) (see §1.460–6(j) for method of electing) or §1.460–6(e), a taxpayer must apply the look-back method to a long-term contract in the completion year and in any post-completion year for which the taxpayer must adjust total contract price or total allocable contract costs, or both, under the PCM. Any year in which the look-back method must be reapplied is treated as a filing year. See Example 3 of paragraph (h)(4) for an illustration of how the look-back method is applied to post-completion adjustments.

(B) *Completion*. A contract is considered to be completed for purposes of the look-back method in the year in which final completion and acceptance within the meaning of §1.460–1(c)(3) have occurred.

(C) *Discounting of contract price and contract cost adjustments subsequent to completion; election not to discount*—(*1*) *General rule*. The amount of any post-completion adjustment to the total contract price or contract costs is discounted, solely for purposes of applying the look-back method, from its value at the time the amount is taken into account in computing taxable income to its value at the completion of the contract. The discount rate for this purpose is the Federal mid-term rate under section 1274(d) in effect at the time the amount is properly taken into account. For purposes of applying the look-back method for the completion year, no amounts are discounted, even if they are received after the completion year.

(*2*) *Election not to discount*. Notwithstanding the general requirement to discount post-completion adjustments, a taxpayer may elect not to discount contract price and contract cost adjustments with respect to any contract. The election not to discount is to be made on a contract-by-contract basis and is binding with respect to all post-completion adjustments that arise with respect to a contract for which an election has been made. An election not to discount with respect to any contract is made by stating that an election is being made on the taxpayer's timely filed Federal income tax return (determined with regard to extensions) for the first tax year after completion in which the taxpayer takes into account (i.e., includes in income or deducts) any adjustment to the contract price or contract costs. See §301.9100–8 of this chapter.

(*3*) *Year-end discounting convention*. In the absence of an election not to discount, any revisions to the contract price and contract costs must be discounted to their value as of the completion of the contract in reapplying the look-back method. For this purpose, the period of discounting is the period between the completion date of the contract and the date that any adjustment is taken into account in computing taxable income. Although taxpayers may use the period between the months in which these two events actually occur, in many cases, these dates may not be readily identifiable. Therefore, for administrative convenience, taxpayers are permitted to use the period between the end of the tax years in which these events occur as the period of discounting provided that the convention is used consistently with respect to all post-completion adjustments for all contracts of the taxpayer the adjustments to which are discounted. In that case, the taxpayer must use as the discount rate the Federal mid-term rate under section 1274(d) as of the end of the tax year in which any revision is taken into account in computing taxable income.

(D) *Revenue acceleration rule*. Section 460(b)(1) imposes a special rule that requires a taxpayer to include in gross income, for the tax year immediately following the year of completion, any previously unreported portion of the total contract price (including amounts that the taxpayer expects to receive in the future) determined as of that year, even if the percentage of completion ratio is less than 100 percent because the taxpayer expects to incur additional allocable contract costs in a later year. At the time any remaining portion of the contract price is includible in income under this rule, no offset against this income is permitted for estimated future contract costs. To achieve the requirement to report all remaining contract revenue without regard to additional estimated costs, a taxpayer must include only costs actually incurred through the end of the tax year in the denominator of the percentage of completion ratio in applying the percentage of completion method for any tax years after the year of completion. The look-back method also must be reapplied for the year immediately following the year of completion if any portion of the contract price is includible in income in that year by reason of section 460(b)(1). For purposes of reapplying the look-back method as a result of this inclusion in income, the taxpayer must only include in the denominator of the percentage of completion ratio the actual contract costs incurred as of the end of the year, even if the taxpayer reasonably expects to incur additional allocable contract costs. To the extent that costs are incurred in a subsequent tax year, the look-back method is reapplied in that year (or a later year if the delayed reapplication method is used), and the taxpayer is entitled to receive interest for the post-completion adjustment to contract costs. Because this reapplication occurs subsequent to the completion year, only the cumulative costs incurred as of the end of the reapplication year are includible in the denominator of the percentage of completion ratio.

(2) *Look-back Step One*—(i) *Hypothetical reallocation of income among prior tax years*. For each filing year, a taxpayer must allocate total contract income among prior tax years, by hypothetically applying the percentage of completion method to all contracts that are completed or adjusted in the filing year using the rules of this paragraph (c)(2). The taxpayer must reallocate income from those contracts among all years preceding the filing year that are affected by those contracts using the total contract price and contract costs, as determined as of the end of the filing year (''actual contract price and costs''), rather than the estimated contract price and contract costs. The taxpayer then must determine the amount of taxable income and the amount of alternative minimum taxable income that would have been reported for each affected tax year preceding the filing year if the percentage of completion method had been applied on the basis of actual contract price and contract costs in reporting income from all contracts completed or adjusted in the filing year and in any preceding year. If the percentage of completion method only applies to alternative minimum taxable income from the contract, only alternative minimum taxable income is recomputed in the first step. For purposes of reallocating income (and costs if the 10-percent year changes for a taxpayer using the 10-percent method of section 460(b)(5)) under the look-back method, the method of computing the percentage of completion ratio is the same method used to report income from the contract on the taxpayer's return. (Thus, an election to use the 10-percent method or the simplified cost-to-cost method is taken into account). See Example 1 of paragraph (h)(2) for an illustration of Step One.

(ii) *Treatment of estimated future costs in year of completion*. If a taxpayer reasonably expects to incur additional allocable contract costs in a tax year subsequent to the year in which the contract is completed, the taxpayer includes the actual costs incurred as of the end of the completion year plus the additional allocable contract costs that are reasonably expected to be incurred (to the extent includible under the taxpayer's percentage of completion method) in the denominator of the percentage of completion ratio. The completion year is the only filing year for which the taxpayer may include additional estimated costs in the denominator of the percentage of completion ratio in applying the look-back method. If the look-back method is reapplied in any year after the completion year, only the cumulative costs incurred as of the end of the year of reapplication are includible in the denominator of the percentage of completion ratio in reapplying the look-back method.

(iii) *Interim reestimates not considered.* The look-back method cannot be applied to a contract before it is completed. Accordingly, for purposes of applying Step One, the actual total contract price and contract costs are substituted for the previous estimates of total contract price and contract costs only with respect to contracts that have been completed in the filing year and in a tax year preceding the filing year. No adjustments are made under Step One for contracts that have not been completed prior to the end of the current filing year, even if, as of the end of this year, the estimated total contract price or contract costs for these uncompleted contracts is different from the estimated amount that was used during any tax year for which taxable income is recomputed with respect to completed contracts under the look-back method for the current filing year.

(iv) *Tax years in which income is affected.* In general, because income under the percentage of completion method is generally reported as costs are incurred, the taxable income and alternative minimum taxable income are recomputed only for each year in which allocable contract costs were incurred. However, there will be exceptions to this general rule. For example, a taxpayer may be required to cumulatively adjust the income from a contract in a year in which no allocable contract costs are incurred if the estimated total contract price or contract costs was revised in that year. However, in applying the look-back method, no contract income is allocated to that year. Thus, there may be a difference between the amount of contract income originally reported for that year and the amount of contract income as reallocated. Similarly, because of the revenue acceleration rule of section 460(b)(1), income may be reported in the year immediately following the completion year even though no costs were incurred during that year and, in applying the look-back method in that year or another year, if additional costs are incurred or the contract price is adjusted in a later year, no income is allocated to the year immediately following the completion year.

(v) *Costs incurred prior to contract execution; 10-percent method*—(A) *General rule.* The look-back method does not require allocation of contract income to tax years before the contract was entered into. Costs incurred prior to the year a contract is entered into are first taken into account in the numerator of the percentage of completion ratio in the year the contract is entered into. A taxpayer using the 10-percent method must also use the 10-percent method in applying the look-back method, using actual total contract costs to determine the 10-percent year. Thus, contract income is never reallocated to a year before the 10-percent year as determined on the basis of actual contract costs. If the 10-percent year is earlier as a result of applying Step One of the look-back method, contract costs incurred up to and including the new 10-percent year (as determined based on actual contract costs), are reallocated from the original 10-percent year to the new 10-percent, and costs incurred in later years but before the old 10-percent year are reallocated to those years. If the 10-percent year is later as a result of applying Step One of the look-back method, contract costs incurred up to and including the new 10-percent year are reallocated from all prior years to the new 10-percent year. This is the only case in which costs are reallocated under the look-back method.

(B) *Example.* The application of the look-back method by a taxpayer using the 10-percent method is illustrated by the following example:

Example. Z elected to use the 10-percent method of section 460(b)(5) for reporting income under the percentage of completion method. Z entered into a contract in 1990 for a fixed price of $\$1{,}000x$. During 1990, Z incurred allocable contract costs of $\$80x$ and estimated that it would incur a total of $\$900x$ for the entire contract. Since $\$80x$ is less than 10 percent of total estimated contract costs, Z reported no revenue from the contract in 1990 and deferred the $\$80x$ of costs incurred. In 1991, Z incurred an additional $\$620x$

of contract costs, and completed the contract. Accordingly, in its 1991 return, Z reported the entire contract price of $1,000$x$, and deducted the 620x$ of costs incurred in 1991 and the 80x$ of costs incurred in 1990.

Under section 460(b)(5), the 10-percent method applies both for reporting contract income and the look-back method. Under the look-back method, since the costs incurred in 1990 (80x$) exceed 10 percent of the actual total contract costs (700x$), Z is required to allocate 114x$ of contract revenue (80x$/$700x × $1,000$x$) and the 80x$ of costs incurred to 1990. Thus, application of the look-back method results in a net increase in taxable income for 1990 of 34x$, solely for purposes of the look-back method.

(vi) *Amount treated as contract price*—(A) *General rule.* The amount that is treated as total contract price for purposes of applying the percentage of completion method and reapplying the percentage of completion method under the look-back method under Step One includes all amounts that the taxpayer expects to receive from the customer. Thus, amounts are treated as part of the contract price as soon as it is reasonably estimated that they will be received, even if the all-events test has not yet been met.

(B) *Contingencies.* Any amounts related to contingent rights or obligations, such as incentive fees or amounts in dispute, are not separated from the contract and accounted for under a non-long-term contract method of accounting, notwithstanding any provision in §1.460–4(b)(4)(i), to the contrary. Instead, those amounts are treated as part of the total contract price in applying the look-back method. For example, if an incentive fee under a contract to manufacture a satellite is payable to the taxpayer after a specified period of successful performance, the incentive fee is includible in the total contract price at the time and to the extent that it can reasonably be predicted that the performance objectives will be met, . A portion of the contract price that is in dispute is included in the total contract price at the time and to the extent that the taxpayer can reasonably expect the dispute will be resolved in the taxpayer's favor (without regard to when the taxpayer receives payment for the amount in dispute or when the dispute is finally resolved).

(C) *Change orders.* In applying the look-back method, a change order with respect to a contract is not treated as a separate contract unless the change order would be treated as a separate contract under the rules for severing and aggregating contracts provided in §1.460–1(e). Thus, if a change order is not treated as a separate contract, the contract price and contract costs attributable to the change order must be taken into account in allocating contract income to all tax years affected by the underlying contract.

(3) *Look-back Step Two: Computation of hypothetical overpayment or underpayment of tax*—(i) *In general.* Step Two involves the computation of a hypothetical overpayment or underpayment of tax for each year in which the tax liability is affected by income from contracts that are completed or adjusted in the filing year (a ''redetermination year''). The application of Step Two depends on whether the taxpayer uses the simplified marginal impact method contained in paragraph (d) or the actual method described in this paragraph (c)(3). The remainder of this paragraph (c)(3) does not apply if a taxpayer uses the simplified marginal impact method.

(ii) *Redetermination of tax liability.* Under the method described in this paragraph (c)(3) (the ''actual method''), a taxpayer, first, must determine what its regular and alternative minimum tax liability would have been for each redetermination year if the amounts of contract income allocated in Step One for all contracts completed or adjusted in the filing year and in any prior year were substituted for the amounts of contract income reported under the percentage of completion method on the taxpayer's original return (or as subsequently adjusted on examination, or by amended return). See Example 2 of paragraph (h)(3) for an illustration of Step Two.

(iii) *Hypothetical underpayment or overpayment.* After redetermining the income tax liability for each tax year affected by the reallocation of contract income, the taxpayer then determines the amount, if any, of the hypothetical underpayment or overpayment of tax for each of these redetermination years. The hypothetical underpayment or overpayment for each affected year is the difference between the tax liability as redetermined under the look-back method for that year and the amount of tax liability determined as of the latest of the following:

(A) The original return date;

(B) The date of a subsequently amended or adjusted return (if, however, the amended return is due to a carryback described in section 6611(f), see paragraph (c)(4)(iii)); or,

(C) The last previous application of the look-back method (in which case, the previous hypothetical tax liability is used).

(iv) *Cumulative determination of tax liability*. The redetermination of tax liability resulting from previous applications of the look-back method is cumulative. Thus, for example, in computing the amount of a hypothetical overpayment or underpayment of tax for a redetermination year, the current hypothetical tax liability is compared to the hypothetical tax liability for that year determined as of the last previous application of the look-back method.

(v) *Years affected by look-back only*. A redetermination of income tax liability under Step Two is required for every tax year for which the tax liability would have been affected by a change in the amount of income or loss for any other year for which a redetermination is required. For example, if the allocation of contract income under Step One changed the amount of a net operating loss that was carried back to a year preceding the year the taxpayer entered into the contract, the tax liability for the earlier year must be redetermined.

(vi) *Definition of tax liability*. For purposes of Step Two, the income tax liability must be redetermined by taking into account all applicable additions to tax, credits, and net operating loss carrybacks and carryovers. Thus, the tax, if any, imposed under section 55 (relating to alternative minimum tax) must be taken into account. For example, if the taxpayer did not pay alternative minimum tax, but would have paid alternative minimum tax for that year if actual rather than estimated contract price and costs had been used in determining contract income for the year, the amount of any hypothetical overpayment or underpayment of tax must be determined by comparing the hypothetical total tax liability (including hypothetical alternative minimum tax liability) with the actual tax liability for that year. The effect of taking these items into account in applying the look-back method is illustrated in Examples (4) through (7) of paragraphs (h)(5) through (h)(8) below.

(4) *Look-back Step Three: Calculation of interest on underpayment or overpayment*—(i) *In general*. After determining a hypothetical underpayment or overpayment of tax for each redetermination year, the taxpayer must determine the interest charged or credited on each of these amounts. Interest on the amount determined under Step Two is determined by applying the overpayment rate designated under section 6621, compounded daily. In general, the time period over which interest is charged on hypothetical underpayments or credited on hypothetical overpayments begins at the due date (not including extensions) of the return for the redetermination year for which the hypothetical underpayment or overpayment determined in Step Two is computed. This time period generally ends on the earlier of:

(A) The due date (not including extensions) of the return for the filing year, and

(B) The date both

(*1*) The income tax return for the filing year is filed, and

(*2*) The tax for that year has been paid in full. If a taxpayer uses the simplified marginal impact method contained in paragraph (d), the remainder of this paragraph (c)(4) does not apply.

(ii) *Changes in the amount of a loss or credit carryback or carryover*. The time period for determining interest may be different in cases involving loss or credit carrybacks or carryovers in order to properly reflect the time period during which the taxpayer (in the case of an underpayment) or the Government (in the case of an overpayment) had the use of the amount determined to be a hypothetical underpayment or overpayment. Thus, if a reallocation of contract income under Step One results in an increase or decrease to a net operating loss carryback (but not a carryforward), the interest due or to be refunded must be computed on the increase or decrease in tax attributable to the change to the carryback only from the due date (not including extensions) of the return for the redetermination year that generated the carryback and not from the due date of the return for the redetermination year in which the carryback was absorbed. In the case of a change in the amount of a carryover as a result of applying the lookback method, interest is computed from the due date of the return for the year in which the carryover was absorbed. See Examples (8) and (9) of paragraph (h)(9) for an illustration of these rules.

(iii) *Changes in the amount of tax liability that generated a subsequent refund.* If the amount of tax liability for a redetermination year (as reported on the taxpayer's original return, as subsequently adjusted on examination, as adjusted by amended return, or as redetermined by the last previous application of the look-back method) is decreased by the application of the look-back method, and any portion of the redetermination year tax liability was absorbed by a loss or credit carryback arising in a year subsequent to the redetermination year, the look-back method applies as follows to properly reflect the time period of the use of the tax overpayment. To the extent the amount of tax absorbed because of the carryback exceeds the total hypothetical tax liability for the year (as redetermined under the look-back method) the taxpayer is entitled to receive interest only until the due date (not including extensions) of the return for the year in which the carryback arose.

Example. Upon the completion of a long-term contract in 1990, the taxpayer redetermines its tax liability for 1988 under the look-back method. This redetermination results in a hypothetical reduction of tax liability from $1,500*x* (actual liability originally reported) to $1,200*x* (hypothetical liability). In addition, the taxpayer had already received a refund of some or all of the actual 1988 tax by carrying back a net operating loss (NOL) that arose in 1989. The time period over which interest would be computed on the hypothetical overpayment of $300*x* for 1988 would depend on the amount of the refund generated by the carryback, as illustrated by the following three alternative situations:

(A) If the amount refunded because of the NOL is $1,500*x:* interest is credited to the taxpayer on the entire hypothetical overpayment of $300*x* from the due date of the 1988 return, when the hypothetical overpayment occurred, until the due date of the 1989 return, when the taxpayer received a refund for the entire amount of the 1988 tax, including the hypothetical overpayment.

(B) If the amount refunded because of the NOL is $1,000*x:* interest is credited to the taxpayer on the entire amount of the hypothetical overpayment of $300*x* from the due date of the 1988 return, when the hypothetical overpayment occurred, until the due date of the 1990 return. In this situation interest is credited until the due date of the return for the completion year of the contract, rather than the due date of the return for the year in which the carryback arose, because the amount refunded was less than the redetermined tax liability. Therefore, no portion of the hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year.

(C) If the amount refunded because of the NOL is $1,300*x*−*:* interest is credited to the taxpayer on $100*x* ($1,300*x*−$1,200*x*) from the due date of the 1988 return until the due date of the 1989 return because only this portion of the total hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year. However, the taxpayer did not receive a refund for the remaining $200*x* of the overpayment at that time and, therefore, is credited with interest on $200*x* through the due date of the tax return for 1990, the filing year. See Examples (10) and (11) of paragraph (h)(9) for a further illustration of this rule.

(d) *Simplified marginal impact method*—(1) *Introduction.* This paragraph (d) provides a simplified method for calculating look-back interest. Any taxpayer may elect this simplified marginal impact method, except that pass-through entities described in paragraph (d)(4) of this section are required to apply the simplified marginal impact method at the entity level with respect to domestic contracts and the owners of those entities do not apply the look-back method to those contracts. Under the simplified marginal impact method, a taxpayer calculates the hypothetical underpayments or overpayments of tax for a prior year based on an assumed marginal tax rate. A taxpayer electing to use the simplified marginal impact method must use the method for each long-term contract for which it reports income (except with respect to domestic contracts if the taxpayer is an owner in a widely held pass-through entity that is required to use the simplified marginal impact method at the entity level for those contracts).

(2) *Operation*—(i) *In general*. Under the simplified marginal impact method, income from those contracts that are completed or adjusted in the filing year is first reallocated in accordance with the procedures of Step One contained in paragraph (c)(2) of this section. Step Two is modified in the following manner. The hypothetical underpayment or overpayment of tax for each year of the contract (a ''redetermination year'') is determined by multiplying the applicable regular tax rate (as defined in paragraph (d)(2)(iii)) by the increase or decrease in regular taxable income (or, if it produces a greater amount, by multiplying the applicable alternative minimum tax rate by the increase or decrease in alternative minimum taxable income, whether or not the taxpayer would have been subject to the alternative minimum tax) that results from reallocating income to the tax year under Step One. Generally, the product of the alternative minimum tax rate and the increase or decrease in alternative minimum taxable income will be the greater of the two amounts described in the preceding sentence only with respect to contracts for which a taxpayer uses the full percentage of completion method only for alternative minimum tax purposes and uses the completed contract method, or the percentage of completion-capitalized cost method, for regular tax purposes. Step Three is then applied. Interest is credited to the taxpayer on the net overpayment and is charged to the taxpayer on the net underpayment for each redetermination year from the due date (determined without regard to extensions) of the return for the redetermination year until the earlier of

(A) The due date (determined without regard to extensions) of the return for the filing year, and

(B) The first date by which both the return is filed and the tax is fully paid.

(ii) *Applicable tax rate*. For purposes of determining hypothetical underpayments or overpayments of tax under the simplified marginal impact method, the applicable regular tax rate is the highest rate of tax in effect for the redetermination year under section 1 in the case of an individual and under section 11 in the case of a corporation. The applicable alternative minimum tax rate is the rate of tax in effect for the taxpayer under section 55(b)(1). The highest rate is determined without regard to the taxpayer's actual rate bracket and without regard to any additional surtax imposed for the purpose of phasing out multiple tax brackets or exemptions.

(iii) *Overpayment ceiling*. The net hypothetical overpayment of tax for any redetermination year is limited to the taxpayer's total federal income tax liability for the redetermination year reduced by the cumulative amount of net hypothetical overpayments of tax for that redetermination year resulting from earlier applications of the look-back method. If the reallocation of contract income results in a net overpayment of tax and this amount exceeds the actual tax liability (as of the filing year) for the redetermination year, as adjusted for past applications of the look-back method and taking into account net operating loss, capital loss, or credit carryovers and carrybacks to that year, the actual tax so adjusted is treated as the overpayment for the redetermination year. This overpayment ceiling does not apply when the simplified marginal impact method is applied at the entity level by a widely held pass-through entity in accordance with paragraph (d)(4) of this section.

(iv) *Example*. The application of the simplified marginal impact method is illustrated by the following example:

Example. Corporation X, a calendar-year taxpayer, reports income from long-term contracts and elected the simplified marginal impact method when it filed its income tax return for 1989. X uses only the percentage of completion method for both regular taxable income and alternative minimum taxable income. X completed contracts A, B, and C in 1989 and, therefore, was required to apply the look-back method in 1989. Income was actually reported for these contracts in 1987, 1988, and 1989. X's applicable tax rate, as determined under section 11, for the redetermination years 1987 and 1988 was 40 percent and 34 percent, respectively. The amount of contract income originally reported and reallocated for contracts A, B, and C, and the net overpayments and underpayments for the redetermination years are as follows:

	1987	1988
Contract A:		
Originally reported	$5,000*x*	$4,000*x*
Reallocated	3,000*x*	5,000*x*
Increase/(Decrease)	(2,000*x*)	1,000*x*
Contract B:		
Originally reported	6,000*x*	2,000*x*
Reallocated	7,000*x*	1,500*x*
Increase/(Decrease)	1,000*x*	(500*x*)
Contract C:		
Originally reported	8,000*x*	5,000*x*
Reallocated	4,000*x*	7,000*x*
Increase/(Decrease)	(4,000*x*)	2,000*x*
Net Increase/(Decrease)	(5,000*x*)	2,500*x*
Tentative (Underpayment)/Overpayment:		
@ .40	2,000*x*	
@ .34		(850*x*)
Ceiling:		
Actual Tax Liability (After Carryovers and Carrybacks)	1,500*x*	500*x*
Final (Underpayment)/Overpayment	1,500*x*	(850*x*)

Under the simplified marginal impact method, X determined a tentative hypothetical net overpayment for 1987 and a net underpayment for 1988. X determined these amounts by first aggregating the difference for contracts A, B, and C between the amount of contract price originally reported and the amount of contract price as reallocated and, then, applying the highest regular tax rate to the aggregate decrease in income for 1987 and the aggregate increase in income for 1988.

However, X's overpayment for 1987 is subject to a ceiling based on X's total tax liability. Because the tentative net overpayment of tax for 1987 exceeds the actual tax liability for that year after taking into account carryovers and carrybacks to that year, the final overpayment under the simplified marginal impact method is the amount of tax liability paid instead of the tentative net overpayment. Since application of the look-back method for 1988 results in a tentative underpayment of tax, it is not subject to a ceiling. If the look-back method is applied in 1991, the ceiling amount for 1987 will be zero and the ceiling amount for 1988 will be $1,350.

X is entitled to receive interest on the hypothetical overpayment from March 15, 1988, to March 15, 1990. X is required to pay interest on the underpayment from March 15, 1989, to March 15, 1990.

(3) *Anti-abuse rule.* If the simplified marginal impact method is used with respect to any long-term contract (including a contract of a widely held pass-through entity), the district director may recompute interest for the contract (including domestic contracts of widely held pass-through entities) under the look-back method using the actual method (and without regard to the simplified marginal impact method). The district director may make such a recomputation only if the amount of income originally reported with respect to the contract for any redetermination year exceeds the amount of income reallocated under the look-back method with respect to that contract for that year (using actual contract price and contract costs) by the lesser of $1,000,000 or 20 percent of the amount of income as reallocated (*i.e.*, based on actual contract price and contract costs) under the look-back method with respect to that contract for that year. In determining whether to exercise this authority upon examination of the Form 8697, the district director may take into account whether the taxpayer overreported income for a purpose of receiving interest under the look-back method on a hypothetical overpayment determined at the applicable tax rate. The district director also may take into account whether the taxpayer underreported income for the year in question with respect to other contracts. Notwithstanding the look-back method, the district director may require an adjustment to the tax liability for any open tax year if the taxpayer did not apply the percentage of completion method properly on its original return.

(4) *Application*—(i) *Required use by certain pass-through entities*—(A) *General rule.* The simplified marginal impact method is required to be used with respect to income reported from domestic contracts by a pass-through entity that is either a partnership, an S corporation, or a trust, and that is not closely held. With respect to contracts described in the preceding sentence, the simplified marginal impact method is applied by the pass-through entity at the entity level. For determining the amount of any hypothetical underpayment or overpayment, the applicable regular and alternative minimum tax rates, respectively, are generally the highest rates of tax in effect for corporations under section 11 and section 55 (b)(1). However, the applicable regular and alternative minimum tax rates are the highest rates of tax imposed on individuals under section 1

and section 55 (b)(1) if, at all times during the redetermination year involved (*i.e.*, the year in which the hypothetical increase or decrease in income arises), more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass-through entities.

(B) *Closely held.* A pass-through entity is closely held if, at any time during any redetermination year, 50 percent of more (by value) of the beneficial interests in that entity are held (directly or indirectly) by or for 5 or fewer persons. For this purpose, the term ''person'' has the same meaning as in section 7701(a)(1), except that a pass-through entity is not treated as a person. In addition, the constructive ownership rules of section 1563(e) apply by substituting the term ''beneficial interest'' for the term ''stock'' and by substituting the term ''pass-through entity'' for the term, ''corporation'' used in that section, as appropriate, for purposes of determining whether a beneficial interest in a pass-through entity is indirectly owned by any person.

(C) *Examples.* The following examples illustrate the application of the rules of paragraph (d)(4)(i):

Example 1. P, a partnership, began a long-term contract on March 1, 1986, and completed this contract in its tax year ending December 31, 1989. P used the percentage of completion method for all contract income. Substantially all of the income from the contract arose from U.S. sources. At all times during all of the years for which income was required to be reported under the contract, exactly 25 percent of the value of P's interests was owned by Corporation M. The remaining 75 percent of the value of P's interests was owned in equal shares by 15 unrelated individuals, who are also unrelated to Corporation M. M's ownership of P represents less than 50 percent of the value of the beneficial interests in P, and, therefore, viewed alone, is insufficient to make P a closely held partnership. In addition, because no 4 of the individual owners together own 25 percent or more of the remaining value of P's beneficial interests, there is no group of 5 owners that together own, directly or indirectly, 50 percent or more by value of the beneficial interests in P. Therefore, P is not closely held pass-through entity.

Because P is not a closely held pass-through entity, and because P completed the contract after the effective date of section 460(b)(4), P is required to use the simplified marginal impact method. Any interest computed under the look-back method will be paid to, or collected from, P, rather than its partners, and must be reported to each of the partners on Form 1065 as interest income or expense. Further, assume that, for the redetermination years, Corporation M is subject to alternative minimum tax at the rate of 20 percent and 3 of the individuals who own interests in P are subject to the highest marginal tax rate of 33 percent in 1988. Regardless of the actual marginal tax rates of its partners, P is required to determine the underpayment or overpayment of tax for each redetermination year at the entity level by applying a single rate to the increase or decrease in income resulting from the reallocation of contract income under the look-back method. Because more than 50 percent of the interests in P are held by individuals, P must use the highest rate specified in section 1 for each redetermination year. Thus, the rate applied by P is 50 percent for 1986, 38.5 percent for 1987, and 28 percent for 1988.

Example 2. Assume the same facts as in Example 1, except that one of the individuals, Individual I, who directly owns 5 percent of the value of the interests of P, also owns 100 percent of the stock of Corporation M. Section 1563(e)(4) of the Code provides that stock owned directly or indirectly by or for a corporation is considered to be owned by any person who owns 5 percent or more in value of its stock in that proportion which the value of the stock which that person so owns bears to the value of all the stock in that corporation. Because section 460(b)(4)(C)(iii) and this paragraph (d)(4) provide that rules similar to the constructive ownership rules of section 1563(e) apply in determining whether a pass-through entity is closely held, all of M's interest in P is attributed to I because I owns 100 percent of the value of the stock in M. Accordingly, because I's direct 5 percent and constructive 25 percent ownership of P, plus the interests owned by any 4 other individual partners, equals 50 percent or more of the value of the beneficial interests of P, P is a closely held pass-through entity within the meaning of section 460(b)(4)(C)(iii). Therefore, P cannot use the simplified marginal impact method at the entity level. Accordingly, each of the partners of P must separately apply the look-back method to their respective interests in the income and expenses attributable to the contract, but each partner may elect to use the simplified marginal impact method with respect to the partner's share of income from the contract.

(D) *Domestic contracts*—(*1*) *General rule.* A domestic contract is any contract substantially all of the income of which is from sources in the United States. For this purpose, ''substantially all'' of the income from a long-term contract is considered to be from United States sources if 95 percent or more of the gross income from the contract is from sources within the United States as determined under the rules in sections 861 through 865.

(*2*) *Portion of contract income sourced.* In determining whether substantially all of the gross income from a long-term contract is from United States sources, taxpayers must apply the allocation and apportionment principles of sections 861 through 865 only to the portion of the contract accounted for under the percentage of completion method. Under the percentage of completion method, gross income from a long-term contract includes all payments to be received under the contract (*i.e.*, any amounts treated as contract price). Similarly, all costs taken into account in the computation of taxable income under the percentage of completion method are deducted from gross income rather than added to a cost of goods sold account that reduces gross income. Therefore, allocable contract costs are not considered in determining whether a long-term contract is a domestic contract or a foreign contract, even if, under the taxpayer's facts, the allocation of contract costs to any portion of a contract not accounted for under the percentage of completion method would affect the relative percentages of United States and foreign source gross income from the entire contract if this portion of the contract were taken into account in applying the 95-percent test.

(E) *Application to foreign contracts.* If a widely held pass-through entity has some foreign contracts and some domestic contracts, the owners of the pass-through entity each apply the look-back method (using, if they elect, the simplified marginal impact method) to their respective share of the income and expense from foreign contracts. Moreover, in applying the look-back method to foreign contracts at the owner level, the owners do not take into account their share of increases or decreases in contract income resulting from the application of the simplified marginal impact method with respect to domestic contracts at the entity level.

(F) *Effective date.* The simplified marginal impact method must be applied to pass-through entities described in paragraph (d)(4)(i) of this section with respect to domestic contracts completed or adjusted in tax years for which the due date of the return (determined with regard to extensions) of the pass-through entity is after November 9, 1988.

(ii) *Elective use*—(A) *General rule.* As provided in paragraph (d)(4)(i) of this section, the simplified marginal impact method must be used by certain pass-through entities with respect to domestic contracts. C corporations, individuals, and owners of closely held pass-through entities may elect the simplified marginal impact method. Owners of other pass-through entities may also elect the simplified marginal impact method with respect to all contracts other than those for which the simplified marginal impact method is required to be applied at the entity level. This rule applies to foreign contracts of widely held pass-through entities. In the case of an electing owner in a pass-through entity, the simplified marginal impact method is applied at the owner level, instead of at the entity level, with respect to the owner's share of the long-term contract income and expense reported by the pass-through entity.

(B) *Election requirements.* A taxpayer elects the simplified marginal impact method by stating that the election is being made on a timely filed income tax return (determined with regard to extensions) for the first tax year the election is to apply. An election to use the simplified marginal impact method applies to all applications of the look-back method to all eligible long-term contracts for the tax year for which the election is made and for any subsequent tax year. The election may not be revoked without the consent of the Commissioner.

(C) *Consolidated group consistency rule.* In the case of a consolidated group of corporations as defined in §1.1502–1(h), an election to use the simplified marginal impact method is made by the common parent of the group. The election is binding on all other affected members of the group (including members that join the group after the election is made with respect to all applications of the look-back method after joining). If a member subsequently leaves the group, the election remains binding as to that member unless the Commissioner consents to a revocation of the election. If a corporation using the simplified marginal impact method joins a group that does not use the method, the election is automatically revoked with respect to all applications of the look-back method after it joins the group.

(e) *Delayed reapplication method*—(1) *In general.* For purposes of reapplying the look-back method after the year of contract completion, a taxpayer may elect the delayed reapplication method to minimize the number of required reapplications of the look-back method. Under this method, the look-back method is reapplied after the year of completion of a contract (or after a subsequent application of the look-back method) only when the first one of the following conditions is met with respect to the contract:

(i) The net undiscounted value of increases or decreases in the contract price occurring since the time of the last application of the look-back method exceeds the lesser of $1,000,000 or 10 percent of the total contract price as of that time,

(ii) The net undiscounted value of increases or decreases in the contract costs occurring since the time of the last application of the look-back method exceeds the lesser of $1,000,000 or 10 percent of the total contract price as of that time,

(iii) The taxpayer goes out of existence,

(iv) The taxpayer reasonably believes the contract is finally settled and closed, or

(v) Neither condition (e)(1) (i), (ii), (iii), nor (iv) above is met by the end of the fifth tax year that begins after the last previous application of the look-back method.

(2) *Time and manner of making election.* An election to use the delayed reapplication method may be made for any filing year for which the due date of the return (determined with regard to extensions) is after June 12, 1990. The election is made by a statement to that effect on the taxpayer's timely filed Federal income tax return (determined with regard to extensions) for the first tax year the election is to be effective. An election to use the delayed reapplication method is binding with respect to all long-term contracts for which the look-back method would be reapplied without regard to the election in the year of election and any subsequent year unless the Commissioner consents to a revocation of the election. In the case of a consolidated group of corporations as defined in §1.1502–1(h), an election to use the delayed reapplication method is made by the common parent of the group. The election is binding on all other affected members of the group (including members that join the group after the election is made with respect to contracts adjusted after joining). If a member subsequently leaves the group, the election remains binding as to that member unless the Commissioner consents to a revocation of the election. If a corporation that has made the election joins a consolidated group that has not made the election, the election is treated as revoked with respect to contracts adjusted after joining.

(3) *Examples.* The operation of this delayed reapplication method is illustrated by the following examples:

Example 1. X completes a contract in 1987, and applies the look-back method when its return for 1987 is filed. X properly uses $600,000 as the actual contract price in applying the look-back method. In 1990, as a result of the settlement of a dispute with its customer, X redetermines total contract price to be $640,000, and includes $40,000 in gross income. On its return for 1990, X states it is electing the delayed reapplication method. X is not required to reapply the look-back method at that time, because $40,000 does not exceed the lesser of $1,000,000 or 10 percent of the unadjusted contract price of $600,000, and 5 years have not passed since the last application of the look-back method.

Example 2. Assume the same facts as in Example 1, except that at the end of 1992, the fifth year after completion of the contract, no other adjustments to contract price or contract costs have occurred. X is required to reapply the look-back method in 1992 and, accordingly, redetermine its tax liability for each redetermination year. After redetermining the underpayment of tax for those years, X must compute the amount of interest charged on the underpayments. Although

1992 is the filing year, interest is due on the amount of each underpayment resulting from the adjustment only from the due date of the return for each redetermination year to the due date of the return for 1990 because the tax liability for the adjustment was fully paid in 1990. However, from the due of the 1990 return until the due date of the 1992 return, when the look-back method is reapplied for the adjustment, interest is due on the amount of interest attributable to the underpayments.

(f) *Look-back reporting*—(1) *Procedure*. The amount of any interest due from, or payable to, a taxpayer as a result of applying the look-back method is computed on Form 8697 for any filing year. In general, the look-back method is applied by the taxpayer that reports income from a long-term contract. See paragraph (g) of this section to determine who is responsible for applying the look-back method when, prior to the completion of a long-term contract, there is a transaction that changes the taxpayer that reports income from the contract.

(2) *Treatment of interest on return*—(i) *General rule*. The amount of interest required to be paid by a taxpayer is treated as an income tax under subtitle A, but only for purposes of subtitle F of the Code (other than sections 6654 and 6655), which addresses tax procedures and administration. Thus, a taxpayer that fails to pay the amount of interest due is subject to any applicable penalties under subtitle F, including, for example, an underpayment penalty under section 6651, and the taxpayer also is liable for underpayment interest under section 6601. However, interest required to be paid under the look-back method is treated as interest expense for purposes of computing taxable income under subtitle A, even though it is treated as income tax liability for subtitle F purposes. Interest received under the look-back method is treated as taxable interest income for all purposes, and is not treated as a reduction in tax liability or a tax refund. The determination of whether or not interest computed under the look-back method is treated as tax is determined on a ''net'' basis for each filing year. Thus, if a taxpayer computes for the current filing year both hypothetical overpayments and hypothetical underpayments for prior years, the taxpayer has an increase in tax only if the interest computed on the underpayments for all those prior years exceeds the interest computed on the overpayments for all those prior years, for all contracts completed or adjusted for the year.

(ii) *Timing of look-back interest*. For purposes of determining taxable income under subtitle A of the Code, any amount of interest payable to the taxpayer under the look-back method is includible in gross income as interest income in the tax year it is properly taken into account under the taxpayer's method of accounting for interest income. Any amount of interest required to be paid is taken into account as interest expense arising from an underpayment of income tax in the tax year it is properly taken into account under the taxpayer's method of accounting for interest expense. Thus, look-back interest required to be paid by an individual, or by a pass-through entity on behalf of an individual owner (or beneficiary) under the simplified marginal impact method, is personal interest and, therefore, is disallowed in accordance with §1.163–9T(b)(2). Interest determined at the entity level under the simplified marginal impact method is allocated among the owners (or beneficiaries) for reporting purposes in the same manner that interest income and interest expense are allocated to owners (or beneficiaries) and subject to the requirements of section 704 and any other applicable rules.

(3) *Statute of limitations and compounding of interest on look-back interest*. For guidance on the statute of limitations applicable to the assessment and collection of look-back interest owed by a taxpayer, see sections 6501 and 6502. A taxpayer's claim for credit or refund of look-back interest previously paid by or collected from a taxpayer is a claim for credit or refund of an overpayment of tax and is subject to the statute of limitations provided in section 6511. A taxpayer's claim for look-back interest (or interest payable on look-back interest) that is not attributable to an amount previously paid by or collected from a taxpayer is a general, non-tax claim against the federal government. For guidance on the statute of limitations that applies to general, non-tax claims against the

federal government, see 28 U.S.C. sections 2401 and 2501. For guidance applicable to the compounding of interest when the look-back interest is not paid, see sections 6601 to 6622.

(g) *Mid-contract change in taxpayer*—(1) *In general*. The rules in this paragraph (g) apply if, as described in §1.460–4(k), prior to the completion of a long-term contract accounted for using the PCM or the PCCM by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for accounting for income from the same contract. The rules governing constructive completion transactions are provided in paragraph (g)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (g)(3) of this section. For purposes of this paragraph, pre-transaction years are all taxable years of the old taxpayer in which the old taxpayer accounted for (or should have accounted for) gross receipts from the contract, and post-transaction years are all taxable years of the new taxpayer in which the new taxpayer accounted for (or should have accounted for) gross receipts from the contract.

(2) *Constructive completion transactions*. In the case of a transaction described in §1.460–4(k)(2)(i) (constructive completion transaction), the look-back method is applied by the old taxpayer with respect to pre-transaction years upon the date of the transaction and, if the new taxpayer uses the PCM or the PCCM to account for the contract, by the new taxpayer with respect to post-transaction years upon completion of the contract. The contract price and allocable contract costs to be taken into account by the old taxpayer or the new taxpayer in applying the look-back method are described in §1.460–4(k)(2).

(3) *Step-in-the-shoes transactions*—(i) *General rules*. In the case of a transaction described in §1.460–4(k)(3)(i) (step-in-the-shoes transaction), the look-back method is not applied at the time of the transaction, but is instead applied for the first time when the contract is completed by the new taxpayer. Upon completion of the contract, the look-back method is applied by the new taxpayer with respect to both pre-transaction years and post-transaction years, taking into account all amounts reasonably expected to be received by either the old or new taxpayer and all allocable contract costs incurred during both periods as described in §1.460–4(k)(3). The new taxpayer is liable for filing the Form 8697 and for interest computed on hypothetical underpayments of tax, and is entitled to receive interest with respect to hypothetical overpayments of tax, for both pre- and post-transaction years. The old taxpayer will be secondarily liable for any interest required to be paid with respect to pre-transaction years reduced by any interest on pre-transaction overpayments.

(ii) *Application of look-back method to pre-transaction period*—(A) *Contract price*. The actual contract price for pre-transaction taxable years must be determined by the new taxpayer without regard to any contract price adjustment described in paragraph (k)(3)(iv)(B)(1) of this section.

(B) *Method*. The new taxpayer may apply the look-back method to each pre-transaction taxable year that is a redetermination year using the simplified marginal impact method described in paragraph (d) of this section (regardless of whether or not the old taxpayer would have actually used that method and without regard to the tax liability ceiling). But see paragraph (d)(4) of this section, which requires use of the simplified marginal impact method by certain pass-through entities.

(C) *Interest accrual period*. With respect to any hypothetical underpayment or overpayment of tax for a pre-transaction taxable year, interest accrues from the due date of the old taxpayer's tax return (not including extensions) for the taxable year of the underpayment or overpayment until the due date of the new taxpayer's return (not including extensions) for the completion year or the year of a post-completion adjustment, whichever is applicable.

(D) *Information old taxpayer must provide*—(*1*) *In general*. Except as provided in paragraph (g)(3)(ii)(D)(*2*) of this section, in order to help the new taxpayer to apply the look-back method with respect to pre-transaction taxable years, any old taxpayer that accounted for income from a long-term contract under the PCM or PCCM for either regular or alternative minimum tax purposes is required to provide the information described in this paragraph to the new taxpayer by the due date (not including extensions) of the old taxpayer's income tax return for the first taxable year ending on or after a step-in-the-shoes transaction described in §1.460–4(k)(3)(i). The required information is as follows—

(*i*) The portion of the contract reported by the old taxpayer under PCM for regular and alternative minimum tax purposes (*i.e.*, whether the old taxpayer used PCM, the 40/60 PCCM method, or the 70/30 PCCM method);

(*ii*) Any submethods used in the application of PCM (*e.g.*, the simplified cost-to-cost method or the 10-percent method);

(*iii*) The amount of total contract price reported by year;

(*iv*) The numerator and the denominator of the completion factor by year;

(*v*) The due date (not including extensions) of the old taxpayer's income tax returns for each taxable year in which income was required to be reported;

(*vi*) Whether the old taxpayer was a corporate or a noncorporate taxpayer by year; and

(*vii*) Any other information required by the Commissioner by administrative pronouncement.

(*2*) *Special rules for certain pass-through entity transactions.* For purposes of paragraph (g)(3)(ii)(D)(*1*) of this section, in the case of a transaction described in §1.460–4(k)(3)(i)(I), the contributing partner is treated as the old taxpayer, and the partnership is treated as the new taxpayer. In the case of transactions described in §1.460–4(k)(3)(i)(F), (G), (J), (K), or (L), the old taxpayer is not required to provide the information described in paragraph (g)(3)(ii)(D)(*1*) of this section, because information necessary for the new taxpayer to apply the look-back method is provided by the pass-through entity. This paragraph (g)(3)(ii)(D) is applicable for transactions on or after August 6, 2003.

(iii) *Application of look-back method to post-transaction years.* With respect to post-transaction taxable years, the new taxpayer must use the same look-back method it uses for other contacts (i.e., the simplified marginal impact method or the acutal method) to determine the amount of any hypothetical overpayment or underpayment of tax and the time period for computing interest on these amounts.

(iv) *S corporation elections.* Following the conversion of a C corporation into an S corporation, the look-back method is applied at the entity level with respect to contracts entered into prior to the conversion, notwithstanding section 460(b)(4)(B)(i).

(4) *Effective date.* Except as provided in paragraph (g)(3)(ii)(D) of this section, this paragraph (g) is applicable for transactions on or after May 15, 2002.

(h) *Examples*—(1) *Overview.* This paragraph provides computational examples of the rules of this section. Except as otherwise noted, the examples involve calendar-year taxpayers and involve long-term contracts subject to section 460 that are accounted for using the percentage of completion method, rather than the percentage of completion-capitalized cost method. If the percentage of completion-capitalized cost method were used by a taxpayer described in the examples, the amounts of contract income and expenses shown in the examples would be reduced, for purposes of determining regular taxable income, to the appropriate fraction (40, 70, or 90 percent) of contract items accounted for under the percentage of completion method. Tens of thousands of dollars ($ 00,000's) are omitted from the figures in the examples. The contracts described in the examples are assumed to be the taxpayers' only contracts that are subject to the look-back method of section 460. Except as otherwise stated, the examples assume that the taxpayer has no adjustments and preferences for purposes of section 55, so that alternative minimum taxable income is the same as taxable income, and no alternative minimum tax is imposed for the years involved. The examples assume that the taxpayer does not elect the 10-percent method, the simplified marginal impact method, or the delayed reapplication method.

(2) *Step One.* The following example illustrates the application of paragraph (c)(2):

Example 1. In 1989, W completes three long-term contracts, A, B, and C, entered into on January 1 of 1986, 1987, and 1988, respectively. For Contract A, W used the completed contract method of accounting. For Contract B, W used the percentage of completion-capitalized cost method of accounting, taking into account 60 percent of contract income under W's normal method of accounting, which was the completed contract method. For Contract C, W used the percentage of completion method of accounting. The total price for each contract was $1,000. In computing alternative minimum taxable income, W is required to use the percentage of completion method for Contracts B and C. W used regular tax costs for purposes of determining the degree of contract completion under the alternative minimum tax.

Contract A is not taken into account for purposes of applying the look-back method, because it is subject to neither section 460 nor section 56(a)(3). Thus, even if W had used the percentage of completion method as permitted under §1.451–3, instead of the completed contract method, the look-back method would not be applicable because the Contract A was entered into before the effective date of section 460.

The actual costs allocated to Contracts B and C under section 460(c) and incurred in each year of the contract were as follows:

Contract	1987	1988	1989	Total
B	$200	$400	$200	$800
C	100	300	400	800

In applying the look-back method, the first step is to allocate the contract price among tax years preceding and including the completion year. That allocation would produce the following amounts of gross income for purposes of the regular tax. Note that no income from Contract C is allocated to 1987, the year before the contract was entered into, even though contract costs were incurred in 1987:

Contract	1987	1988	1989
B	$100 (40%X$200/$800X$1000)	$200 ((40%X$600/$800X$1000)–$100)	$700
C	0	500 ($400/$800X$1000)	500

Because the percentage of completion-capitalized cost method may not be used for alternative minimum tax purposes, the allocation of contract income would produce the following amounts of gross income for purposes of computing alternative minimum taxable income:

Contract	1987	1988	1989
B	$250 ($200/$800X$1000)	$500 (($600/$800X$1000)–$250)	$250
C	0	500	500

(3) *Step Two.* The following example illustrates the application of paragraph (c)(3):

Example 2. (i) X enters into two long-term contracts (D and E) in 1988. X determines its tax liability for 1988 as follows:

e = estimate

a = amount originally reported (actual)

h = hypothetical

	1988		Total
	D	E	
1988 contract costs	$3,000a	$2,000a	
Total contract costs	8,000e	8,000e	
Total contract price	10,000e	10,000e	
1988 completion %	37.5e	25e	
1988 gross income	3,750a	2,500a	
Less, 1988 costs	(3,000a)	(2,000a)	
1988 net contract income	750a	500a	$1,250a
Other 1988 net income (loss)			(2,000a)

	1988 D	1988 E	Total
Taxable income (NOL)	....	....	(750a)
Tax	....	....	0a
Refund from NOL carryback fully absorbed in 1985, at 46%	....	....	345a

(ii) X completes Contract D during 1989. X determines its taxable income for 1989 as follows:

	1989 D	1989 E	Total
1989 contract costs	$3,000a	0a	....
Total contract costs	6,000a	$9,000e	....
Total contract price	10,000a	10,000e	....
1989 completion %	100a	22.2e	....
1989 gross income/(loss)	6,250a	(278a)	....
Less, 1989 costs	(3,000a)	0a	....
1989 net contract income	3,250a	(278a)	$2,972a
Other 1989 net income (loss)	....	....	0a
Taxable income (NOL)	....	....	2,972a
Tax at 34%	....	....	1,011a

(iii) For purposes of the look-back method, X must reallocate the actual total contract D price between 1988 and 1989 based on the actual total contract D costs. This results in the following hypothetical underpayment of tax for 1988 for purposes of the look-back method. Note that X does not reallocate the contract E price in applying the look-back method in 1989 because contract E has not been completed, even though X's estimate of contract E costs has changed. The following computation is only for purposes of applying the look-back method, and does not result in the assessment of a tax deficiency.

	1988 D	1988 E	Total
1988 contract costs	$3,000a	$2,000a	....
Total contract costs	6,000a	8,000e	....
Total contract price	10,000a	10,000e	....
1988 completion %	50a	25e	....
1988 gross income	5,000h	2,500a	....
Less, 1988 costs	(3,000a)	(2,000a)	....
1988 net contract income	2,000h	500a	$2,500h
Other 1988 net income (loss)	....	....	(2,000a)
Taxable income (NOL)	....	....	500h
Tax at 34%	....	....	170h
Less, previously computed tax	....	....	−0a
Underpayment of 1988 tax	....	....	170h
Underpayment of 1985 tax from NOL carryback refund in 1988	....	....	345h
Total underpayment of tax	....	....	515h

For purposes of any subsequent application of the look-back method for which 1989 is a redetermination year, because the reallocation of contract income and redetermination of tax liability are cumulative, X will use for 1989 the amount of contract D income and the amount of tax liability that would have been reported in 1989 if X had used actual contract costs instead of the amounts that were originally reported using the estimate of $8,000. Assuming no subsequent revisions (due to, for example, adjustments to contract D price and costs determined after the end of 1989), this amount would be determined as follows:

	1989		Total
	D	E	
1989 contract costs	$3,000a	0a	
Total contract costs	6,000a	$9,000e	
Total contract price	10,000a	10,000e	
1989 completion %	100a	22.2e	
1989 gross income	5,000h	(278a)	
Less, 1989 costs	(3,000a)	0a	
1989 net contract income	2,000h	(278a)	$1,722h
Other 1989 net income (loss)			0a
Taxable income (NOL)			1,722h
Tax at 34%			585h

(iv) X completes contract E during 1990. X determines its taxable income for 1990 as follows:

	1990		Total
	D	E	
1990 contract costs		$7,000a	
Total contract costs		9,000a	
Total contract price		10,000a	
1990 completion %		100a	
1990 gross income		7,778a	
Less, 1990 costs		(7,000a)	
1990 net contract income		778a	$778a
Other 1990 net income (loss)			0a
Taxable income (NOL)			778a
Tax at 34%			265a

(v) For purposes of the look-back method, X must reallocate the actual total contract E price between the 1988, 1989, and 1990, based on the actual total contract E costs.
This results in the following hypothetical overpayment of tax for 1988. Note that X uses the amount of income for contract D determined in the last previous application of the look-back method, and not the amount of income actually reported:

	1988		Total
	D	E	
1988 contract costs	$3,000a	$2,000a	
Total contract costs	$6,000a	$9,000a	
Total contract price	$10,000a	$10,000a	
1988 completion (%)	50a	22.2a	
1988 gross income	$5,000h	$2,222h	
Less, 1988 costs	($3,000a)	($2,000a)	
1988 net contract income	$2,000h	$222h	$2,222h
Other 1988 net income (loss)			($2,000a)
Taxable income (NOL)			$222h
Tax at 34%			$75h
Less, previously computed tax (based on most recent application of the look-back method)			$170h
Overpayment of 1988 tax			($95h)

In applying the look-back method to 1989, X again uses the amounts substituted as of the last previous application of the look-back method with respect to contract D.

Thus, X computes its hypothetical underpayment for 1989 as follows:

	1989		Total
	D	E	
1989 contract costs	$3,000a	0a	
Total contract costs	$6,000a	$9,000a	
Total contract price	$10,000a	$10,000a	
1989 completion (%)	100a	22.2a	
1989 gross income	$5,000h	$0h	
Less, 1989 costs	($3,000a)	($0a)	
1989 net contract income	$2,000h	0a	$2,000h
Other 1989 net income (loss)			($0a)
Taxable income (NOL)			$2,000h
Tax at 34%			$680h
Less, previously computed tax			$585h
Underpayment of 1989 tax			$95h

For purposes of any subsequent application of the look-back method for which 1990 is a redetermination year, X will use for 1990 the amount of Contract E income, and the amount of tax liability, that was originally reported in 1990 because X's estimate of the total contract costs from $8,000 to $9,000 did not change after 1989. Without regard to any subsequent revisions, these amounts are the same as in the table in paragraph (h)(3)(iv) above.

(4) *Post-completion adjustments*. The following example illustrates the application of paragraph (c)(1)(ii):

Example 3. The facts are the same as in Example 2. In 1991, X settles a lawsuit against its customer in Contract E. The customer pays X an additional $3,000, without interest, in 1991. Applying the Federal mid-term rate then in effect, this $3,000 has a discounted value at the time of contract completion in 1990 of $2,700. X is required to apply the look-back method for 1991 even though no contract was completed in 1991. X must include the full $3,000 adjustment (which was not previously includible in total contract price) in gross income for 1991. X does not elect not to discount adjustments to the contract price or costs. Thus, X adjusts the contract price by the discounted amount of the adjustment and, therefore, uses $12,700 (not $13,000) for total Contract E price, rather than $10,000, which was used when the look-back method was first applied with respect to Contract E.

For purposes of the look-back method, X must allocate the revised total Contract E price of $12,700 between 1988, 1989 and 1990 based on the actual total Contract E costs, and compare the resulting revised tax liability with the tax liability determined for the last previous application of the look-back method involving those years. This results in the following hypothetical underpayments of tax for purposes of the look-back method:

r = revised

	1988		Total
	D	E	
1988 contract costs	$3,000a	$2,000a	
Total contract costs	$6,000a	$9,000a	
Total contract price	$10,000a	$12,700r	
1988 completion (%)	50a	22.2a	
1988 gross income	$5,000h	$2,822rh	
Less, 1988 costs	($3,000a)	($2,000a)	
1988 net contract income	$2,000h	822rh	$2,222rh
Other 1988 net income (loss)			($2,000a)
Taxable income			$822rh
Tax at 34%			$279rh
Less, previously computed tax			$75h
Underpayment of 1988 tax			$204rh

No Contract E costs were incurred in 1989, and there is no hypothetical underpayment for 1989.

	1990		
	D	E	Total
1990 contract costs		$7,000a	
Total contract costs		$9,000a	
Total contract price		$12,700r	
1990 completion (%)		100a	
1990 gross income		$9,878rh	
Less 1990 costs		(*$7,000a*)	
1990 net contract income		$2,878rh	$2,878rh
Other 1990 net income (loss)			0a
Taxable income (NOL)			$2,878rh
Tax at 34%			$978rh
Less, previously computed tax			$265h
Underpayment of 1990 tax			$713rh

In 1992, X incurs an additional cost of $1,000 allocable to the contract, which was not previously includible in total contract costs. Applying the Federal mid-term rate then in effect, the $1,000 has a discounted value at the time of contract completion of $800. X deducts this additional $1,000 in expenses in 1992. Based on this increase to contract costs, X reapplies the look-back method, and determines the following hypothetical underpayments for 1988, 1989 and 1990 for purposes of the look-back method:

	1988		Total
	D	E	
1988 contract costs	$3,000a	$2,000a	
Total contract costs	$6,000a	$9,800r	
Total contract price	$10,000a	$12,700r	
1988 completion (%)	50a	20.4r	
1988 gross income	$5,000h	$2,592rh	
Less, 1988 costs	(*$3,000a*)	(*$2,000a*)	
1988 net contract income	$2,000h	592rh	$2,592rh
Other 1988 net income (loss)			(*$2,000a*)
Taxable income (NOL)			$592rh
Tax at 34%			$201rh
Less, previously computed tax			$279rh
Overpayment of 1988 tax			($78rh)

No Contract E costs were incured in 1989, and there is no hypothetical underpayment for 1989.

	1990		Total
	D	E	
1990 contract costs			$7,000a
Total contract costs		9,800r	
Total contract price		12,700r	
1990 completion (%)		92a	
1990 gross income		9,071rh	
Less, 1990 costs		(*7,000a*)	
1990 Net contract income		2,071rh	$2,071rh
Other 1990 net income (loss)			*0a*
Taxable income (NOL)			2,071rh
Tax at 34%			704rh

	1990		Total
	D	E	
Less, previously computed tax			978rh
Overpayment of 1990 tax			(274rh)

(5) *Alternative minimum tax*. The operation of the look-back method in the case of a taxpayer liable for the alternative minimum tax as provided in paragraph (c)(3)(vi) is illustrated by the following examples:

Example 4. Y enters into a long-term contract in 1988 that is completed in 1989. Y used regular tax costs for purposes of determining the degree of contract completion under the alternative minimum tax.

(i) Y determines its tax liability for 1988 as follows:

1988 contract costs	$4,000a
Total contract costs	$8,000e
Total contract price	$20,000e
1988 completion (%)	50e
1988 gross income	$10,000a
Less, 1988 contract costs	($4,000a
1988 net contract income	$6,000a
Other 1988 net income/(loss)	($3,400a)
Taxable income	$2,600a
Regular tax at 34%	884a
Adjustments and preferences to produce alternative minimum taxable income	$600a
Alternative minimum taxable income	$3,200a
Tentative minimum tax at 20%	640a
Tax liability	$884a

In 1989, Y determines the following amounts:

1989 contract costs	$6,000a
Total contract costs	$10,000a
Total contract price	$20,000a

(ii) For purposes of applying the look-back method, Y redetermines its tax liability for 1988, which results in a hypothetical overpayment of tax. This hypothetical overpayment is determined by comparing Y's original regular tax liability for 1988 with the hypothetical total tax liability (including alternative minimum tax liability) for that year because Y would have paid the alternative minimum tax if Y had used its actual contract costs to report income:

1988 contract costs	$4,000a
Total contract costs	$10,000a
Total contract price	$20,000a
1988 completion(%)	40a
1988 gross income	$8,000h
less, 1988 contract costs	($4,000a)
1988 net contract income	$4,000h
Other 1988 net income/(loss)	($3,400a)
Taxable income	$600h
Regular tax at 34%	$204h
Adjustments and preferences to produce alternative minimum taxable income	$600a
Alternative minimum taxable income	$1,200h
Tentative minimum tax at 20%	240h
Alternative minimum tax	$36h
Total tax liability	$240h
less, previously computed tax	$884a
Underpayment/(overpayment)	($644h)

(6) *Credit carryovers*. The operation of the look-back method in the case of credit carryovers as provided in paragraph (c)(3)(v) is illustrated by the following example:

Example 5. Z enters into a contract in 1986 that is completed in 1987. Z determines its tax liability for 1986 as follows:

1986 contract costs	$400a
Total contract costs	$1,000e
Total contract price	$2,000e
1986 completion (%)	40e
1986 gross income	$800a
Less, 1986 costs	($400a)
1986 net contract income	$400a
Other 1986 net income	$0a
Taxable income	$400a
Tax at 46%	$184a
Unused tax credits carried forward from 1985 allowable in 1986	$350a
Net tax due	$0a

Z determines the following amounts for 1987:

1987 contract costs	$400a
Total contract price	$2,000a
Total contract costs	$800a

If Z had used actual rather than estimated contract costs in determining gross income for 1986, Z would have reported tax liability of $276 (46%x$600) rather than $184. However, Z would have paid no additional tax for 1986 because its unused tax credits carried forward from 1985 would have been sufficient to offset this increased tax liability. Therefore, there is no hypothetical underpayment for 1986 for purposes of the look-back method. However, this hypothetical earlier use of the credit may increase the hypothetical tax liability for 1987 (or another subsequent year) for purposes of subsequent applications of the look-back method.

(7) *Net operating losses*. The operation of the look-back method in the case of net operating loss (''NOL'') carryovers as provided in paragraph (c)(3)(v) is illustrated by the following example:

Example 6. A entered into a long-term contract in 1986, which was completed in 1987. A determined its tax liability for 1986 as follows:

1986 contract costs	$400a
Total contract costs	$1,000e

Total contract price	$2,000e
1986 completion (%)	40e
1986 gross income	$800a
Less, 1986 costs	($400a)
1986 net contract income	$400a
Other 1986 net income/(loss)	($1,000a)
Taxable income/(NOL)	($600a)
Tax	$0a

A elected to carry this loss forward to 1987 pursuant to section 172(b)(3)(C).

For 1987, A determined the following amounts:

1987 contract costs	$400a
Total contract costs	$800a
Total contract price	$2,000a

If actual rather than estimated contract costs had been used in determining gross income for 1986, A would have reported $1,000 of gross income from the contract rather than $800, and thus would have reported a loss of $400 rather than $600. However, since A would have paid no tax for 1986 regardless of whether actual or estimated contract costs had been used, A does not have an underpayment for 1986 for purposes of the look-back method. If A had, instead, carried back the 1986 NOL, and this NOL had been absorbed in the tax years 1983 through 1985, it would have resulted in refunds of tax for those years in 1986. When A applies the look-back method, a hypothetical underpayment of tax would have resulted for those years due to a hypothetical reduction in the amount that would have been refunded if income had been reported on the basis of actual contract costs. See Example 2(iii).

(8) *Alternative minimum tax credit.* The following example illustrates the application of the look-back method if affected by the alternative minimum tax credit as provided in paragraph (c)(3)(vi):

(i) Example 4, above illustrates that the reallocation of contract income under the look-back method can result in a hypothetical underpayment or overpayment determined using the alternative minimum tax rate, even though the taxpayer actually paid only the regular tax for that year. However, application of the look-back method had no effect on the difference between the amount of alternative minimum taxable income and the amount of regular taxable income taken into account in that year because the taxpayer was required to use the percentage of completion method for both regular and alternative minimum tax purposes and used the same version of the percentage of completion method for both regular and alternative minimum tax purposes (*i.e.*, the taxpayer had made an election to use regular tax costs in determining the percentage of completion for purposes of computing alternative minimum taxable income).

(ii) The following example illustrates the application of the look-back method in the case of a taxpayer that does not use the percentage of completion method of accounting for long-term contracts in computing taxable income for regular tax purposes and thus must make an adjustment to taxable income to determine alternative minimum taxable income. The example also shows how interest is computed under the look-back method when the taxpayer is entitled to a credit under section 53 for minimum tax paid because of this adjustment.

Example 7. X is a taxpayer engaged in the construction of real property under contracts that are completed within a 24-month period and whose average annual gross receipts do not exceed $10,000,000. As permitted by section 460(e)(1)(B), X uses the completed contract method (''CCM'') for regular tax purposes. However, X is engaged in the construction of commercial real property and, therefore, is required to use the percentage of completion method (''PCM'') for alternative minimum tax (''AMT'') purposes.

Assume that for 1988, 1989, and 1990, X has only one long-term contract, which is entered into in 1988 and completed in 1990. Assume further that X estimates gross income from the contract to be $2,000, total contract costs to be $1,000, and that the contract is 25 percent complete in 1988 and 75 percent complete in 1989. In 1990, the year of completion, the percentage of completion does not change but, upon completion, gross income from the contract is actually $3,000, instead of $2,000, and costs are actually $1,000.

For 1988, 1989, and 1990, X's income and tax liability using estimated contract price and costs are as follows:

Estimates	1988	1989	1990
Regular tax:			
Long-term:			
Contract-CCM	0	0	$2,000
Other Income	0	$5,000	0
Total Income	0	$5,000	$2,000
Tax @ 34%	0	$1,700	$680

Estimates	1988	1989	1990
AMT			
Gross Income	$500	$1,000	$1,500
Deductions	$(250)	$(500)	$(250)
Total long-term:			
Contract-PCM	$250	$500	$1,250
Other Income	0	$5,000	0
Total Income	$250	$5,500	$1,250
Tax @ 20%	$50	$1,100	$250
Tentative Minimum Tax	$50	$1,100	$250
Regular Tax	0	$1,700	$680
Minimum Tax Credit	0	$(50)	0
Net Tax Liability	$50	$1,650	$680

When X files its tax return for 1990, X applies the look-back method to the contract. For 1988, 1989, and 1990, X's income and tax liability using actual contract price and costs are as follows:

Actual	1988	1989	1990
Regular tax:			
Long-term:			
Contract-CCM	0	0	$2,000
Other Income	0	$5,000	0
Total Income	0	$5,000	$2,000
Tax @ 34%	0	$1,700	$680
AMT			
Gross Income	$750	$1,500	$750
Deductions	$(250)	$(500)	$(250)
Total long-term:			
Contract-PCM	$500	$1,000	$500
Other Income	0	$5,000	0
Total Income	$500	$6,000	$500
Tax @ 20%	$100	$1,200	$100
Tentative Minimum Tax	$100	$1,200	$100
Regular Tax	0	$1,700	$680
Minimum Tax Credit	0	$(100)	0
Net Tax Liability	$100	$1,600	$680
Underpayment	$50		
Overpayment		$50	

As shown above, application of the look-back method results in a hypothetical underpayment of $50 for 1988 because X was subject to the alternative minimum tax for that year. Interest is charged to X on this $50 underpayment from the due date of X's 1988 return until the due date of X's 1990 return.

In 1989, although X was required to compute alternative minimum taxable income using the percentage of completion method, X was not required to pay alternative minimum tax. Nevertheless, the look-back method must be applied to 1989 because use of actual rather than estimated contract price in computing alternative minimum taxable income for 1988 would have changed the amount of the alternative minimum tax credit carried to 1989. Interest is paid to X on the resulting $50 overpayment from the due date of X's 1989 return until the due date of X's 1990 return.

(9) *Period for interest.* The following Examples (8) through (11) illustrate how to determine the period for computing interest as provided in paragraph (c)(4):

Example 8. The facts are the same as in Example 6, except that the contract is completed in 1988, and A determined the following amounts for 1987 and 1988:

For 1987:	
1987 contract costs	0
Total contract costs	$1,000e
Total contract price	$2,000e
1987 completion (%)	$40e
1987 gross income	0a
Less, 1987 costs	0a
Other 1987 net income	$600a
Net operating loss carryforward from 1986	$(600a)
Taxable income	0a
Tax	0a
For 1988:	
1988 contract costs	$400a
Total contract costs	$800a
Total contract price	$2,000a

If actual rather than estimated contract costs had been used in determining gross income for 1986, A would have reported $1,000 of gross income from the contract for 1986 rather than $800, and would have reported a net operating loss carryforward to 1987 of $400 rather than $600. Therefore, A would have reported taxable income of $200, and would have paid tax of $80 (*i.e.*, $200 × 40%) for 1987. The due date for filing A's Federal income tax return for its 1988 taxable year is March 15. A obtains an extension and files its 1988 return on September 15, 1989. Under the look-back method, A is required to pay interest on the amount of this hypothetical underpayment ($80) computed from the due date (determined without regard to extensions) for A's return for 1987 (not 1986, even though 1986 was the year in which the net operating loss arose) until March 15 (not September 15), the due date (without regard to extensions) of A's return for 1988. A is required to pay additional interest from March 15 until September 15 on the amount of interest outstanding as of March 15 with respect to the hypothetical underpayment of $80.

Example 9. The facts are the same as in Example 6, except that A carries the net operating loss of $600 back to 1983 rather than forward to 1987, and receives a refund of $276 ($600 reduction in 1983 taxable income × 46% rate in effect in 1983). As in Example 6, if actual contract costs had been used, A would have reported a loss for 1986 of $400 rather than $600. Thus, A would have received a refund of 1983 tax of $184 ($400 × 46%) rather than $276. Under the look-back method A is required to pay interest on the difference in these two amounts ($92) computed from the due date (determined without regard to extensions) of A's return for 1986 (the year in which the carryback arose rather than 1983, the year in which it was used) until the due date of A's return for 1988.

Example 10. B enters into a long-term contract in 1986 that is completed in 1988. B determines its 1986 tax liability as follows:

1986 contract costs	$400a
Total contract costs	$1,000e
Total contract price	$2,000e
1986 completion (%)	40e
1986 gross income	$800a
Less, 1986 costs	($400a)
1986 net contract income	$400a
Other 1986 net income	$2,000a
Taxable income	$2,400a
Tax at 46%	$1,104a
B determines its tax liability for 1987 as follows:	
1987 contract costs	$400a
Total contract costs	$1,600e
Total contract price	$2,000e
1987 completion (%)	50e
1987 gross income	$200a
(= (50% × $2,000) − $800 previously reported)	
less, 1987 costs	($400a)
1987 net contract income	($200a)
Other 1987 net income/(loss)	($2,200a)
Taxable income (NOL)	($2,400a)
Tax	0a

Assume that B had no taxable income in either 1984 or 1985, so that the entire amount of the $2,400 net operating loss is carried back to 1986, and B receives a refund, with interest from the due date of B's 1987 return, of the entire $1,104 in tax that it paid for 1986.

In 1988, B determines the following amounts:

1988 contract costs	$800a
Total contract costs	$1,600a
Total contract price	$2,000a

If B had used actual contract costs rather than estimated costs in determining its gross income for 1986, B would have had gross income from the contract of $500 rather than $800, and thus would have had taxable income of $2,100 rather than $2,400, and would have paid tax of $966 rather than $1,104. B is entitled to receive interest on the difference between these two amounts, the hypothetical overpayment of tax of $138. Interest is computed from the due date (without regard to extensions) of B's return for 1986 until the due date for B's return for 1987. Interest stops running at this date, because B's hypothetical overpayment of tax ended when B filed its original 1987 return and received a refund for the carryback to 1986, and interest on this refund began to run only from the due date of B's 1987 return. See section 6611(f).

Example 11. C enters into a long-term contract in 1986, its first year in business, which is completed in 1988. C determines its tax liability for 1986 as follows:

1986 contract costs	$400a
Total contract costs	$1,000e
Total contract price	$2,000e
1986 completion (%)	40e
1986 gross income	$800a
less, 1986 costs	($400a)
1986 net contract income	$400a
Other 1986 net income	$2,000a
Taxable income (NOL)	$2,400a
Tax at 46%	$1,104a

C determines its tax liability for 1987 as follows:

1987 contract costs	$400a
Total contract costs	$1,066e
Total contract price	$2,000e
1987 completion (%)	75e
1987 gross income	$700a
Less, 1987 costs	($400a)
1987 net contract income	$300a
Other 1987 net income	($2,450a)
Taxable income (NOL)	($2,150a)
Tax	$10a

C carries back the net operating loss to 1986, and files an amended return for 1986, showing taxable income of $250, and receives a refund of $989 (46% × $2,150). Interest on this refund begins to run only as of the due date of C's 1987 return. See section 6611(f).

In 1988, when the contract is completed, C determines the following amounts:

1988 contract costs	$800a
Total contract costs	$1,600a
Total contract price	$2,000a

If C had used actual contract price and contract costs in determining gross income for 1986, it would have reported gross income from the contract of $500 rather than $800, taxable income of $2,100 rather than $2,400, and tax liability of $966 rather than $1,104.

If C had used actual contract price and contract costs in determining gross income for 1987, it would have reported gross income from the contract of $500 rather than $700, and would have reported a net operating loss of $2,350, rather than $2,150, which would have been carried back to 1986.

Under the look-back method, C receives interest with respect to a total 1986 hypothetical overpayment of $138 ($1,104 minus $966). C is credited with interest on $23 of this amount only from the due date of C's 1986 return until the due date of C's 1987 tax return, because this portion of C's total hypothetical overpayment for 1986 was refunded to C with interest computed from the due date of C's 1987 return and, therefore, was no longer held by the government. However, because the remainder of the total hypothetical overpayment of $115 was not refunded to C, C is credited with interest on this amount from the due date of C's 1986 return until the due date of C's 1988 tax return.

Under the look-back method, C receives no interest with respect to 1987, because C had no tax liability for 1987 using either estimated or actual contract price and costs.

(i) [Reserved]

(j) *Election not to apply look-back method in de minimis cases.* Section 460(b)(6) provides taxpayers with an election not to apply the look-back method to long-term contracts in de minimis cases, effective for contracts completed in taxable years ending after August 5, 1997. To make an election, a taxpayer must attach a statement to its timely filed original federal income tax return (including extensions) for the taxable year the election is to become effective or to an amended return for that year, provided the amended return is filed on or before March 31, 998. This statement must have the legend ''NOTIFICATION OF ELECTION UNDER SECTION 460(b)(6)''; provide the taxpayer's name and identifying number and the effective date of the election; and identify the trades or businesses that involve long-term contracts. An election applies to all long-term contracts completed during and after the taxable year for which the election is effective. An election may not be revoked without the Commissioner's consent. For taxpayers who elected to use the delayed reapplication method under paragraph (e) of this section, an election under this paragraph (j) automatically revokes the election to use the delayed reapplication method for contracts subject to section 460(b)(6). A consolidated group of corporations, as defined in §1.1502–1(h), is subject to consistency rules analogous to those in paragraph (e)(2) of this section and in paragraph (d)(4)(ii)(C) of this section (concerning election to use simplified marginal impact method).

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TAXABLE YEAR FOR WHICH DEDUCTIONS TAKEN

§ 1.461–0 Table of contents.

This section lists the captions that appear in the regulations under section 461 of the Internal Revenue Code.

§ 1.461–1 General rule for taxable year of deduction.

§ 1.461–2 Contested liabilities.

(b) Contest of asserted liability.
(1) Asserted liability.
(2) Definition of the term ''contest.''
(3) Example.
(c) Transfer to provide for the satisfaction of an asserted liability.
(1) In general.
(2) Examples.
(d) Contest exists after transfer.
(e) Deduction otherwise allowed.
(1) In general.
(2) Example.
(f) Treatment of money or property transferred to an escrowee, trustee, or court and treatment of any income attributable thereto. [Reserved]
(g) Effective dates.

§ 1.461–3 Prepaid interest. [Reserved]

§ 1.461–4 Economic performance.

(a) Introduction.
(1) In general.
(2) Overview.
(b) Exceptions to the economic performance requirement.
(c) Definitions.
(1) Liability.
(2) Payment.
(d) Liabilities arising out of the provision of services, property, or the use of property.
(1) In general.
(2) Services or property provided to the taxpayer.
(3) Use of property provided to the taxpayer.
(4) Services or property provided by the taxpayer.
(5) Liabilities that are assumed in connection with the sale of a trade or business.
(6) Rules relating to the provision of services or property to a taxpayer.
(7) Examples.
(e) Interest.
(f) Timing of deductions from notional principal contracts.
(g) Certain liabilities for which payment is economic performance.
(1) In general.
(2) Liabilities arising under a workers compensation act or out of any tort, breach of contract, or violation of law.
(3) Rebates and refunds.
(4) Awards, prizes, and jackpots.
(5) Insurance, warranty, and service contracts.
(6) Taxes.
(7) Other liabilities.
(8) Examples.
(h) Liabilities arising under the Nuclear Waste Policy Act of 1982.
(i) [Reserved]
(j) Contingent liabilities. [Reserved]
(k) Special effective dates.
(1) In general.
(2) Long-term contracts.
(3) Payment liabilities.
(l) [Reserved]
(m) Change in method of accounting required by this section.
(1) In general.
(2) Change in method of accounting for long-term contracts and payment liabilities.

§ 1.461–5 Recurring item exception.

(a) In general.
(b) Requirements for use of the exception.
(1) General rule.
(2) Amended returns.
(3) Liabilities that are recurring in nature.
(4) Materiality requirement.
(5) Matching requirement.
(c) Types of liabilities not eligible for treatment under the recurring item exception.
(d) Time and manner of adopting the recurring item exception.
(1) In general.
(2) Change to the recurring item exception method for the first taxable year beginning after December 31, 1991.
(3) Retroactive change to the recurring item exception method.
(e) Examples.

§ 1.461–6 Economic performance when certain liabilities are assigned or are extinguished by the establishment of a fund.

(a) Qualified assignments of certain personal injury liabilities under section 130.
(b) Section 468B.
(c) Payments to other funds or persons that constitute economic performance. [Reserved]
(d) Effective dates.

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§ 1.461–1 General rule for taxable year of deduction.

(a) *General rule*—(1) *Taxpayer using cash receipts and disbursements method.* Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures. See section 467 and the regulations thereunder for rules under which a liability arising out of the use of property pursuant to a section 467 rental agreement is taken into account.

(2) *Taxpayer using an accrual method*—(i) *In general.* Under an accrual method of accounting, a liability (as defined in §1.446–1(c)(1)(ii)(B)) is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of this section for examples of liabilities that may not be taken into account until a taxable year subsequent to the taxable year incurred, and see §§1.461–4 through 1.461–6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that the deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of §1.263A–1(c)(3)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and guidance published by the Secretary. The principles of this paragraph (a)(2) also apply in the calculation of earnings and profits and accumulated earnings and profits.

(ii) *Uncertainty as to the amount of a liability.* While no liability shall be taken into account before economic performance and all of the events that fix the liability have occurred, the fact that the exact amount of the liability cannot be determined does not prevent a taxpayer from taking into account that portion of the amount of the liability which can be computed with reasonable accuracy within the taxable year. For example, A renders services to B during the taxable year for which A charges $10,000. B admits a liability to A for $6,000 but contests the remainder. B may take into account only $6,000 as an expense for the taxable year in which the services were rendered.

(iii) *Alternative timing rules.* (A) If any provision of the Code requires a liability to be taken into account in a taxable year later than the taxable year provided in paragraph (a)(2)(i) of this section, the liability is taken into account as prescribed in that Code provision. See, for example, section 267 (transactions between related parties) and section 464 (farming syndicates).

(B) If the liability of a taxpayer is subject to section 170 (charitable contributions), section 192 (black lung benefit trusts), section 194A (employer liability trusts), section 468 (mining and solid waste disposal reclamation and closing costs), or section 468A (certain nuclear decommissioning costs), the liability is taken into account as determined under that section and not under section 461 or the regulations thereunder. For special rules relating to certain loss deductions, see sections 165(e), 165(i), and 165(l), relating to theft losses, disaster losses, and losses from certain deposits in qualified financial institutions.

(C) Section 461 and the regulations thereunder do not apply to any amount allowable under a provision of the Code as a deduction for a reserve for estimated expenses.

(D) Except as otherwise provided in any Internal Revenue regulations, revenue procedure, or revenue ruling, the economic performance requirement of section 461(h) and the regulations thereunder is satisfied to the extent that any amount is otherwise deductible under section 404 (employer contributions to a plan of deferred compensation), section 404A (certain foreign deferred compensation plans), or section 419 (welfare benefit funds). See §1.461–4(d)(2)(iii).

(E) Except as otherwise provided by regulations or other published guidance issued by the Commissioner (See §601.601(b)(2) of this chapter), in the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, the all events test (including economic performance) is considered met in the taxable year in which the liability is to be taken into account under section 467 and the regulations thereunder.

(3) *Effect in current taxable year of improperly accounting for a liability in a prior taxable year*. Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year generally cannot be used to reduce the income of a subsequent year. A taxpayer may not take into account in a return for a subsequent taxable year liabilities that, under the taxpayer's method of accounting, should have been taken into account in a prior taxable year. If a taxpayer ascertains that a liability should have been taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a liability was improperly taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file an amended return and pay any additional tax due. However, except as provided in section 905(c) and the regulations thereunder, if a liability is properly taken into account in an amount based on a computation made with reasonable accuracy and the exact amount of the liability is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year.

(4) *Deductions attributable to certain foreign income*. In any case in which, owing to monetary, exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in gross income of the taxpayer for that year, the deductions and credits properly chargeable against the amount so restricted shall not be deductible in such year but shall be deductible proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See paragraph (b) of §1.905–1 for rules relating to credit for foreign income taxes when foreign income is subject to exchange controls.

(b) *Special rule in case of death*. A taxpayer's taxable year ends on the date of his death. See section 443(a)(2) and paragraph (a)(2) of §1.443–1. In computing taxable income for such year, there shall be deducted only amounts properly deductible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, no deduction shall be allowed for amounts accrued only by reason of his death. For rules relating to the inclusion of items of partnership deduction, loss, or credit in the return of a decedent partner, see subchapter K, chapter 1 of the Code, and the regulations thereunder.

(c) *Accrual of real property taxes*—(1) *In general*. If the accrual of real property taxes is proper in connection with one of the methods of accounting described in section 446(c), any taxpayer using such a method of accounting may elect to accrue any real property tax, which is related to a definite period of time, ratably over that period in the manner described in this paragraph.

For example, assume that such an election is made by a calendar-year taxpayer whose real property taxes, applicable to the period from July 1, 1955, to June 30, 1956, amount to $1,200. Under section 461(c), $600 of such taxes accrue in the calendar year 1955, and the balance accrues in 1956. For special rule in the case of certain contested real property taxes in respect of which the taxpayer transfers money or other property to provide for the satisfaction of the contested tax, see § 1.461–2. For general rules relating to deductions for taxes, see section 164 and the regulations thereunder.

(2) *Special rules*—(i) *Effective date*. Section 461(c) and this paragraph do not apply to any real property tax allowable as a deduction under the Internal Revenue Code of 1939 for any taxable year beginning before January 1, 1954.

(ii) If real property taxes which relate to a period prior to the taxpayer's first taxable year beginning on or after January 1, 1954, would, but for section 461(c), be deductible in such first taxable year, the portion of such taxes which applies to the prior period is deductible in such first taxable year (in addition to the amount allowable under section 461(c)(1)).

(3) *When election may be made*—(i) *Without consent*. A taxpayer may elect to accrue real property taxes ratably in accordance with section 461(c) and this paragraph without the consent of the Commissioner for his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in which the taxpayer incurs real property taxes. Such election must be made not later than the time prescribed by law for filing the return for such year (including extensions thereof). An election may be made by the taxpayer for each separate trade or business (and for nonbusiness activities, if accounted for separately). Such an election shall apply to all real property taxes of the trade, business, or nonbusiness activity for which the election is made. The election shall be made in a statement submitted with the taxpayer's return for the first taxable year to which the election is applicable. The statement should set forth:

(*a*) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(*b*) The period of time to which the taxes are related; and

(*c*) The computation of the deduction for real property taxes for the first year of the election (or a summary of such computation).

(ii) *With consent*. A taxpayer may elect with the consent of the Commissioner to accrue real property taxes ratably in accordance with section 461 (c) and this paragraph. A written request for permission to make such an election shall be submitted to the Commissioner of Internal Revenue, Washington, D.C. 20224, within 90 days after the beginning of the taxable year to which the election is first applicable, or before March 26, 1958, whichever date is later. The request for permission shall state:

(*a*) The name and address of the taxpayer;

(*b*) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(*c*) The taxable year to which the election first applies;

(*d*) The period to which the real property tax relate;

(*e*) The computation of the deduction for real property taxes for the first year of election (or a summary of such computation); and

(*f*) An adequate description of the manner in which all real property taxes were deducted in the year prior to the year of election.

(4) *Binding effect of election*. An election to accrue real property taxes ratably under section 461(c) is binding upon the taxpayer unless the consent of the Commissioner is obtained under section 446(e) and paragraph (e) of § 1.446–1 to change such method of deducting real property taxes. If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 461(c) is applicable falls before March 25, 1958, consent is hereby given for the taxpayer to revoke an election previously made to accrue real property taxes in the manner prescribed by section 461(c). If the taxpayer revokes his

election under the preceding sentence, he must, on or before March 25, 1958, notify the district director for the district in which the return was filed of such revocation. For any taxable year for which such revocation is applicable, an amended return reflecting such revocation shall be filed on or before March 25, 1958.

(5) *Apportionment of taxes on real property between seller and purchaser.* For apportionment of taxes on real property between seller and purchaser, see section 164(d) and the regulations thereunder.

(6) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example 1. A taxpayer on an accrual method reports his taxable income for the taxable year ending June 30. He elects to accrue real property taxes ratably for the taxable year ending June 30, 1955 (which is his first taxable year beginning on or after January 1, 1954). In the absence of an election under section 461(c), such taxes would accrue on January 1 of the calendar year to which they are related. The real property taxes are $1,200 for 1954; $1,600 for 1955; and $1,800 for 1956. Deductions for such taxes for the fiscal years ending June 30, 1955, and June 30, 1956, are computed as follows:

FISCAL YEAR ENDING JUNE 30, 1955

July through December 1954	[1] None
January through June 1955 (6/12 of $1,600)	$800
Deduction for fiscal year ending June 30, 1955	800

[1] The taxes for 1954 were deductible in the fiscal year ending June 30, 1954, since such taxes accrued on January 1, 1954.

FISCAL YEAR ENDING JUNE 30, 1956

July through December 1955 (6/12 of $1,600)	$800
January through June 1956 (6/12 of $1,800)	900
Deduction for fiscal year ending June 30, 1956	1,700

Example 2. A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461(c), such taxes would accrue on July 1 and are assessed for the 12-month period beginning on that date. The real property taxes assessed for the year ending June 30, 1954, are $1,200; $1,600 for the year ending June 30, 1955; and $1,800 for the year ending June 30, 1956. Deductions for such taxes for the calendar years 1954 and 1955 are computed as follows:

YEAR ENDING DECEMBER 31, 1954

January through June 1954	[1] None
July through December 1954 (6/12 of $1,600)	$800
Deduction for year ending December 31, 1954	800

[1] The entire tax of $1,200 for the year ended June 30, 1954, was deductible in the return for 1953, since such tax accrued on July 1, 1953.

YEAR ENDING DECEMBER 31, 1955

January through June 1955 (6/12 of $1,600)	$800
July through December 1955 (6/12 of $1,800)	900
Deduction for year ending December 31, 1955	1,700

Example 3. A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461(c), such taxes, which relate to the calendar year 1954, are accruable on December 1 of the preceding calendar year. No deduction for real property taxes is allowable for the taxable year 1954 since such taxes accrued in the taxable year 1953 under section 23(c) of the Internal Revenue Code of 1939.

Example 4. A taxpayer on an accrual method reports his taxable income for the taxable year ending March 31. He elects to accrue real property taxes ratably for the taxable year ending March 31, 1955. In the absence of an election under section 461(c), such taxes are accruable on June 1 of the calendar year to which they relate. The real property taxes are $1,200 for 1954; $1,600 for 1955; and $1,800 for 1956. Deductions for such taxes for the taxable years ending March 31, 1955, and March 31, 1956, are computed as follows:

FISCAL YEAR ENDING MARCH 31, 1955

April through December 1954 (9/12 of $1,200)	$900
January through March 1955 (3/12 of $1,600)	400
Taxes accrued ratably in fiscal year ending March 31, 1955	1,800
Tax relating to period January through March 1954, paid in June 1954, and not deductible in prior taxable year (3/12 of $1,200)	300
Deduction for fiscal year ending March 31, 1955	1,600

FISCAL YEAR ENDING MARCH 31, 1956

April through December 1955 (9/12 of $1,600)	$1,200
January through March 1956 (3/12 of $1,800)	450
Deduction for fiscal year ending March 31, 1956	1,650

Example 5. The facts are the same as in Example 4 except that in June 1955, when the taxpayer pays his $1,600 real property taxes for 1955, he pays $400 of such amount under protest. Deductions for taxes for the taxable years ending March 31, 1955, and March 31, 1956, are computed as follows:

FISCAL YEAR ENDING MARCH 31, 1955

April through December 1954 (9/12 of $1,200)	$900
January through March 1955 (3/12 of $1,200, that is, $1,600 minus $400 (the contested portion which is not properly accruable))	300

FISCAL YEAR ENDING MARCH 31, 1955—Continued

Taxes accrued ratably in fiscal year ending March 31, 1955	1,200
Tax relating to period January through March 1954, paid in June 1954, and not deductible in prior taxable years (3/12 of $1,200)	300
Deduction for fiscal year ending March 31, 1955	1,500

FISCAL YEAR ENDING MARCH 31, 1956

April through December 1955 (9/12 of $1,200)	$900
January through March 1956 (3/12 of $1,800)	450
Taxes accrued ratably in fiscal year ending March 31, 1956	1,350
Contested portion of tax relating to period January through December 1955, paid in June 1955, and deductible, under section 461(f), for taxpayer's fiscal year ending March 31, 1956	400
Deduction for fiscal year ending March 31, 1956	1,750

(d) *Limitation on acceleration of accrual of taxes.* (1) Section 461(d)(1) provides that, in the case of a taxpayer whose taxable income is computed under an accrual method of accounting, to the extent that the time for accruing taxes is earlier than it would be but for any action of any taxing jurisdiction taken after December 31, 1960, such taxes are to be treated as accruing at the time they would have accrued but for such action. Any such action which, but for the provisions of section 461(d) and this paragraph, would accelerate the time for accruing a tax is to be disregarded in determining the time for accruing such tax for purposes of the deduction allowed for such tax. Such action is to be disregarded not only with respect to a taxpayer (whose taxable income is computed under an accrual method of accounting) upon whom the tax is imposed at the time of the action, but also with respect to such a taxpayer upon whom the tax is imposed at any time subsequent to such action. Thus, in the case of a tax imposed on property, the acceleration of the time for accruing taxes is to be disregarded not only with respect to the taxpayer who owned the property at the time of such acceleration, but also with respect to any subsequent owner of the property whose taxable income is computed under an accrual method of accounting. Similarly, such action is to be disregarded with respect to all property subject to such tax, even if such property is acquired after the action. Whenever the time for accruing taxes is to be disregarded in accordance with the provisions of this paragraph, the taxpayer shall accrue the tax at the time (original accrual date) the tax would have accrued but for such action, and shall, in the absence of any action of the taxing jurisdiction placing the time for accruing such tax at a time subsequent to the original accrual date, continue to accrue the tax as of the original accrual date for all future taxable years.

(2) For purposes of this paragraph—

(i) The term "a taxpayer whose taxable income is computed under an accrual method of accounting" means a taxpayer who, for Federal income tax purposes, accounts for any tax which is the subject of "any action" (as defined in subdivision (iii) of this subparagraph) under an accrual method of accounting. See section 446 and the regulations thereunder. If a taxpayer uses an accrual method as his overall method of accounting, it shall be presumed that he is "a taxpayer whose taxable income is computed under an accrual method of accounting." However, if the taxpayer establishes to the satisfaction of the district director that he has, for Federal income tax purposes, consistently accounted for such tax under the cash method of accounting, he shall be considered not to be "a taxpayer whose taxable income is computed under an accrual method of accounting."

(ii) The time for accruing taxes shall be determined under section 461 and the regulations in this section.

(iii) The term "any action" includes the enactment or reenactment of legislation, the adoption of an ordinance, the exercise of any taxing or administrative authority, or the taking of any other step, the result of which is an acceleration of the accrual event of any tax. The term also applies to the substitution of a substantially similar tax by either the original taxing jurisdiction or a substitute jurisdiction. However, the term does not include either a judicial interpretation, or an administrative determination by the Internal Revenue Service, as to the event which fixes the accrual date for the tax.

(iv) The term "any taxing jurisdiction" includes the District of Columbia, any State, possession of the United States, city, county, municipality, school district, or other political subdivision or authority, other than the United States, which imposes, assesses, or collects a tax.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example 1. State X imposes a tax on intangible and tangible personal property used in a trade or business conducted in the State. The tax is assessed as of July 1, and becomes a lien as of that date. As a result of administrative and judicial decisions, July 1 is recognized as the proper date on which accrual method taxpayers may accrue their personal property tax for Federal income tax purposes. In 1961 State X, by legislative action, changes the assessment and lien dates from July 1, 1962, to December 31, 1961, for the property tax year 1962. The action taken by State X is considered to be "any action" of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action. Therefore, for purposes of the deduction allowed for such tax, the personal property tax imposed by State X, for the property tax year 1962, shall be treated as though it accrued on July 1, 1962.

Example 2. Assume the same facts as in Example 1 except that State X repeals the personal property tax and in lieu thereof enacts a franchise tax which is imposed on the privilege of conducting a trade or business within State X, and is based on the value of intangible and tangible personal property used in the trade or business. The franchise tax is to be assessed and will become a lien as of December 31, 1961, for the franchise tax year 1962, and on December 31 for all subsequent franchise tax years. Since the franchise tax is substantially similar to the former personal property tax and since the enactment of the franchise tax has the effect of accelerating the accrual date of the personal property tax from July 1, 1962, to December 31, 1961, the action taken by State X is considered to be "any action" of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action. Therefore, for purposes of the deduction allowed for such tax, the franchise tax imposed by State X shall be treated as though it accrued on July 1, 1962, for the franchise tax year 1962, and on July 1 for all subsequent franchise tax years.

Example 3. Assume the same facts as in Example 1 except that State X repealed the personal property tax and empowered the counties within the State to impose a personal property tax. Assuming the counties in State X subsequently imposed a personal property tax and chose December 31 of the preceding year as the assessment and lien date, the action of each of the counties would be considered to be "any action" of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action since it is immaterial whether the original taxing jurisdiction or a substitute jurisdiction took the action.

(4) Section 461(d)(1) shall not be applicable to the extent that it would prevent the taxpayer and all other persons, including successors in interest, from ever taking into account, for Federal income tax purposes, any tax to which that section would otherwise apply. For example, assume that State Y imposes a personal property tax on tangible personal property used in a trade or business conducted in the State during a calendar year. The tax is assessed as of February 1 of the year following the personal property tax year, and becomes a lien as of that date. As a result of administrative and judicial decisions, February 1 of the following year is recognized as the proper date on which accrual method taxpayers may accrue the personal property tax for Federal income tax purposes. In 1962 State Y, by legislative action, changes the assessment and lien dates for the personal property tax year 1962 from February 1, 1963, to December 1, 1962, and to December 1 of the personal property tax year for all subsequent years. Corporation A, an accrual method taxpayer which uses the calendar year as its taxable year, pays the tax for 1962 on December 10, 1962. On December 15, 1962, the property which was taxed is completely destroyed and, on December 20, 1962, corporation A transfers all of its remaining assets to its shareholders, and is dissolved. Since corporation A is not in existence in 1963, and therefore could not take the personal property tax into account in computing its 1963 Federal income tax if February 1, 1963, is considered to be the time for accruing the tax, and no other person could ever take such tax into account in computing his Federal income tax, such tax shall be treated as accruing as of December 1, 1962. To the extent that any person other than the taxpayer may at any time take such tax into account in computing his taxable income,

the provisions of section 461(d)(1) shall apply. Thus, upon the dissolution of a corporation or the termination of a partnership between the time which, but for the provisions of section 461(d)(1) and this paragraph, would be the time for accruing any tax which was the subject of ''any action'' (as defined in subdivision (iii) of subparagraph (2)), and the original accrual date, the corporation or the partnership would be entitled to a deduction for only that portion, if any, of such tax with respect to which it can establish, to the satisfaction of the district director, that no other taxpayer can properly take into account in computing his taxable income. However, to the extent that the corporation or partnership cannot establish, at the time of its dissolution or termination, as the case may be, that no other taxpayer would be entitled to take such tax into account in computing his taxable income, and it is subsequently determined that no other taxpayer is entitled to take such tax into account in computing his taxable income, the corporation or partnership may file a claim for refund for the year of its dissolution or termination (subject to the limitations prescribed in section 6511) and claim as a deduction therein the portion of such tax determined to be not deductible by any other taxpayer.

(5) Section 461(d) and this paragraph shall apply to taxable years ending after December 31, 1960.

(e) *Dividends or interest paid by certain savings institutions on certain deposits or withdrawable accounts*—(1) *Deduction not allowable*—(i) *In general.* Except as otherwise provided in this paragraph, pursuant to section 461(e) amounts 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 to withdraw) by a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank shall not be allowed as a deduction for the taxable year to the extent such amounts are paid or credited for periods representing more than 12 months. The provisions of section 461(e) are applicable with respect to taxable years ending after December 31, 1962. Whether amounts are paid or credited for periods representing more than 12 months depends upon all the facts and circumstances in each case. For example, payments or credits which under all the facts and circumstances are in the nature of bona fide bonus interest or dividends paid or credited because a shareholder or depositor maintained a certain balance for more than 12 months, will not be considered made for more than 12 months, providing the regular payments or credits represent a period of 12 months or less. The nonallowance of a deduction to the taxpayer under section 461(e) and this subparagraph has no effect either on the proper time for reporting dividends or interest by a depositor or holder of a withdrawable account, or on the obligation of the taxpayer to make a return setting forth, among other things, the aggregate amounts paid to a depositor or shareholder under section 6049 (relating to returns regarding payments of interest) and the regulations thereunder. With respect to a short period (a taxable year consisting of a period of less than 12 months), amounts of dividends or interest paid or credited shall not be allowed as a deduction to the extent that such amounts are paid or credited for a period representing more than the number of months in such short period. In such a case, the rules contained in section 461(e) and this paragraph apply to the short period in a manner consistent with the application of such rules to a 12-month taxable year. Subparagraph (2) of this paragraph provides rules for computing amounts not allowed in the taxable year and subparagraph (3) provides rules for determining when such amounts are allowed. See section 7701(a) (19) and (32) and the regulations thereunder for the definitions of domestic building and loan association and cooperative bank.

(ii) *Exceptions.* The rule of nonallowance set forth in subdivision (i) of this subparagraph is not applicable to a taxpayer in the year in which it liquidates (other than following, or as part of, an acquisition of its assets in which the acquiring corporation, pursuant to section 381(a), takes into account certain items of the taxpayer, which for purposes of this paragraph shall be referred to as an acquisition described in section 381(a)). In addition, such rule of nonallowance is not applicable to a taxpayer which pays or credits grace interest or dividends to terminating depositors or shareholders, provided the total amount of the grace interest or dividends paid or credited during the payment or crediting period (for example, a quarterly or semiannual period) does not exceed 10 percent of the total amount of the interest or dividends paid or credited during such period, computed without regard to the grace interest or dividends. For example, providing the 10 percent limitation is met, the rule of nonallowance does not apply in a case in which a calendar year taxpayer, with regular interest payment dates of January 1, April 1, July 1, and October 1, pays grace interest for the period beginning October 1 to a depositor who terminates his account on December 10.

(2) *Computation of amounts not allowed as a deduction*—(i) *Method of computation.* The amount of the dividends or interest to which subparagraph (1) of this paragraph applies, which is not allowed as a deduction, shall be computed under the rules of this subparagraph. The amount which is not allowed as a deduction is the difference between the total amount of dividends or interest paid or credited to that class of accounts with respect to which a deduction is not allowed under subparagraph (1) of this paragraph during the taxable year (or short period, if applicable) and an amount which bears the same ratio to such total as the number 12 (or number of months in the short period) bears to the number of months with respect to which such amounts of dividends or interest are paid or credited.

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

Example 1. X Association, a domestic building and loan association filing its return on the basis of a calendar year, regularly credits its dividends on its withdrawable accounts quarterly on the first day of the quarter following the quarter with respect to which they are earned. X changes the time of crediting dividends commencing with the credit for the fourth quarter of 1964. Such credit and all subsequent credits are made on the last day of the quarter with respect to which they are earned. As a result of this change X's credits for the year 1964 are as follows:

Period with respect to which earned	Date credited in 1964	Amt.
4th quarter, 1963	Jan. 1	$250,000
1st quarter, 1964	Apr. 1	300,000
2d quarter, 1964	July 1	300,000
3d quarter, 1964	Oct. 1	300,000
4th quarter, 1964	Dec. 31	350,000
Total dividends credited		1,500,000

Since the change in the time of crediting dividends results in the crediting in 1964 of amounts of dividends representing periods totaling 15 months (October 1963 through December 1964), amounts shall not be allowed as a deduction in 1964 which are in excess of $1,200,000, which is the amount which bears the same ratio to the amounts of dividends credited during the year ($1,500,000) as the number 12 bears to the number of months (15) with respect to which such dividends are credited. Thus, $300,000 ($1,500,000 minus $1,200,000) is not allowed as a deduction in 1964.

Example 2. Y Association, a domestic building and loan association filing its return on the basis of a calendar year, regularly credits its dividends on its withdrawable accounts on the basis of a semiannual period on March 31 and September 30 of each year. Y changes the period with respect to which credits are made from the semiannual period to the quarterly basis, commencing with the last quarter in 1964. The credit for this last quarter and all subsequent credits are made on the last day of the quarter with respect to which they are earned. As a result of this change, Y's credits for the year 1964 are as follows:

Period with respect to which earned	Date credited in 1964	Amt.
6-month period ending Mar. 31, 1964.	Mar. 31	$300,000
6-month period ending Sept. 30, 1964.	Sept. 30	400,000
4th quarter, 1964	Dec. 31	200,000
Total dividends credited		900,000

Since the change in the basis of crediting dividends results in a crediting in 1964 of dividends representing periods totaling 15 months (October 1963 through December 1964), amounts shall not be allowed as a deduction in 1964 which are in excess of $720,000, which is the amount which bears the same ratio to the amounts of dividends credited during the year ($900,000) as the number 12 bears to the number of months (15) with respect to which such dividends are credited. Thus, $180,000 ($900,000 minus $720,000) is not allowed as a deduction in 1964.

Example 3. Z Association, a domestic building and loan association regularly files its return on the basis of a fiscal year ending on the last day of February and regularly credits dividends on its withdrawable accounts quarterly on the last day of the quarter with respect to which they are earned. Z receives approval from the Commissioner of Internal Revenue to change its accounting period to a calendar year and effects the change by filing a return for a short period ending on December 31, 1964. Dividend credits for the short period beginning on March 1 and ending on December 31, 1964, are as follows:

Period with respect to which earned	Date credited in 1964	Amt.
January-March 1964	Mar. 31	$250,000
April-June 1964	June 30	300,000
July-September 1964	Sept. 30	300,000
October-December 1964	Dec. 31	350,000
Total dividends credited		1,200,000

Since the change of accounting period results in amounts of dividends credited ($1,200,000) representing periods totaling 12 months (January through December 1964), and such periods represent more than the number of months (10) in the short period, an amount shall not be allowed as a deduction in such short period which is in excess of $1,000,000, which is the amount which bears the same ratio to the amount of dividends credited in the short period ($1,200,000) as the number of months (10) in the short period bears to the number of months (12) with respect to which such dividends are credited. Thus, $200,000 ($1,200,000 minus $1,000,000) is not allowed as a deduction in the short period.

(3) *When amounts allowable.* The amount of dividends or interest not allowed as a deduction under subparagraph (1) of this paragraph shall be allowed as follows (subject to the limitation that the total of the amounts so allowed shall not exceed the amount not allowed under subparagraph (1)):

(i) Such amount shall be allowed as a deduction in a later taxable year or years subject to the limitation that, when taken together with the deductions otherwise allowable in the later taxable year or years, it does not bring the deductions for any later taxable year to a total representing a period of more than 12 months (or number of months in the short period, if applicable). However, in any event, an amount otherwise allowable under subdivision (ii) of this subparagraph shall be allowed notwithstanding the fact that it may bring the deductions allowable to a total representing a period of more than 12 months (or number of months in the short period, if applicable).

(ii) In any case in which it is established to the satisfaction of the Commissioner that the taxpayer does not intend to avoid taxes, one-tenth of such amount shall be allowed as a deduction in each of the 10 succeeding taxable years—

(*a*) Commencing with the taxable year for which such amount is not allowed as a deduction under subparagraph (1), or

(*b*) In the case of such amount not allowed for a taxable year ending before July 1, 1964, commencing with either the first or second taxable year after the taxable year for which such amount is not allowed as a deduction under subparagraph (1) if the taxpayer has not taken a deduction on his return, or filed a claim for credit or refund, in respect of such amount under (*a*).

Normally, if the deduction not allowed under subparagraph (1) is a result of a change, not requested by the taxpayer, in the taxpayer's annual accounting period or dividend or interest payment or crediting dates solely as a consequence of a requirement of a Federal or State regulatory authority, or if the deduction is not allowed solely as a result of the taxpayer being a party to an acquisition to which section 381(a) applies, the Commissioner will permit the allowance of the amount not allowed in the manner provided in this subdivision. Nothing set forth in this subdivision shall be construed as permitting the allowance of a credit or refund for any year which is barred by the limitations on credit or refund provided by section 6511.

(iii) If the total of the amounts, if any, allowed under subdivisions (i) and (ii) of this subparagraph before the taxable year in which the taxpayer liquidates or otherwise ceases to engage in trade or business is less than the amount not allowed under subparagraph (1), there shall be allowed a deduction in such taxable year for the difference between the amount not allowed under subparagraph (1) and the amounts allowed, if any, as deductions under subdivisions (i) and (ii) unless the circumstances under which the taxpayer ceased to do business constitute an acquisition described in section 381(a) (relating to carryovers in certain corporate acquisitions). If the circumstances under which the taxpayer ceased to do business constitute an acquisition described in section 381(a), the acquiring corporation shall succeed to and take into account the balance of the amounts not allowed on the same basis as the taxpayer, had it not ceased to engage in business.

[T.D. 6500, 25 FR 11720, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.461–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§ 1.461–2 Contested liabilities.

(a) *General rule*—(1) *Taxable year of deduction*. If—

(i) The taxpayer contests an asserted liability,

(ii) The taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

(iii) The contest with respect to the asserted liability exists after the time of the transfer, and

(iv) But for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable),

then the deduction with respect to the contested amount shall be allowed for the taxable year of the transfer.

(2) *Exception*. Subparagraph (1) of this paragraph shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, including a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

(3) *Refunds includible in gross income*. If any portion of the contested amount which is deducted under subparagraph (1) of this paragraph for the taxable year of transfer is refunded when the contest is settled, such portion is includible in gross income except as provided in § 1.111–1, relating to recovery of certain items previously deducted or credited. Such refunded amount is includible in gross income for the taxable year of receipt, or for an earlier taxable year if properly accruable for such earlier year.

(4) *Examples*. The provisions of this paragraph are illustrated by the following examples:

Example 1. X Corporation, which uses an accrual method of accounting, in 1964 contests $20 of a $100 asserted real property tax liability but pays the entire $100 to the taxing authority. In 1968, the contest is settled and X receives a refund of $5. X deducts $100 for the taxable year 1964, and includes $5 in gross income for the taxable year 1968 (assuming § 1.111–1 does not apply to such amount). If in 1964 X pays only $80 to the taxing authority, X deducts only $80 for 1964. The result would be the same if X Corporation used the cash method of accounting.

Example 2. Y Corporation makes its return on the basis of a calendar year and uses an accrual method of accounting. Y's real property taxes are assessed and become a lien on December 1, but are not payable until March 1 of the following year. On December 10, 1964, Y contests $20 of the $100 asserted real property tax which was assessed and became a lien on December 1, 1964. On March 1, 1965, Y pays the entire $100 to the taxing authority. In 1968, the contest is settled and Y receives a refund of $5. Y deducts $80 for the taxable year 1964, deducts $20 for the taxable year 1965, and includes $5 in gross income for the taxable year 1968 (assuming § 1.111–1 does not apply to such amount).

(b) *Production costs*—(1) *In general; asserted liability*. For purposes of paragraph (a)(1) of this section, the term ''asserted liability'' means an item with respect to which, but for the existence of any contest in respect of such item, a deduction would be allowable under an accrual method of accounting. For example, a notice of a local real estate tax assessment and a bill received for services may represent asserted liabilities.

(2) *Definition of the term ''contest''*. Any contest which would prevent accrual of a liability under section 461(a) shall be considered to be a contest in determining whether the taxpayer satisfies paragraph (a)(1)(i) of this section. A contest arises when there is a bona fide dispute as to the proper evaluation

of the law or the facts necessary to determine the existence or correctness of the amount of an asserted liability. It is not necessary to institute suit in a court of law in order to contest an asserted liability. An affirmative act denying the validity or accuracy, or both, of an asserted liability to the person who is asserting such liability, such as including a written protest with payment of the asserted liability, is sufficient to commence a contest. Thus, lodging a protest in accordance with local law is sufficient to contest an asserted liability for taxes. It is not necessary that the affirmative act denying the validity or accuracy, or both, of an asserted liability be in writing if, upon examination of all the facts and circumstances, it can be established to the satisfaction of the Commissioner that a liability has been asserted and contested.

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

Example: O Corporation makes its return on the basis of a calendar year and uses an accrual method of accounting. O receives a large shipment of typewriter ribbons from S Company on January 30, 1964, which O pays for in full on February 10, 1964. Subsequent to their receipt, several of the ribbons prove defective because of inferior materials used by the manufacturer. On August 9, 1964, O orally notifies S and demands refund of the full purchase price of the ribbons. After negotiations prove futile and a written demand is rejected by S, O institutes an action for the full purchase price. For purposes of paragraph (a)(1)(i) of this section, S has asserted a liability against O which O contests on August 9, 1964. O deducts the contested amount for 1964.

(c) *Transfer to provide for the satisfaction of an asserted liability*—(1) *In general.* (i) A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to—

(A) The person who is asserting the liability;

(B) An escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest;

(C) An escrowee or trustee pursuant to an order of the United States or of any State or political subdivision thereof or any agency or instrumentality of the foregoing, or of a court, that the money or other property be delivered in accordance with the settlement of the contest; or

(D) A court with jurisdiction over the contest.

(ii) In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over the money or other property.

(iii) The following are not transfers to provide for the satisfaction of an asserted liability—

(A) Purchasing a bond to guarantee payment of the asserted liability;

(B) An entry on the taxpayer's books of account;

(C) A transfer to an account that is within the control of the taxpayer;

(D) A transfer of any indebtedness of the taxpayer or of any promise by the taxpayer to provide services or property in the future; and

(E) A transfer to a person (other than the person asserting the liability) of any stock of the taxpayer or of any stock or indebtedness of a person related to the taxpayer (as defined in section 267(b)).

(2) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example 1. M Corporation contests a $5,000 liability asserted against it by L Company for services rendered. To provide for the contingency that it might have to pay the liability, M establishes a separate bank account in its own name. M then transfers $5,000 from its general account to such separate account. Such transfer does not qualify as a transfer to provide for the satisfaction of an asserted liability because M has not transferred the money beyond its control.

Example 2. M Corporation contests a $5,000 liability asserted against it by L Company for services rendered. To provide for the contingency that it might have to pay the liability, M transfers $5,000 to an irrevocable trust pursuant to a written agreement among the trustee, M (the taxpayer), and L (the person who is asserting the liability) that the money shall be held until the contest is settled and then disbursed in accordance with the settlement. Such transfer qualifies as a transfer to provide for the satisfaction of an asserted liability.

(d) *Contest exists after transfer.* In order for a contest with respect to an asserted liability to exist after the time of transfer, such contest must be pursued subsequent to such time. Thus, the contest must have been neither settled nor abandoned at the time of the transfer. A contest may be settled by a decision, judgment, decree, or other order of any court of competent jurisdiction which has become final, or by written or oral agreement between the parties. For example, Z Corporation, which uses an accrual method of accounting, in 1964 contests a $100 asserted liability. In 1967 the contested liability is settled as being $80 which Z accrues and deducts for such year. In 1968 Z pays the $80. Section 461(f) does not apply to Z with respect to the transfer because a contest did not exist after the time of such transfer.

(e) *Deduction otherwise allowed*—(1) *In general.* The existence of the contest with respect to an asserted liability must prevent (without regard to section 461(f)) and be the only factor preventing a deduction for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable) to provide for the satisfaction of such liability. Nothing in section 461(f) or this section shall be construed to give rise to a deduction since section 461(f) and this section relate only to the timing of deductions which are otherwise allowable under the Code.

(2) *Application of economic performance rules to transfers under section 461(f).* (i) A taxpayer using an accrual method of accounting is not allowed a deduction under section 461(f) in the taxable year of the transfer unless economic performance has occurred.

(ii) Economic performance occurs for liabilities requiring payment to another person arising out of any workers compensation act or any tort, or any other liability designated in § 1.461–4(g), as payments are made to the person to which the liability is owed. Except as provided in section 468B or the regulations thereunder, economic performance does not occur when a taxpayer transfers money or other property to a trust, an escrow account, or a court to provide for the satisfaction of an asserted workers compensation, tort, or other liability designated under § 1.461–4(g) that the taxpayer is contesting unless the trust, escrow account, or court is the person to which the liability is owed or the taxpayer's payment to the trust, escrow account, or court discharges the taxpayer's liability to the claimant. Rather, economic performance occurs in the taxable year the taxpayer transfers money or other property to the person that is asserting the workers compensation, tort, or other liability designated under § 1.461–4(g) that the taxpayer is contesting or in the taxable year that payment is made from a trust, an escrow account, or a court registry funded by the taxpayer to the person to which the liability is owed.

(3) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example 1. A, an individual, makes a gift of certain property to B, an individual. A pays the entire amount of gift tax assessed against him but contests his liability for the tax. Section 275(a)(3) provides that gift taxes are not deductible. A does not satisfy the requirement of paragraph (a)(1)(iv) of this section because a deduction would not be allowed for the taxable year of the transfer even if A did not contest his liability to the tax.

Example 2. Corporation X is a defendant in a class action suit for tort liabilities. In 2002, X establishes a trust for the purpose of satisfying the asserted liability and transfers $10,000,000 to the trust. The trust does not satisfy the requirements of section 468B or the regulations thereunder. In 2004, the trustee pays $10,000,000 to the plaintiffs in settlement of the litigation. Under paragraph (e)(2) of this section, economic performance with respect to X's liability to the plaintiffs occurs in 2004. X may deduct the $10,000,000 payment to the plaintiffs in 2004.

(f) *Treatment of money or property transferred to an escrowee, trustee, or court and treatment of any income attributable thereto.* [Reserved]

(g) *Effective dates.* (1) Except as otherwise provided, this section applies to transfers of money or other property in taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(2) Paragraph (c)(1)(iii)(E) of this section applies to transfers of any stock of

the taxpayer or any stock or indebtedness of a person related to the taxpayer on or after November 19, 2003.

(3) Paragraph (e)(2)(i) of this section applies to transfers of money or other property after July 18, 1984.

(4) Paragraph (e)(2)(ii) and paragraph (e)(3) *Example 2* of this section apply to—

(i) Transfers after July 18, 1984, of money or other property to provide for the satisfaction of an asserted workers compensation or tort liability; and

(ii) Transfers in taxable years beginning after December 31, 1991, of money or other property to provide for the satisfaction of asserted liabilities designated in §1.461–4(g) (other than liabilities for workers compensation or tort).

[T.D. 6772, 29 FR 15753, Nov. 24, 1964, as amended by T.D. 8408, 57 FR 12421, Apr. 10, 1992; T.D. 9095, 68 FR 65636, Nov. 21, 2003; T.D. 9140, 69 FR 43303, July 20, 2004]

§ 1.461–3 Prepaid interest. [Reserved]

§ 1.461–4 Economic performance.

(a) *Introduction*—(1) *In general*. For purposes of determining whether an accrual basis taxpayer can treat the amount of any liability (as defined in §1.446–1(c)(1)(ii)(B)) as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.

(2) *Overview*. Paragraph (b) of this section lists exceptions to the economic performance requirement. Paragraph (c) of this section provides cross-references to the definitions of certain terms for purposes of section 461 (h) and the regulations thereunder. Paragraphs (d) through (m) of this section and §1.461–6 provide rules for determining when economic performance occurs. Section 1.461–5 provides rules relating to an exception under which certain recurring items may be incurred for the taxable year before the year during which economic performance occurs.

(b) *Exceptions to the economic performance requirement*. Paragraph (a)(2)(iii)(B) of §1.461–1 provides examples of liabilities that are taken into account under rules that operate without regard to the all events test (including economic performance).

(c) *Definitions*. The following cross-references identify certain terms defined for purposes of section 461(h) and the regulations thereunder:

(1) *Liability*. See paragraph (c)(1)(ii)(B)d of §1.446–1 for the definition of ''liability.''

(2) *Payment*. See paragraph (g)(1)(ii) of this section for the definition of ''payment.''

(d) *Liabilities arising out of the provision of services, property, or the use of property*—(1) *In general*. The principles of this paragraph (d) determine when economic performance occurs with respect to liabilities arising out of the performance of services, the transfer of property, or the use of property. This paragraph (d) does not apply to liabilities described in paragraph (e) (relating to interest expense) or paragraph (g) (relating to breach of contract, workers compensation, tort, etc.) of this section. In addition, except as otherwise provided in Internal Revenue regulations, revenue procedures, or revenue rulings this paragraph (d) does not apply to amounts paid pursuant to a notional principal contract. The Commissioner may provide additional rules in regulations, revenue procedures, or revenue rulings concerning the time at which economic performance occurs for items described in this paragraph (d).

(2) *Services or property provided to the Taxpayer*—(i) *In general*. Except as otherwise provided in paragraph (d)(5) of this section, if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided.

(ii) *Long-term contracts*. In the case of any liability of a taxpayer described in paragraph (d)(2)(i) of this section that is an expense attributable to a long-term contract with respect to which the taxpayer uses the percentage of completion method, economic performance occurs—

(A) As the services or property is provided; or, if earlier,

(B) As the taxpayer makes payment (as defined in paragraph (g)(1)(ii) of this section) in satisfaction of the liability to the person providing the services or property. See paragraph (k)(2) of this section for the effective date of this paragraph (d)(2)(ii).

(iii) *Employee benefits*—(A) *In general.* Except as otherwise provided in any Internal Revenue regulation, revenue procedure, or revenue ruling, the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under section 404 (employer contributions to a plan of deferred compensation), section 404A (certain foreign deferred compensation plans), and section 419 (welfare benefit funds). See § 1.461–1(a)(2)(iii)(D).

(B) *Property transferred in connection with performance of services.* [Reserved]

(iv) *Cross-references.* See *Examples 4* through *6* of paragraph (d)(7) of this section. See paragraph (d)(6) of this section for rules relating to when a taxpayer may treat services or property as provided to the taxpayer.

(3) *Use of property provided to the taxpayer*—(i) *In general.* Except as otherwise provided in this paragraph (d)(3)d and paragraph (d)(5) of this section, if the liability of a taxpayer arises out of the use of property by the taxpayer, economic performance occurs ratably over the period of time the taxpayer is entitled to the use of the property (taking into account any reasonably expected renewal periods when necessary to carry out the purposes of section 461(h)). See *Examples 6* through *9* of paragraph (d)(7) of this section.

(ii) *Exceptions*—(A) *Volume, frequency of use, or income.* If the liability of a taxpayer arises out of the use of property by the taxpayer and all or a portion of the liability is determined by reference to the frequency or volume of use of the property or the income from the property, economic performance occurs for the portion of the liability determined by reference to the frequency or volume of use of the property or the income from the property as the taxpayer uses the property or includes income from the property. See *Examples 8* and *9* of paragraph (d)(7) of this section. This paragraph (d)(3)(ii) shall not apply if the District Director determines, that based on the substance of the transaction, the liability of the taxpayer for use of the property is more appropriately measured ratably over the period of time the taxpayer is entitled to the use of the property.

(B) *Section 467 rental agreements.* In the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, economic performance occurs as provided in § 1.461–1(a)(2)(iii)(E).

(4) *Services or property provided by the taxpayer*—(i) *In general.* Except as otherwise provided in paragraph (d)(5) of this section, if the liability of a taxpayer requires the taxpayer to provide services or property to another person, economic performance occurs as the taxpayer incurs costs (within the meaning of § 1.446–1(c)(1)(ii)) in connection with the satisfaction of the liability. See *Examples 1* through *3* of paragraph (d)(7) of this section.

(ii) *Barter transactions.* If the liability of a taxpayer requires the taxpayer to provide services, property, or the use of property, and arises out of the use of property by the taxpayer, or out of the provision of services or property to the taxpayer by another person, economic performance occurs to the extent of the lesser of—

(A) The cumulative extent to which the taxpayer incurs costs (within the meaning of § 1.446–1(c)(1)(ii)) in connection with its liability to provide the services of property; or

(B) The cumulative extent to which the services or property is provided to the taxpayer.

(5) *Liabilities that are assumed in connection with the sale of a trade or business*—(i) *In general.* If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer. See § 1.1001–2 for rules relating to the inclusion in amount realized from a discharge of liabilities resulting from a sale or exchange.

(ii) *Trade or business.* For purposes of this paragraph (d)(5), a trade or business is a specific group of activities carried on by the taxpayer for the purpose of earning income or profit if every operation that is necessary to the process of earning income or profit is included in the group. Thus, for example, the group of activities generally must include the collection of income and the payment of expenses.

(iii) *Tax avoidance.* This paragraph (d)(5) does not apply if the District Director determines that tax avoidance is one of the taxpayer's principal purposes for the sale or exchange.

(6) *Rules relating to the provision of services or property to a taxpayer.* The following rules apply for purposes of this paragraph (d):

(i) Services or property provided to a taxpayer include services or property provided to another person at the direction of the taxpayer.

(ii) A taxpayer is permitted to treat services or property as provided to the taxpayer as the taxpayer makes payment to the person providing the services or property (as defined in paragraph (g)(1)(ii) of this section), if the taxpayer can reasonably expect the person to provide the services or property within 3½ months after the date of payment.

(iii) A taxpayer is permitted to treat property as provided to the taxpayer when the property is delivered or accepted, or when title to the property passes. The method used by the taxpayer to determine when property is provided is a method of accounting that must comply with the rules of §1.446–1(e). Thus, the method of determining when property is provided must be used consistently from year to year, and cannot be changed without the consent of the Commissioner.

(iv) If different services or items of property are required to be provided to a taxpayer under a single contract or agreement, economic performance generally occurs over the time each service is provided and as each item of property is provided. However, if a service or item of property to be provided to the taxpayer is incidental to other services or property to be provided under a contract or agreement, the taxpayer is not required to allocate any portion of the total contract price to the incidental service or property. For purposes of this paragraph (d)(6)(iv), services or property is treated as incidental only if—

(A) The cost of the services or property is treated on the taxpayer's books and records as part of the cost of the other services or property provided under the contract; and

(B) The aggregate cost of the services or property does not exceed 10 percent of the total contract price.

(7) *Examples.* The following examples illustrate the principles of this paragraph (d). For purposes of these examples, it is assumed that the requirements of the all events test other than economic performance have been met, and that the recurring item exception is not used. Assume further that the examples do not involve section 467 rental agreements and, therefore, section 467 is not applicable. The examples are as follows:

Example 1. Services or property provided by the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, is an oil company. During March 1990, X enters into an oil and gas lease with Y. In November 1990, X installs a platform and commences drilling. The lease obligates X to remove its offshore platform and well fixtures upon abandonment of the well or termination of the lease. During 1998, X removes the platform and well fixtures at a cost of $200,000.

(ii) Under paragraph (d)(4)(i) of this section, economic performance with respect to X's liability to remove the offshore platform and well fixtures occurs as X incurs costs in connection with that liability. X incurs these costs in 1998 as, for example, X's employees provide X with removal services (see paragraph (d)(2) of this section). Consequently, X incurs $200,000 for the 1998 taxable year. Alternatively, assume that during 1990 X pays Z $130,000 to remove the platform and fixtures, and that Z performs these removal services in 1998. Under paragraph (d)(2) of this section, X does not incur this cost until Z performs the services. Thus, economic performance with respect to the $130,000 X pays Z occurs in 1998.

Example 2. Services or property provided by the taxpayer. (i) W corporation, a calendar year, accrual method taxpayer, sells tractors under a three-year warranty that obligates W to make any reasonable repairs to each tractor it sells. During 1990, W sells ten tractors. In 1992 W repairs, at a cost of $5,000, two tractors sold during 1990.

(ii) Under paragraph (d)(4)(i) of this section, economic performance with respect to

W's liability to perform services under the warranty occurs as W incurs costs in connection with that liability. W incurs these costs in 1992 as, for example, replacement parts are provided to W (see paragraph (d)(2) of this section). Consequently, $5,000 is incurred by W for the 1992 taxable year.

Example 3. Services or property provided by the taxpayer; Long-term contracts. (i) W corporation, a calendar year, accrual method taxpayer, manufactures machine tool equipment. In November 1992, W contracts to provide X corporation with certain equipment. The contract is not a long-term contract under section 460 or §1.451–3. In 1992, W pays Z corporation $50,000 to lease from Z, for the one-year period beginning on January 1, 1993, testing equipment to perform quality control tests required by the agreement with X. In 1992, pursuant to the terms of a contract, W pays Y corporation $100,000 for certain parts necessary to manufacture the equipment. The parts are provided to W in 1993. W's employees provide W with services necessary to manufacture the equipment during 1993, for which W pays $150,000 in 1993.

(ii) Under paragraph (d)(4) of this section, economic performance with respect to W's liability to provide the equipment to X occurs as W incurs costs in connection with that liability. W incurs these costs during 1993, as services, property, and the use of property necessary to manufacture the equipment are provided to W (see paragraphs (d)(2) and (d)(3) of this section). Thus, $300,000 is incurred by W for the 1993 taxable year. See section 263A and the regulations thereunder for rules relating to the capitalization and inclusion in inventory of these incurred costs.

(iii) Alternatively, assume that the agreement with X is a long-term contract as defined in section 460(f), and that W takes into account all items with respect to such contracts under the percentage of completion method as described in section 460(b)(1). Under paragraph (d)(2)(ii) of this section, the $100,000 W pays in 1992 for parts is incurred for the 1992 taxable year, for purposes of determining the percentage of completion under section 460(b)(1)(A). W's other costs under the agreement are incurred for the 1993 taxable year for this purpose.

Example 4. Services or property provided to the taxpayers. (i) LP1, a calendar year, accrual method limited partnership, owns the working interest in a parcel of property containing oil and gas. During December 1990, LP1 enters into a turnkey contract with Z corporation pursuant to which LP1 pays Z $200,000 and Z is required to provide a completed well by the close of 1992. In May 1992, Z commences drilling the well, and, in December 1992, the well is completed.

(ii) Under paragraph (d)(2) of this section, economic performance with respect to LP1's liability for drilling and development services provided to LP1 by Z occurs as the services are provided. Consequently, $200,000 is incurred by LP1 for the 1992 taxable year.

Example 5. Services or property provided to the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, is an automobile dealer. On Jaunary 15, 1990, X agrees to pay an additional $10 to Y, the manufacturer of the automobiles, for each automobile purchased by X from Y. Y agrees to provide advertising and promotional activities to X.

(ii) During 1990, X purchases from Y 1,000 new automobiles and pays to Y an additional $10,000 as provided in the agreement. Y, in turn, uses this $10,000 to provide advertising and promotional activities during 1992.

(iii) Under paragraph (d)(2) of this section, economic performance with respect to X's liability for advertising and promotional services provided to X by Y occurs as the services are provided. Consequently, $10,000 is incurred by X for the 1992 taxable year.

Example 6. Use of property provided to the taxpayer; services or property provided to the taxpayer. (i) V corporation, a calendar year, accrual method taxpayer, charters aircrafts. On December 20, 1990, V leases a jet aircraft from L for the four-year period that begins on January 1, 1991. The lease obligates V to pay L a base rental of $500,000 per year. In addition, the lease requires V to pay $25 to an escrow account for each hour that the aircraft is flown. The escrow account funds are held by V and are to be used by L to make necessary repairs to the aircraft. Any amount remaining in the escrow account upon termination of the lease is payable to V. During 1991, the aircraft is flown 1,000 hours and V pays $25,000 to the escrow account. The aircraft is repaired by L in 1993. In 1994, $20,000 is released from the escrow account to pay L for the repairs.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to V's base rental liability occurs ratably over the period of time V is entitled to use the jet aircraft. Consequently, the $500,000 rent is incurred by V for the 1991 taxable year and for each of the next three taxable years. Under paragraph (d)(2) of this section, economic performance with respect to the liability to place amounts in escrow occurs as the aircraft is repaired. Consequently, V incurs $20,00 for the 1993 taxable year.

Example 7. Use of property provided to the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, manufactures and sells electronic circuitry. On November 15, 1990, X enters into a contract with Y that entitles X to the exclusive use of a product owned by Y for the five-year period beginning on January 1, 1991. Pursuant to the contract, X pays Y $100,000 on December 30, 1990.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to X's liability for the use of property occurs ratably over the period of time X is entitled to use the product. Consequently, $20,000 is incurred by X for 1991 and for each of the succeeding four taxable years.

Example 8. Use of property provided to the taxpayer. (i) Y corporation, a calendar year, accrual method taxpayer, enters into a five-year lease with Z for the use of a copy machine on July 1, 1991. Y also receives elivery of the copy machine on July 1, 1991. The lease obligates Y to pay Z a base rental payment of $6,000 per year at the beginning of each lease year and an additional charge of 5 cents per copy 30 days after the end of each lease year. The machine is used to make 50,000 copies during the first lease year: 20,000 copies in 1991 and 30,000 copies from January 1, 1992, to July 1, 1992. Y pays the $6,000 base rental payment to Z on July 1, 1991, and the $2,500 variable use payment on July 30, 1992.

(ii) under paragraph (d)(3)(i) of this section, economic performance with respect to Y's base rental liability occurs ratably over the period of time Y is entitled to use the copy machine. Consequently, $3,000 rent is incurred by Y for the 1991 taxable year. Under paragraph (d)(3)(ii) of this section, economic performance with respect to Y's variable use portion of the liability occurs as Y uses the machine. Thus, the $1,000 of the $2,500 variable-use liability that relates to the 20,000 copies made in 1991 is incurred by Y for the 1991 taxable year.

Example 9. Use of property provided to the taxpayer. (i) X corporation, a calendar year, accrual method taxpayer, enters into a five-year product distribution agreement with Y, on January 1, 1992. The agreement provides for a payment of $100,000 on January 1, 1992, plus 10 percent of the gross profits earned by X from distribution of the product. The variable income portion of X's liability is payable on April 1 of each subsequent year. On January 1, 1992, X pays Y $100,000. On April 1, 1993, X pays Y $3 million representing 10 percent of X's gross profits from January 1 through December 31, 1992.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to X's $100,000 payment occurs ratably over the period of time X is entitled to use the product. Consequently, $20,000 is incurred by X for each year of the agreement beginning with 1992. Under paragraph (d)(3)(ii) of this section, economic performance with respect to X's variable income portion of the liability occurs as the income is earned by X. Thus, the $3 million variable-income liability is incurred by X for the 1992 taxable year.

(e) *Interest.* In the case of interest, economic performance occurs as the interest cost economically accrues, in accordance with the principles of relevant provisions of the Code.

(f) *Timing of deductions from notional principal contracts.* Economic performance on a notional principal contract occurs as provided under §1.446–3.

(g) *Certain liabilities for which payment is economic performance*—(1) *In general*—(i) *Person to which payment must be made.* In the case of liabilities described in paragraphs (g) (2) through (7) of this section, economic performance occurs when, and to the extent that, payment is made to the person to which the liability is owed. Thus, except as otherwise provided in paragraph (g)(1)(iv) of this section and §1.461–6, economic performance does not occur as a taxpayer makes payments in connection with such a liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed under paragraph (g)(1)(ii)(B) of this section. Instead, economic performance occurs as payments are made from that other person or fund to the person to which the liability is owed. The amount of economic performance that occurs as payment is made from the other person or fund to the person to which the liability is owed may not exceed the amount the taxpayer transferred to the other person or fund. For special rules relating to the taxation of amounts transferred to ''qualified settlement funds,'' see section 468B and the regulations thereunder. The Commissioner may provide additional rules in regulations, revenue procedures, and revenue rulings concerning the time at which economic performance occurs for items described in this paragraph (g).

(ii) *Payment to person to which liability is owed.* Paragraph (d)(6) of this section provides that for purposes of paragraph (d) of this section (relating to the provision of services or property to the taxpayer) in certain cases a taxpayer may treat services or property as provided to the taxpayer as the taxpayer makes payments to the person providing the services or property. In addition, this paragraph (g) provides that in the case of certain liabilities of a taxpayer, economic performance occurs as the taxpayer makes payment to persons specified therein. For these and all other purposes of section 461(h) and the regulations thereunder:

(A) *Payment*. The term *payment* has the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment. Thus, for example, payment includes the furnishing of cash or cash equivalents and the netting of offsetting accounts. Payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument (including a standby letter of credit) or by any third party (including a government agency). As a further example, payment does not include a promise of the taxpayer to provide services or property in the future (whether or not the promise is evidenced by a contract or other witten agreement). In addition, payment does not include an amount transferred as a loan, refundable deposit, or contingent payment.

(B) *Person to which payment is made*. Payment to a particular person is accomplished if paragraph (g)(1)(ii)(A) of this section is satisfied and a cash basis taxpayer in the position of that person would be treated as having actually or constructively received the amount of the payment as gross income under the principles of section 451 (without regard to section 104(a) or any other provision that specifically excludes the amount from gross income). Thus, for example, the purchase of an annuity contract or any other asset generally does not constitute payment to the person to which a liability is owed unless the ownership of the contract or other asset is transferred to that person.

(C) *Liabilities that are assumed in connection with the sale of a trade or business*. Paragraph (d)(5) of this section provides rules that determine when economic performance occurs in the case of liabilities that are assumed in connection with the sale of a trade or business. The provisions of paragraph (d)(5) of this section also apply to any liability described in paragraph (g) (2) through (7) of this section that the purchaser expressly assumes in connection with the sale or exchange of a trade or business by a taxpayer, provided the taxpayer (but for the economic performance requirement) would have been entitled to incur the liability as of the date of the sale.

(iii) *Person*. For purposes of this paragraph (g), ''person'' has the same meaning as in section 7701(a)(1), except that it also includes any foreign state, the United States, any State or political subdivision thereof, any possession of the United States, and any agency or instrumentality of any of the foregoing.

(iv) *Assignments*. If a person that has a right to receive payment in satisfaction of a liability described in paragraphs (g) (2) through (7) of this section makes a valid assignment of that right to a second person, or if the right is assigned to the second person through operation of law, then payment to the second person in satisfaction of that liability constitutes payment to the person to which the liability is owed.

(2) *Liabilities arising under a workers compensation act or out of any tort, breach of contract, or violation of law*. If the liability of a taxpayer requires a payment or series of payments to another person and arises under any workers compensation act or out of any tort, breach of contract, or violation of law, economic performance occurs as payment is made to the person to which the liability is owed. See *Example 1* of paragraph (g)(8) of this section. For purposes of this paragraph (g)(2)—

(i) A liability to make payments for services, property, or other consideration provided under a contract is not a liability arising out of a breach of that contract unless the payments are in the nature of incidental, consequential, or liquidated damages; and

(ii) A liability arising out of a tort, breach of contract, or violation of law includes a liability arising out of the settlement of a dispute in which a tort, breach of contract, or violation of law, respectively, is alleged.

(3) *Rebates and refunds*. If the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance

occurs as payment is made to the person to which the liability is owed. This paragraph (g)(3) applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold. In the case of a rebate or refund made as a reduction in the price of goods or services to be provided in the future by the taxpayer, ''payment'' is deemed to occur as the taxpayer would otherwise be required to recognize income resulting from a disposition at an unreduced price. See *Example 2* of paragraph (g)(8) of this section. For purposes of determining whether the recurring item exception of §1.461–5 applies, a liability that arises out of a tort, breach of contract, or violation of law is not considered a rebate or refund.

(4) *Awards, prizes, and jackpots.* If the liability of a taxpayer is to provide an award, prize, jackpot, or other similar payment to another person, economic performance occurs as payment is made to the person to which the liability is owed. See *Examples 3* and *4* of paragraph (g)(8) of this section.

(5) *Insurance, warranty, and service contracts.* If the liability of a taxpayer arises out of the provision to the taxpayer of insurance, or a warranty or service contract, economic performance occurs as payment is made to the person to which the liability is owed. See *Examples 5* through *7* of paragraph (g)(8) of this section. For purposes of this paragraph (g)(5)—

(i) A warranty or service contract is a contract that a taxpayer enters into in connection with property bought or leased by the taxpayer, pursuant to which the other party to the contract promises to replace or repair the property under specified circumstances.

(ii) The term ''insurance'' has the same meaning as is used when determining the deductibility of amounts paid or incurred for insurance under section 162.

(6) *Taxes*—(i) *In general.* Except as otherwise provided in this paragraph (g)(6), if the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax. For purposes of this paragraph (g)(6), payment includes payments of estimated income tax and payments of tax where the taxpayer subsequently files a claim for credit or refund. In addition, for purposes of this paragraph (g)(6), a tax does not include a charge collected by a governmental authority for specific extraordinary services or property provided to a taxpayer by the governmental authority. Examples of such a charge include the purchase price of a parcel of land sold to a taxpayer by a governmental authority and a charge for labor engaged in by government employees to improve that parcel. In certain cases, a liability to pay a tax is permitted to be taken into account in the taxable year before the taxable year during which economic performance occurs under the recurring item exception of §1.461–5. See *Example 8* of paragraph (g)(8) of this section.

(ii) *Licensing fees.* If the liability of a taxpayer is to pay a licensing or permit fee required by a governmental authority, economic performance occurs as the fee is paid to the governmental authority, or as payment is made to any other person at the direction of the governmental authority.

(iii) *Exceptions*—(A) *Real property taxes.* If a taxpayer has made a valid election under section 461 (c), the taxpayer's accrual for real property taxes is determined under section 461 (c). Otherwise, economic performance with respect to a property tax liability occurs as the tax is paid, as specified in paragraph (g)(6)(i) of this section.

(B) *Certain foreign taxes.* If the liability of a taxpayer is to pay an income, war profits, or excess profits tax that is imposed by the authority of any foreign country or possession of the United States and is creditable under section 901 (including a creditable tax described in section 903 that is paid in lieu of such a tax), economic performance occurs when the requirements of the all events test (as described in §1.446–1 (c)(1)(ii)) other than economic performance are met, whether or not the taxpayer elects to credit such taxes under section 901 (a).

(7) *Other liabilities.* In the case of a taxpayer's liability for which economic

perfomance rules are not provided elsewhere in this section or in any other Internal Revenue regulation, revenue ruling or revenue procedure, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed. This paragraph (g)(7) applies only if the liability cannot properly be characterized as a liability covered by rules provided elsewhere in this section. If a liability may properly be characterized as, for example, a liability arising from the provision of services or property to, or by, a taxpayer, the determination as to when economic performance occurs with respect to that liability is made under paragraph (d) of this section and not under this paragraph (g)(7).

(8) *Examples.* The following examples illustrate the principles of this paragraph (g). For purposes of these examples, it is assumed that the requirements of the all events test other than economic performance have been met and, except as otherwise provided, that the recurring item exception is not used.

Example 1. Liabilities arising out of a tort. (i) During the period 1970 through 1975, Z corporation, a calendar year, accrual method taxpayer, manufactured and distributed industrial products that contained carcinogenic substances. In 1992, a number of lawsuits are filed against Z alleging damages due to exposure to these products. In settlement of a lawsuit maintained by A, Z agrees to purchase an annuity contract that will provide annual payments to A of $50,000 for a period of 25 years. On December 15, 1992, Z pays W, an unrelated life insurance company, $491,129 for such an annuity contract. Z retains ownership of the annuity contract.

(ii) Under paragraph (g)(2) of this section, economic performance with respect to Z's liability to A occurs as each payment is made to A. Consequently, $50,000 is incurred by Z for each taxable year that a payment is made to A under the annuity contract. (Z must also include in income a portion of amounts paid under the annuity, pursuant to section 72.) The result is the same if in 1992 Z secures its obligation with a standby letter of credit.

(iii) If Z later transfers ownership of the annuity contract to A, an amount equal to the fair market value of the annuity on the date of transfer is incurred by Z in the taxable year of the transfer (see paragraph (g)(1)(ii)(B) of this section). In addition, the transfer constitutes a transaction to which section 1001 applies.

Example 2. Rebates and refunds. (i) X corporation, a calendar year, accrual method taxpayer, manufactures and sells hardware products. X enters into agreements that entitle each of its distributors to a rebate (or discount on future purchases) from X based on the amount of purchases made by the distributor from X during any calendar year. During the 1992 calendar year, X becomes liable to pay a $2,000 rebate to distributor A. X pays A $1,200 of the rebate on January 15, 1993, and the remaining $800 on October 15, 1993. Assume the rebate is deductible (or allowable as an adjustment to gross receipts or cost of goods sold) when incurred.

(ii) If X does not adopt the recurring item exception described in § 1.461–5 with respect to rebates and refunds, then under paragraph (g)(3) of this section, economic performance with respect to the $2,000 rebate liability occurs in 1993. However, if X has made a proper election under § 1.461–5, and as of December 31, 1992, all events have occurred that determine the fact of the rebate liability, X incurs $1,200 for the 1992 taxable year. Because economic performance (payment) with respect to the remaining $800 does not occur until October 15, 1993 (more than 8½ months after the end of 1992), X cannot use the recurring item exception for this portion of the liability (see § 1.461–5). Thus, the $800 is not incurred by X until the 1993 taxable year. If, instead of making the cash payments to A during 1993, X adjusts the price of hardware purchased by A that is delivered to A during 1993, X's "payment" occurs as X would otherwise be required to recognize income resulting from a disposition at an unreduced price.

Example 3. Awards, prizes, and jackpots. (i) W corporation, a calendar year, accrual method taxpayer, produces and sells breakfast cereal. W conducts a contest pursuant to which the winner is entitled to $10,000 per year for a period of 20 years. On December 1, 1992, A is declared the winner of the contest and is paid $10,000 by W. In addition, on December 1 of each of the next nineteen years, W pays $10,000 to A.

(ii) Under paragraph (g)(4) of this section, economic performance with respect to the $200,000 contest liability occurs as each of the $10,000 payments is made by W to A. Consequently, $10,000 is incurred by W for the 1992 taxable year and for each of the succeeding nineteen taxable years.

Example 4. Awards, prizes, and jackpots. (i) Y corporation, a calendar year, accrual method taxpayer, owns a casino that contains progressive slot machines. A progressive slot machine provides a guaranteed jackpot amount that increases as money is gambled through the machine until the jackpot is won or until a maximum predetermined amount is reached. On July 1, 1993, the guaranteed jackpot amount on one of Y's slot machines reaches the maximum predetermined amount of $50,000. On October 1, 1994, the $50,000 jackpot is paid to B.

(ii) Under paragraph (g)(4) of this section, economic performance with respect to the $50,000 jackpot liability occurs on the date the jackpot is paid to B. Consequently, $50,000 is incurred by Y for the 1994 taxable year.

Example 5. Insurance, warranty, and service contracts. (i) V corporation, a calendar year, accrual method taxpayer, manufactures toys. V enters into a contract with W, an unrelated insurance company, on December 15, 1992. The contract obligates V to pay W a premium of $500,000 before the end of 1995. The contract obligates W to satisfy any liability of V resulting from claims made during 1993 or 1994 against V by any third party for damages attributable to defects in toys manufactured by V. Pursuant to the contract, V pays W a premium of $500,000 on October 1, 1995.

(ii) Assuming the arrangement constitutes insurance, under paragraph (g)(5) of this section economic performance occurs as the premium is paid. Thus, $500,000 is incurred by V for the 1995 taxable year.

Example 6. Insurance, warranty, and service contracts. (i) Y corporation, a calendar year, accrual method taxpayer, is a common carrier. On December 15, 1992, Y enters into a contract with Z, an unrelated insurance company, under which Z must satisfy any liability of Y that arises during the succeeding 5 years for damages under a workers compensation act or out of any tort, provided the event that causes the damages occurs during 1993 or 1994. Under the contract, Y pays $360,000 to Z on December 31, 1993.

(ii) Assuming the arrangement constitutes insurance, under paragraph (g)(5) of this section economic performance occurs as the premium is paid. Consequently, $360,000 is incurred by Y for the 1993 taxable year. The period for which the $360,000 amount is permitted to be taken into account is determined under the capitalization rules because the insurance contract is an asset having a useful life extending substantially beyond the close of the taxable year.

Example 7. Insurance, warranty, and service contracts. Assume the same facts as in *Example 6*, except that Y is obligated to pay the first $5,000 of any damages covered by the arrangement with Z. Y is, in effect, self-insured to the extent of this $5,000 ''deductible.'' Thus, under paragraph (g)(2) of this section, economic performance with respect to the $5,000 liability does not occur until the amount is paid to the person to which the tort or workers compensation liability is owed.

Example 8. Taxes. (i) The laws of State A provide that every person owning personal property located in State A on the first day of January shall be liable for tax thereon and that a lien for the tax shall attach as of that date. In addition, the laws of State A provide that 60% of the tax is due on the first day of December following the lien date and the remaining 40% is due on the first day of July of the succeeding year. On January 1, 1992, X corporation, a calendar year, accrual method taxpayer, owns personal property located in State A. State A imposes a $10,000 tax on S with respect to that property on January 1, 1992. X pays State A $6,000 of the tax on December 1, 1992, and the remaining $4,000 on July 1, 1993.

(ii) Under paragraph (g)(6) of this section, economic performance with respect to $6,000 of the tax liability occurs on December 1, 1992. Consequently, $6,000 is incurred by X for the 1992 taxable year. Economic performance with respect to the remaining $4,000 of the tax liability occurs on July 1, 1993. If X has adopted the recurring item exception described in §1.461–5 as a method of accounting for taxes, and as of December 31, 1992, all events have occurred that determine the liability of X for the remaining $4,000, X also incurs $4,000 for the 1992 taxable year. If X does not adopt the recurring item exception method, the $4,000 is not incurred by X until the 1993 taxable year.

(h) *Liabilities arising under the Nuclear Waste Policy Act of 1982.* Notwithstanding the principles of paragraph (d) of this section, economic performance with respect to the liability of an owner or generator of nuclear waste to make payments to the Department of Energy (''DOE'') pursuant to a contract required by the Nuclear Waste Policy Act of 1982 (Pub. L. 97–425, 42 U.S.C. 10101–10226 (1982)) occurs as each payment under the contract is made to DOE and not when DOE satisfies its obligations under the contract. This rule applies to the continuing fee required by 42 U.S.C. 10222(a)(2) (1982), as well as the one-time fee required by 42 U.S.C. 10222 (a)(3) (1982). For rules relating to when economic performance occurs with respect to interest, see paragraph (e) of this section.

(i) [Reserved]

(j) *Contingent liabilities.* [Reserved]

(k) *Special effective dates*—(1) *In general.* Except as otherwise provided in this paragraph (k), section 461(h) and this section apply to liabilities that would, under the law in effect before the enactment of section 461(h), be allowable as a deduction or otherwise incurred after July 18, 1984. For example, the economic performance requirement applies to all liabilities arising under a workers compensation act or out of any tort that would, under the law in effect before the enactment of section 461(h), be incurred after July 18, 1984. For taxable years ending before April 7, 1995, see Q&A–2 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995), which provides an election to make this change in method of accounting applicable to either the portion of the first taxable year that occurs after July 18, 1984 (part-year change method), or the entire first taxable year ending after July 18, 1984 (full-year change method). With respect to the effective date rules for interest, section 461(h) applies to interest accruing under any obligation (whether or not evidenced by a debt instrument) if the obligation is incurred in any transaction occurring after June 8, 1984, and is not incurred under a written contract which was binding on March 1, 1984, and at all times thereafter until the obligation is incurred. Interest accruing under an obligation described in the preceding sentence is subject to section 461(h) even if the interest accrues before July 19, 1984. Similarly, interest accruing under any obligation incurred in a transaction occurring before June 9, 1984, (or under a written contract which was binding on March 1, 1984, and at all times thereafter until the obligation is incurred) is not subject to section 461(h) even to the extent the interest accrues after July 18, 1984.

(2) *Long-term contracts.* Except as otherwise provided in paragraph (M)(2) of this section, in the case of liabilities described in paragraph (d)(2)(ii) of this section (relating to long-term contracts), paragraph (d)(2)(ii) of this section applies to liabilities that would, but for the enactment of section 461(h), be allowable as a deduction or otherwise incurred for taxable years beginning after December 31, 1991.

(3) *Payment liabilities.* Except as otherwise provided in paragraph (m)(2) of this section, in the case of liabilities described in paragraph (g) of this section (other than liabilities arising under a workers compensation act or out of any tort described in paragraph (g)(2) of this section), paragraph (g) of this section applies to liabilities that would, but for the enactment of section 461(h), be allowable as a deduction or otherwise incurred for taxable years beginning after December 31, 1991.

(l) [Reserved]

(m) *Change in method of accounting required by this section*—(1) *In general.* For the first taxable year ending after July 18, 1984, a taxpayer is granted the consent of the Commissioner to change its method of accounting for liabilities to comply with the provisions of this section pursuant to any of the following procedures:

(i) For taxable years ending before April 7, 1995, the part-year change in method election described in Q&A–2 through Q&A–6 and Q&A–8 through Q&A–10 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995);

(ii) For taxable years ending before April 7, 1995, the full-year change in method election described in Q&A–2 through Q&A–6 and Q&A–8 through Q&A–10 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995); or

(iii) For taxable years ending before April 7, 1995, if no election is made, the cut-off method described in Q&A–1 and Q&A–11 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995).

(2) *Change in method of accounting for long-term contracts and payment liabilities*—(i) *First taxable year beginning after December 31, 1991.* For the first taxable year beginning after December 31, 1991, a taxpayer is granted the consent of the Commissioner to change its method of accounting for long-term contract liabilities described in paragraph (D)(2)(ii) of this section and payment liabilities described in paragraph (g) of this section (other than liabilities arising under a workers compensation act or out of any tort described in paragraph (g)(2) of this section) to comply with the provisions of this section. The change must be made in accordance with paragraph (m)(1)(ii) or (m)(1)(iii) of this section, except the effective date is the first day of the first taxable year beginning December 31, 1991.

(ii) *Retroactive change in method of accounting for long-term contracts and payment liabilities.* For the first taxable year beginning after December 31, 1989, or the first taxable year beginning after December 31, 1990, a taxpayer is granted the consent of the Commissioner to change its method of accounting for long-term contract liabilities described in paragraph (d)(2)(ii) of this section and payment liabilities described in paragraph (g) of this section (other than liabilities arising under a workers compensation act or out of any tort described in paragraph (g)(2) of this section) to comply with the provisions of this section. The change must be made in accordance with paragraph (m)(1)(ii) or (m)(1)(iii) of this section, except the effective date is the first day of the first taxable year beginning after December 31, 1989, or the first day of the first taxable year beginning after December 31, 1990. For taxable years ending before April 7, 1995, the taxpayer may make the change in method of accounting, including a full-year change in method election under paragraph (m)(1)(ii) of this section and Q&A–5 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995), by filing an amended return for such year, provided the amended return is filed on or before October 7, 1992.

[T.D. 8408, 57 FR 12421, Apr. 10, 1992, as amended by T.D. 8491, 58 FR 53135, Oct. 14, 1993; T.D. 8593, 60 FR 18743, Apr. 13, 1995; T.D. 8820, 64 FR 26851, May 18, 1999; T.D. 8408, 69 FR 44597, July 27, 2004]

§ 1.461–5 Recurring item exception.

(a) *In general.* Except as otherwise provided in paragraph (c) of this section, a taxpayer using an accrual method of accounting may adopt the recurring item exception described in paragraph (b) of this section as method of accounting for one or more types of recurring items incurred by the taxpayer. In the case of the ''other payment liabilities'' described in §1.461–4(g)(7), the Commissioner may provide for the application of the recurring item exception by regulation, revenue procedure or revenue ruling.

(b) *Requirements for use of the exception*—(1) *General rule.* Under the recurring item exception, a liability is treated as incurred for a taxable year if—

(i) As of the end of that taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy;

(ii) Economic performance with respect to the liability occurs on or before the earlier of—

(A) The date the taxpayer files a timely (including extensions) return for that taxable year; or

(B) The 15th day of the 9th calendar month after the close of that taxable year;

(iii) The liability is recurring in nature; and

(iv) Either—

(A) The amount of the liability is not material; or

(B) The accrual of the liability for that taxable year results in a better matching of the liability with the income to which it relates than would result from accruing the liability for the taxable year in which economic performance occurs.

(2) *Amended returns.* A taxpayer may file an amended return treating a liability as incurred under the recurring item exception for a taxable year if economic performance with respect to the liability occurs after the taxpayer files a return for that year, but within 8½ months after the close of that year.

(3) *Liabilities that are recurring in nature.* A liability is recurring if it can generally be expected to be incurred from one taxable year to the next. However, a taxpayer may treat such a liability as recurring in nature even if it is not incurred by the taxpayer in each taxable year. In addition, a liability that has never previously been incurred by a taxpayer may be treated as recurring if it is reasonable to expect that the liability will be incurred on a recurring basis in the future.

(4) *Materiality requirement.* For purposes of this paragraph (b):

(i) In determining whether a liability is material, consideration shall be given to the amount of the liability in absolute terms and in relation to the amount of other items of income and expense attributable to the same activity.

(ii) A liability is material if it is material for financial statement purposes under generally acepted accounting principles.

(iii) A liability that is immaterial for financial statement purposes under generally accepted accounting principles may be material for purposes of this paragraph (b).

(5) *Matching requirement.* (i) In determining whether the matching requirement of paragraph (b)(1)(iv)(B) of this section is satisfied, generally accepted accounting principles are an important factor, but are not dispositive.

(ii) In the case of a liability described in paragraph (g)(3) (rebates and refunds), paragraph (g)(4) (awards, prizes, and jackpots), paragraph (g)(5) (insurance, warranty, and service contracts), paragraph (g)(6) (taxes), or paragraph (h) (continuing fees under the Nuclear Waste Policy Act of 1982) of §1.461–4, the matching requirement of paragraph (b)(1)(iv)(B) of this section shall be deemed satisfied.

(c) *Types of liabilities not eligible for treatment under the recurring item exception.* The recurring item exception does not apply to any liability of a taxpayer described in paragraph (e) (interest), paragraph (g)(2) (workers compensation, tort, breach of contract, and violation of law), or paragraph (g)(7) (other liabilities) of §1.461–4. Moreover, the recurring item exception does not apply to any liability incurred by a tax shelter, as defined in section 461(i) and §1.448–1T(b).

(d) *Time and manner of adopting the recurring item exception*—(1) *In general.* The recurring item exception is a method of accounting that must be consistently applied with respect to a type of item, or for all items, from one taxable year to the next in order to clearly reflect income. A taxpayer is permitted to adopt the recurring item exception as part of its method of accounting for any type of item for the first taxable year in which that type of item is incurred. Except as otherwise provided, the rules of section 446(e) and §1.446–1(e) apply to changes to or from the recurring item exception as a method of accounting. For taxable years ending before April 7, 1995, see Q&A–7 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995) for rules concerning the time and manner of adopting the recurring item exception for taxable years that include July 19, 1984. For purposes of this section, items are to be classified by type in a manner that results in classifications that are no less inclusive than the classifications of production costs provided in the full-absorption regulations of §1.471–11(b) and(c), whether or not the taxpayer is required to maintain inventories.

(2) *Change to the recurring item exception method for the first taxable year beginning after December 31, 1991*—(i) *In general.* For the first taxable year beginning after December 31, 1991, a taxpayer is granted the consent of the Commissioner to change to the recurring item exception method of accounting. A taxpayer is also granted the consent of the Commissioner to expand or modify its use of the recurring item exception method for the first taxable year beginning after December 31, 1991. For each trade or business for which a taxpayer elects to use the recurring item exception method, the taxpayer must use the same method of change (cut-off or full-year change) it is using for that trade or business under §1.461–4(m). For taxable year sending before April 7, 1995, see Q&A–11 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995) for an explanation of how amounts are taken into account under the cut-off method (except that, for purposes of this paragraph (d)(2), the change applies to all amounts otherwise incurred on or after the first day of the first taxable year beginning after December 31, 1991). For taxable years ending before April 7, 1995, see Q&A–6 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995) for an explanation of how amounts are taken into account under the full-year change method (except that the change in method occurs on the first day of the first taxable year beginning after December 31, 1991). For taxable years ending before April 7, 1995, the full-year change in method may result in a section 481(a) adjustment that must be taken into account in the manner described in Q&A–8 and Q&A–9 of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995) (except that the taxable year of change is the first taxable year beginning after December 31, 1991).

(ii) *Manner of changing to the recurring item exception method.* For the first taxable year beginning after December 31, 1991, a taxpayer may change to the recurring item exception method by accounting for the item on its timely filed original return for such taxable year (including extensions). For taxable years ending before April 7, 1995, the automatic consent of the Commissioner is limited to those items accounted for under the recurring item exception method on the timely filed return, unless the taxpayer indicates a wider scope of change by filing the statement provided in Q&A–7(b)(2) of §1.461–7T (as it appears in 26 CFR part 1 revised April 1, 1995).

(3) *Retroactive change to the recurring item exception method.* For the first taxable year beginning after December 31, 1989, or December 31, 1990, a taxpayer is granted consent of the Commissioner to change to the recurring item exception method of accounting, provided the taxpayer complies with paragraph (d)(2) of this section on either the original return for such year or on an amended return for such year filed on or before October 7, 1991. For this purpose the effective date is the first day of the first taxable year beginning after December 31, 1989, or the first day of the first taxable year beginning after December 31, 1990. A taxpayer is also granted the consent of the Commissioner to expand or modify its use of the recurring item exception method for the first taxable year beginning after December 31, 1989, December 31, 1990, or December 31, 1991.

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

Example 1. Requirements for use of the recurring item exception. (i) Y corporation, a calendar year, accrual method taxpayer, manufactures and distributes video cassette recorders. Y timely files its federal income tax return for each taxable year on the extended due date for the return (September 15, of the following taxable year). Y offers to refund the price of a recorder to any purchaser not satisfied with the recorder. During 1992, 100 purchasers request a refund of the $500 purchase price. Y refunds $30,000 on or before September 15, 1993, and the remaining $20,000 after such date but before the end of 1993.

(ii) Under paragraph (g)(3) of §1.461–4, economic performance with respect to $30,000 of the refund liability occurs on September 15, 1993. Assume the refund is deductible (or allowable as an adjustment to gross receipts or cost of goods sold) when incurred. If Y does not adopt the recurring item exception with respect to rebates and refunds, the $30,000 refund is incurred by Y for the 1993 taxable year. However, if Y has properly adopted the recurring item exception method of accounting under this section, and as of December 31, 1992, all events have occurred that determine the fact of the liability for the $30,000 refund, Y incurs that amount for the 1992 taxable year. Because economic performance (payment) with respect to the remaining $20,000 occurs after September 15, 1993 (more than 8½ months after the end of 1992), that amount is not eligible for recurring item treatment under this section. Thus, the $20,000 amount is not incurred by Y until the 1993 taxable year.

Example 2. Requirements for use of the recurring item exception; amended returns. The facts are the same as in *Example 2,* except that Y files its income tax return for 1992 on March 15, 1993, and Y does not refund the price of any recorder before that date. Under paragraph (b)(1) of this section, the refund liability is not eligible for the recurring item exception because economic performance with respect to the refund does not occur before Y files a return for the taxable year for which the item would have been incurred under the exception. However, since economic performance occurs within 8½ months after 1992, Y may file an amended return claiming the $30,000 as incurred for its 1992 taxable year (see paragraph (b)(2) of this section).

[T.D. 8408, 57 FR 12427, Apr. 10, 1992, as amended by T.D. 8593, 60 FR 18743, Apr. 13, 1995]

§ 1.461–6 Economic performance when certain liabilities are assigned or are extinguished by the establishment of a fund.

(a) *Qualified assignments of certain personal injury liabilities under section 130.* In the case of a qualified assignment (within the meaning of section 130(c)), economic performance occurs as a taxpayer-assignor makes payments that are excludible from the income of the assignee under section 130(a).

(b) *Section 468B.* Economic performance occurs as a taxpayer makes qualified payments to a designated settlement fund under section 468B, relating to special rules for designated settlement funds.

(c) *Payments to other funds or persons that constitute economic performance.* [Reserved]

(d) *Effective dates.* The rules in paragraph (a) of this section apply to payments after July 18, 1984.

[T.D. 8408, 57 FR 12428, Apr. 10, 1992]

§ 1.465–1T Aggregation of certain activities (temporary).

(a) *General rule.* A partner in a partnership or an S corporation shareholder may aggregate and treat as a single activity—

(1) The holding, production, or distribution of more than one motion picture film or video tape by the partnership or S corporation,

(2) The farming (as defined in section 464 (e)) of more than one farm by the partnership or S corporation,

(3) The exploration for, or exploitation of, oil and gas resources with respect to more than one oil and gas property by the partnership or S corporation, or

(4) The exploration for, or exploitation of, geothermal deposits (within the meaning of section 613(e)(3)) with respect to more than one geothermal property by the partnership or S corporation.

Thus, for example, if a partnership or S corporation is engaged in the activity of exploring for, or exploiting, oil and gas resources with respect to 10 oil and gas properties, a partner or S corporation shareholder may aggregate those properties and treat the aggregated oil and gas activities as a single activity. If that partnership or S corporation also is engaged in the activity of farming with respect to two farms, the partner or shareholder may aggregate the farms and treat the aggregated farming activities as a single separate activity. Except as provided in section 465(c)(2)(B)(ii), the partner or shareholder cannot aggregate the farming activity with the oil and gas activity.

(b) *Effective date.* This section shall apply to taxable years beginning after December 31, 1983 and before January 1, 1985.

(Secs. 465(c)(2)(B) and 7805 of the Internal Revenue Code of 1954 (98 Stat. 814, 68A Stat. 917; 26 U.S.C. 465(c)(2)(B) and 7805))

[T.D. 8012, 50 FR 9614, Mar. 11, 1985]

§ 1.465–8 General rules; interest other than that of a creditor.

(a) *In general*—(1) *Amounts borrowed.* This section applies to amounts borrowed for use in an activity described in section 465(c)(1) or (c)(3)(A). Amounts borrowed with respect to an activity will not increase the borrower's amount at risk in the activity if the lender has an interest in the activity other than that of a creditor or is related to a person (other than the borrower) who has an interest in the activity other than that of a creditor. This rule applies even if the borrower is personally liable for the repayment of the loan or the loan is secured by property not used in the activity. For additional rules relating to the treatment of amounts borrowed from these persons, *see* § 1.465–20.

(2) *Certain borrowed amounts excepted.* (i) For purposes of determining a corporation's amount at risk, an interest in the corporation as a shareholder is not an interest in any activity of the corporation. Thus, amounts borrowed by a corporation from a shareholder may increase the corporation's amount at risk.

(ii) For purposes of determining a taxpayer's amount at risk in an activity of holding real property, paragraph (a)(1) of this section does not apply to financing that is secured by real property used in the activity and is either—

(A) Qualified nonrecourse financing described in section 465(b)(6)(B); or

(B) Financing that, if it were nonrecourse, would be financing described in section 465(b)(6)(B).

(b) *Loans for which the borrower is personally liable for repayment*—(1) *General rule.* If a borrower is personally liable for the repayment of a loan for use in an activity, a person shall be considered a person with an interest in the activity other than that of a creditor only if the person has either a capital interest in the activity or an interest in the net profits of the activity.

(2) *Capital interest.* For the purposes of this section a capital interest in an activity means an interest in the assets of the activity which is distributable to the owner of the capital interest upon the liquidation of the activity. The partners of a partnership and the shareholders of an S corporation are considered to have capital interests in the activities conducted by the partnership or S corporation.

(3) *Interest in net profits.* For the purposes of this section it is not necessary for a person to have any incidents of ownership in the activity in order to

have an interest in the net profits of the activity. For example, an employee or independent contractor any part of whose compensation is determined with reference to the net profits of the activity will be considered to have an interest in the net profits of the activity.

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

Example 1. A, the owner of a herd of cattle sells the herd to partnership BCD. BCD pays A $10,000 in cash and executes a note for $30,000 payable to A. Each of the three partners, B, C, and D, assumes personal liability for repayment of the amount owed A. In addition, BCD enters into an agreement with A under which A is to take care of the cattle for BCD in return for compensation equal to 6 percent of BCD's net profits from the activity. Because A has an interest in the net profits of BCD's farming activity, A is considered to have an interest in the activity other than that of a creditor. Accordingly, amounts payable to A for use in that activity do not increase the partners' amount at risk even though the partners assume personal liability for repayment.

Example 2. Assume the same facts as in *Example 1* except that instead of receiving compensation equal to 6 percent of BCD's net profits from the activity, A instead receives compensation equal to 1 percent of the gross receipts from the activity. A does not have a capital interest in BCD. A's interest in the gross receipts is not considered an interest in the net profits. Because B, C, and D assumed personal liability for the amounts payable to A, and A has neither a capital interest nor an interest in the net profits of the activity, A is not considered to have an interest in the activity other than that of a creditor with respect to the $30,000 loan. Accordingly, B, C, and D are at risk for their share of the loan if the other provisions of section 465 are met.

Example 3. Assume the same facts as in Example 1 except that instead of receiving compensation equal to 6 percent of BCD's net profits from the activity, A instead receives compensation equal to 6 percent of the net profits from the activity or $15,000, whichever is greater. A is considered to have an interest in the net profits from the activity and accordingly will be treated as a person with an interest in the activity other than that of a creditor.

(c) *Nonrecourse loans secured by assets with a readily ascertainable fair market value*—(1) *General rule.* This paragraph shall apply in the case of a nonrecourse loan for use in an activity where the loan is secured by property which has a readily ascertainable fair market value. In the case of such a loan a person shall be considered a person with an interest in the activity other than that of a creditor only if the person has either a capital interest in the activity or an interest in the net profits of the activity.

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

Example. X is an investor in an activity described in section 465(c)(1). In order to raise money for the investment, X borrows money from A, the promoter (the person who brought X together with other taxpayers for the purpose of investing in the activity). The loan is secured by stock unrelated to the activity which is listed on a national securities exchange. X's stock has a readily ascertainable fair market value. A does not have a capital interest in the activity or an interest in its net profits. Accordingly, with respect to the loan secured by X's stock, A does not have an interest in the activity other than that of a creditor.

(d) *Nonrecourse loans secured by assets without a readily ascertainable fair market value*—(1) *General rule.* This paragraph shall apply in the case of a nonrecourse loan for use in an activity where the loan is secured by property which does not have a readily ascertainable fair market value. In the case of such a loan a person shall be considered a person with an interest in the activity other than that of a creditor if the person stands to receive financial gain (other than interest) from the activity or from the sale of interests in the activity. For the purposes of this section persons who stand to receive financial gain from the activity include persons who receive compensation for services rendered in connection with the organization or operation of the activity or for the sale of interests in the activity. Such a person will generally include the promoter of the activity who organizes the activity or solicits potential investors in the activity.

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

Example. A is the promoter of an activity described in section 465(c)(1). As the promoter, A organizes the activity and solicits potential investors. For these services A is paid a flat fee of $130x. This fee is paid out of the amounts contributed by the investors to the activity. X, one of the investors in the activity, borrows money from A for use in the activity. X is not personally liable for repayment to A of the amount borrowed. As security for the loan, X pledges an asset which does not have a readily ascertainable fair market value. A is considered a person with an interest in the activity other than that of a creditor with respect to this loan because the asset pledged as security does not have a readily ascertainable fair market value, X is not personally liable for repayment of the loan, and A received financial gain from the activity. Accordingly, X's amount at risk in the activity is not increased despite the fact that property was pledged as security.

(e) *Effective date.* This section applies to amounts borrowed after May 3, 2004.

[T.D. 9124, 69 FR 24079, May 3, 2004; 69 FR 26305, May 12, 2004]

§ 1.465–20 Treatment of amounts borrowed from certain persons and amounts protected against loss.

(a) *General rule.* The following amounts are treated in the same manner as borrowed amounts for which the taxpayer has no personal liability and for which no security is pledged—

(1) Amounts that do not increase the taxpayer's amount at risk because they are borrowed from a person who has an interest in the activity other than that of a creditor or from a person who is related to a person (other than the taxpayer) who has an interest in the activity other than that of a creditor; and

(2) Amounts (whether or not borrowed) that are protected against loss.

(b) *Interest other than that of a creditor; cross reference. See* § 1.465–8 for additional rules relating to amounts borrowed from a person who has an interest in the activity other than that of a creditor or is related to a person (other than the taxpayer) who has an interest in the activity other than that of a creditor.

(c) *Amounts protected against loss; cross reference. See* § 1.465–6 for rules relating to amounts protected against loss.

(d) *Effective date.* This section applies to amounts borrowed after May 3, 2004.

[T.D. 9124, 69 FR 24079, May 3, 2004]

§ 1.465–27 Qualified nonrecourse financing.

(a) *In general.* Notwithstanding any provision of section 465(b) or the regulations under section 465(b), for an activity of holding real property, a taxpayer is considered at risk for the taxpayer's share of any qualified nonrecourse financing which is secured by real property used in such activity.

(b) *Qualified nonrecourse financing secured by real property*—(1) *In general.* For purposes of section 465(b)(6) and this section, the term *qualified nonrecourse financing* means any financing—

(i) Which is borrowed by the taxpayer with respect to the activity of holding real property;

(ii) Which is borrowed by the taxpayer from a qualified person or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government;

(iii) For which no person is personally liable for repayment, taking into account paragraphs (b)(3), (4), and (5) of this section; and

(iv) Which is not convertible debt.

(2) *Security for qualified nonrecourse financing*—(i) *Types of property.* For a taxpayer to be considered at risk under section 465(b)(6), qualified nonrecourse financing must be secured only by real property used in the activity of holding real property. For this purpose, however, property that is incidental to the activity of holding real property will be disregarded. In addition, for this purpose, property that is neither real property used in the activity of holding real property nor incidental property will be disregarded if the aggregate gross fair market value of such property is less than 10 percent of the aggregate gross fair market value of all the property securing the financing.

(ii) *Look-through rule for partnerships.* For purposes of paragraph (b)(2)(i) of this section, a borrower shall be treated as owning directly its proportional share of the assets in a partnership in which the borrower owns (directly or indirectly through a chain of partnerships) an equity interest.

(3) *Personal liability; partial liability.* If one or more persons are personally liable for repayment of a portion of a financing, the portion of the financing for which no person is personally liable may qualify as qualified nonrecourse financing.

(4) *Partnership liability.* For purposes of section 465(b)(6) and this paragraph (b), the personal liability of any partnership for repayment of a financing is disregarded and, provided the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, the financing will be treated as qualified nonrecourse financing secured by real property if—

(i) The only persons personally liable to repay the financing are partnerships;

(ii) Each partnership with personal liability holds only property described in paragraph (b)(2)(i) of this section (applying the principles of paragraph (b)(2)(ii) of this section in determining the property held by each partnership); and

(iii) In exercising its remedies to collect on the financing in a default or default-like situation, the lender may proceed only against property that is described in paragraph (b)(2)(i) of this section and that is held by the partnership or partnerships (applying the principles of paragraph (b)(2)(ii) of this section in determining the property held by the partnership or partnerships).

(5) *Disregarded entities.* Principles similar to those described in paragraph (b)(4) of this section shall apply in determining whether a financing of an entity that is disregarded for federal tax purposes under §301.7701–3 of this chapter is treated as qualified nonrecourse financing secured by real property.

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

Example 1. Personal liability of a partnership; incidental property. (i) X is a limited liability company that is classified as a partnership for federal tax purposes. X engages only in the activity of holding real property. In addition to real property used in the activity of holding real property, X owns office equipment, a truck, and maintenance equipment that it uses to support the activity of holding real property. X borrows $500 to use in the activity. X is personally liable on the financing, but no member of X and no other person is liable for repayment of the financing under local law. The lender may proceed against all of X's assets if X defaults on the financing.

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

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

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

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

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

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

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

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

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

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

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

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

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

(i) The lesser of:

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

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

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

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

(2) *Costs not deductible under section 466.* The term "redemption cost" includes only the amounts stated in

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

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

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

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

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

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

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

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

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

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

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

(3) *Coupons received.* The deduction provided for in section 466(a)(1) is limited to the redemption costs associated with coupons that are actually received by the taxpayer within the redemption period. For purposes of this paragraph, if the issuer uses a redemption agent or clearinghouse to group, count, and verify coupons after they have been redeemed by a retailer, the

coupons received by the redemption agent or clearinghouse will be considered to have been received by the issuer. Nothing in section 466, however, allows deductions to be made on the basis of estimated redemptions, whether such estimates are made by either the issuer or some other party.

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

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

(3) *Suspense account*—(i) *In general.* In the case of a transitional adjustment that would result in a net decrease in taxable income under section 481(a)(2) for the year of change, in lieu of applying section 481, the taxpayer must establish a separate suspense account for each trade or business for which the taxpayer has made an election to use section 466. The computation of the initial opening balance in the suspense account is described in paragraph (e)(3)(ii)(A) of this section. An initial adjustment to gross income for the year of election is described in 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, and gross income adjustments are described in paragraph (e)(3)(iii)(B) of this section. Examples are provided in paragraph (e)(4) of this section. The effect of the suspense account is to defer some part of, or all of, the deduction of the transitional adjustment until the taxpayer no longer redeems discount coupons in connection with the trade or business to which the suspense account relates.

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

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

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

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

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

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

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

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

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

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

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

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

(f) *Subchapter C transactions*—(1) *General rule*. If a transfer of substantially all the assets of a trade or business in which discount coupons are redeemed is made to an acquiring corporation, and if the acquiring corporation determines its bases in these assets, in whole or part, with reference to the basis of these assets in the hands of the transferor, then for the purposes of section 466(e) the principles of section 381 and §1.381(c)(4)–1 will apply. The application of this rule is not limited to the transactions described in section 381(a). Thus, the rule also applies, for example, to transactions described in section 351.

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

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

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

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

§ 1.466–2 Special protective election for certain taxpayers.

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

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

(1) For a continuous period of one or more prior taxable years, (the last year of which ends before Jan. 1, 1979), the taxpayer must have used a method of accounting for discount coupons that is reasonably similar to the method provided in § 1.451–4 or its predecessors under the Internal Revenue Code of 1954;

(2) The taxpayer must make an election under section 466 of the Internal Revenue Code of 1954 according to the rules contained in § 1.466–3 for its first taxable year ending after December 31, 1978; and

(3) The taxpayer must make an election under section 373(c) of the Revenue Act of 1978 according to the rules contained in § 1.466–4 for its first taxable year ending after December 31, 1978.

(c) *Amount to be subtracted from gross receipts.* The amount the taxpayer may subtract under this section for the redemption costs of coupons shall include only:

(1) Costs of the type permitted by § 1.451–4 to be included in the estimated average cost of redeeming coupons, plus

(2) Any amount designated or referred to on the coupon payable by the taxpayer to the person who allowed the discount on a sale by such person to the user of the coupon.

Nothing in this paragraph shall allow an item to be deducted more than once.

(d) *Right to amend prior tax returns.* This paragraph applies only to those taxpayers who have agreed in a prior year to discontinue the use of the method of accounting described in § 1.451–4 for discount coupon redemptions. If the taxpayer used such method of accounting on the original return filed for the prior taxable year, and if any such year is not closed under the statute of limitations or by reason of a closing agreement with the Internal Revenue Service, a taxpayer who has made a protective election may file an amended return and a claim for refund for such years. In this amended return, the taxpayer should account for its discount coupon redemptions, according to the method of accounting described in § 1.451–4. This is not to be construed, however, to abrogate in any way the rules regarding the close of taxable years due to the statute of limitations or a binding closing agreement between the Internal Revenue Service and the taxpayer.

(e) *Suspense account not required.* If the following three conditions are satisfied, the taxpayer need not establish the suspense account otherwise required by section 466(e). First, the taxpayer must make a timely election under these rules to protect prior years. Second, the method of accounting used in those years must have been used for all discount coupons issued by the taxpayer in those years in all the taxpayer's separate trades or businesses in which coupons were issued. Third, either before or after an amendment to the taxpayer's tax returns as described in paragraph (d) of this section, a method of accounting reasonably similar to the method of accounting described in §1.451–4 must have been used for the taxable year ending on or before December 31, 1978. If these conditions are met, the taxpayer will treat the election of the method under section 466 as a change in method of accounting to which the rules in section 481 and the regulations thereunder apply.

(f) *Definition: reasonably similar.* For purposes of paragraphs (b)(1) and (e) of this section, a taxpayer will be considered to have used a method of accounting for discount coupons that is ''reasonably similar'' to the method of accounting provided in §1.451–4 if the taxpayer followed the method of accounting described in §1.451–4 as if that method were a valid method of accounting for discount coupon redemptions.

[T.D. 8022, 50 FR 18476, May 1, 1985]

§ 1.466–3 Manner of and time for making election under section 466.

(a) *In general.* Section 466 provides a special method of accounting for accrual basis taxpayers who issue qualified discount coupons (as defined in section 466(b)). In order to use the special method under section 466, a taxpayer must make an election with respect to the trade or business in connection with which the qualified discount coupons are issued. If a taxpayer issues qualified discount coupons in connection with more than one trade or business, the taxpayer may use the special method of accounting under section 466 only with respect to the qualified discount coupons issued in connection with a trade or business for which an election is made. The election must be made in the manner prescribed in this section. The election does not require the prior consent of the Internal Revenue Service. An election under section 466 is effective for the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the prior consent of the Internal Revenue Service to revoke such election.

(b) *Manner of and time for making election*—(1) *General rule.* Except as provided in paragraph (b)(2) of this section, an election is made under section 466 and this section by filing a statement of election containing the information described in paragraph (c) of this section with the taxpayer's income tax return for the taxpayer's first taxable year for which the election is made. The election must be made not later than the time prescribed by law (including extensions thereof) for filing the income tax return for the first taxable year for which the election is made. Thus, the election may not be made for a taxable year by filing an amended income tax return after the time prescribed (including extensions) for filing the original return for such year.

(2) *Transitional rule.* If the last day of the time prescribed by law (including extensions thereof) for filing a taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978, falls before December 3, 1979, and the taxpayer does not make an election under section 466 with respect to such taxable year in the manner prescribed by paragraph (b)(1) of this section, an election is made under section 466 and this section with respect to such taxable year if—

(i) Within the time prescribed by law (including extensions thereof) for filing the taxpayer's income tax return for such taxable year, the taxpayer has made a reasonable effort to notify the Commissioner of the taxpayer's intent to make an election under section 466 with respect to such taxable year, and

(ii) Before January 2, 1980, the taxpayer files a statement of election containing the information described in paragraph (c) of this section to be associated with the taxpayer's income tax return for such taxable year.

For purposes of paragraph (b)(2)(i) of this section, a reasonable effort to notify the Commissioner of an intent to make an election under section 466 with respect to a taxable year includes the timely filing of an income tax return for such taxable year if the taxable income reported on the return reflects a deduction for the redemption costs of qualified discount coupons as determined under section 466(a).

(c) *Required information.* The statement of election required by paragraph (b) of this section must indicate that the taxpayer (identified by name, address, and taxpayer identification number) is making an election under section 466 and must set forth the following information:

(1) A description of each trade or business for which the election is made;

(2) The first taxable year for which the election is made;

(3) The redemption period (as defined in section 466(c)(2)) for each trade or business for which the election is made;

(4) If the taxpayer is required to establish a suspense account under section 466(e) for a trade or business for which the election is made, the initial opening balance of such account (as defined in section 466(e)(2)) for each such trade or business; and

(5) In the case of an election under section 466 that results in a net increase in taxable income under section 481(a)(2), the amount of such net increase.

The statement of election should be made on a Form 3115, which need contain no information other than that required by this paragraph or paragraph (c) of §1.466–4.

[T.D. 8022, 50 FR 18477, May 1, 1985]

§1.466–4 Manner of and time for making election under section 373(c) of the Revenue Act of 1978.

(a) *In general.* Section 373(c)(2) of the Revenue Act of 1978 (92 Stat. 2865) provides an election for taxpayers who satisfy the requirements of section 373(c)(2)(A) (i) and (ii) of the Act. The election is made with respect to a method of accounting for the redemption costs of discount coupons used by the electing taxpayer in a continuous period of one or more taxable years ending before January 1, 1979. The election must be made in the manner prescribed by this section. The election does not require the prior consent of the Internal Revenue Service.

(b) *Manner of and time for making election*—(1) *General rule.* Except as provided in paragraph (b)(2) of this section, the election under section 373(c) of the Revenue Act of 1978 is made by filing a statement of election containing the information described in paragraph (c) of this section with the taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978. The election must be made not later than the time prescribed by law (including extensions thereof) for filing the income tax return for the taxpayer's first taxable year ending after December 31, 1978. Thus, the election may not be made with an amended income tax return for such year filed after the time prescribed (including extensions) for filing the original return.

(2) *Transitional rule.* If the last day of the time prescribed by law (including extensions thereof) for filing a taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978, falls before December 3, 1979, and the taxpayer does not make an election in the manner prescribed by paragraph (b)(1) of this section, an election is made under section 373(c) of the Act and this section with respect to a continuous period if—

(i) Within the time prescribed by law (including extensions thereof) for filing the taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978, the taxpayer has made a reasonable effort to notify the Commissioner of the taxpayer's intent to make election under section 373(c) of the Act with respect to the continuous period, and

(ii) Before January 2, 1980, the taxpayer files a statement of election containing the information described in paragraph (c) of this section to be associated with the taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978.

(c) *Required information.* The statement of election required by paragraph (b) of this section must indicate that the taxpayer (identified by name, address, and taxpayer identification number) is making an election under section 373(c) of the Revenue Act of 1978 and must set forth the taxable years in the continuous period for which the election is made. The statement of election should be made on the same form 3115 on which the taxpayer has made a statement of election under section 466. The Form 3115 need contain no information other than that required by this paragraph or paragraph (c) of §1466–3.

[T.D. 8022, 50 FR 18478, May 1, 1985]

§ 1.467–0 Table of contents.

This section lists the captions that appear in §§1.467–1 through 1.467–9.

(1) In general.
(2) Section 467 rental agreements that provide for a variable rate of interest.
(d) Present value.
(e) Applicable Federal rate.
(1) In general.
(2) Source of applicable Federal rates.
(3) 110 percent of applicable Federal rate.
(4) Term of the section 467 rental agreement.
(i) In general.
(ii) Section 467 rental agreements with variable interest.
(f) Examples.

§ 1.467–3 Disqualified leasebacks and long-term agreements.

(a) General rule.
(b) Disqualified leaseback or long-term agreement.
(1) In general.
(2) Leaseback.
(3) Long-term agreement.
(i) In general.
(ii) Statutory recovery period.
(A) In general.
(B) Special rule for rental agreements relating to properties having different statutory recovery periods.
(c) Tax avoidance as principal purpose for increasing or decreasing rent.
(1) In general.
(2) Tax avoidance.
(i) In general.
(ii) Significant difference in tax rates.
(iii) Special circumstances.
(3) Safe harbors.
(4) Uneven rent test.
(i) In general.
(ii) Special rule for real estate.
(iii) Operating rules.
(d) Calculating constant rental amount.
(1) In general.
(2) Initial or final short periods.
(3) Method to determine constant rental amount; no short periods.
(i) Step 1.
(ii) Step 2.
(iii) Step 3.
(e) Examples.

§ 1.467–4 Section 467 loan.

(a) In general.
(1) Overview.
(2) No section 467 loan in the case of certain section 467 rental agreements.
(3) Rental agreements subject to constant rental accrual.
(4) Special rule in applying the provisions of § 1.467–7 (e), (f), or (g).
(b) Principal balance.
(1) In general.
(2) Section 467 rental agreements that provide for prepaid fixed rent and adequate interest.
(3) Timing of payments.
(c) Yield.
(1) In general.
(i) Method of determining yield.
(ii) Method of stating yield.
(iii) Rounding adjustments.
(2) Yield of section 467 rental agreements for which constant rental amount or proportional rental amount is computed.
(3) Yield for purposes of applying paragraph (a)(4) of this section.
(4) Determination of present values.
(d) Contingent payments.
(e) Section 467 rental agreements that call for payments before or after the lease term.
(f) Examples.

§ 1.467–5 Section 467 rental agreements with variable interest.

(a) Variable interest on deferred or prepaid rent.
(1) In general.
(2) Exceptions.
(b) Variable rate treated as fixed.
(1) In general.
(2) Variable interest adjustment amount.
(i) In general.
(ii) Positive or negative adjustment.
(3) Section 467 loan balance.
(c) Examples.

§ 1.467–6 Section 467 rental agreements with contingent payments. [Reserved]

§ 1.467–7 Section 467 recapture and other rules relating to dispositions and modifications.

(a) Section 467 recapture.
(b) Recapture amount.
(1) In general.
(2) Prior understated inclusion.
(3) Section 467 gain.
(i) In general.
(ii) Certain dispositions.
(c) Special rules.
(1) Gifts.
(2) Dispositions at death.
(3) Certain tax-free exchanges.
(i) In general.
(ii) Dispositions covered.
(A) In general.
(B) Transfers to certain tax-exempt organizations.
(4) Dispositions by transferee.
(5) Like-kind exchanges and involuntary conversions.
(6) Installment sales.
(7) Dispositions covered by section 170(e), 341(e)(12), or 751(c).
(d) Examples.
(e) Other rules relating to dispositions.
(1) In general.
(2) Treatment of section 467 loan.
(3) [Reserved]
(4) Examples.
(f) Treatment of assignments by lessee and lessee-financed renewals.
(1) Substitute lessee use.
(2) Treatment of section 467 loan.

[T.D. 8820, 64 FR 26851, May 18, 1999, as amended by T.D. 8917, 66 FR 1039, Jan. 5, 2001]

§ 1.467–1 Treatment of lessors and lessees generally.

(a) *Overview*—(1) *In general.* When applicable, section 467 requires a lessor and lessee of tangible property to treat rents consistently and to use the accrual method of accounting (and time value of money principles) regardless of their overall method of accounting. In addition, in certain cases involving tax avoidance, the lessor and lessee must take rent and stated or imputed interest into account under a constant rental accrual method, pursuant to which the rent is treated as accruing ratably over the entire lease term.

(2) *Cases in which rules are inapplicable.* Section 467 applies only to leases (or other similar arrangements) that constitute section 467 rental agreements as defined in paragraph (c) of this section. For example, a rental agreement is not a section 467 rental agreement, and, therefore, is not subject to the provisions of this section and §§ 1.467–2 through 1.467–9 (the section 467 regulations), if it specifies equal amounts of rent for each month throughout the lease term and all payments of rent are due in the calendar year to which the rent relates (or in the preceding or succeeding calendar year). In addition, the section 467 regulations do not apply to a rental agreement that requires total rents of $250,000 or less. For purposes of determining whether the agreement has total rents of $250,000 or less, certain specified contingent rent is disregarded.

(3) *Summary of rules*—(i) *Basic rules.* Paragraph (c) of this section provides rules for determining whether a rental agreement is a section 467 rental agreement. Paragraphs (d) and (e) of this section provide rules for determining the amount of rent and interest, respectively, required to be taken into account by a lessor and lessee under a section 467 rental agreement. Paragraphs (f) through (h) and (j) of this section provide various definitions and special rules relating to the application of the section 467 regulations. Paragraph (i) of this section is reserved.

(ii) *Special rules.* Section 1.467–2 provides rules for section 467 rental agreements that have deferred or prepaid rents without providing for adequate interest. Section 1.467–3 provides rules for application of the constant rental accrual method, including criteria for determining whether an agreement is subject to this method. Section 1.467–4 provides rules for establishing and adjusting a section 467 loan (the amount that a lessor is deemed to have loaned to the lessee, or vice versa, pursuant to the application of the section 467 regulations). Section 1.467–5 provides rules for applying the section 467 regulations where a rental agreement requires payments of interest at a variable rate. Section 1.467–6, relating to the treatment of certain section 467 rental agreements with contingent payments, is reserved. Section 1.467–7 provides rules for the treatment of dispositions by a lessor of property subject to a section 467 rental agreement and the treatment of assignments by lessees and certain lessee-financed renewals of a section 467 rental agreement. Section 1.467–7 also provides rules for the treatment of modified rental agreements. Section 1.467–8 provides special transitional rules relating to the method of accounting for certain rental agreements entered into on or before May 18, 1999. Finally, §1.467–9 provides the effective date rules for the section 467 regulations.

(4) *Scope of rules.* No inference should be drawn from any provision of this section or §§1.467–2 through 1.467–9 concerning whether—

(i) For Federal tax purposes, an arrangement constitutes a lease; or

(ii) For Federal tax purposes, any obligation of the lessee under a rental agreement is treated as rent.

(5) *Application of other authorities.* Notwithstanding section 467 and the regulations thereunder, other authorities such as section 446(b) clear-reflection-of-income principles, section 482, and the substance-over-form doctrine, may be applied by the Commissioner to determine the income and expense from a rental agreement (including the proper allocation of fixed rent under a rental agreement).

(b) *Method of accounting for section 467 rental agreements.* If a rental agreement is a section 467 rental agreement, as described in paragraph (c) of this section, the lessor and lessee must each take into account for any taxable year the sum of—

(1) The section 467 rent for the taxable year (as defined in paragraph (d) of this section); and

(2) The section 467 interest for the taxable year (as defined in paragraph (e) of this section).

(c) *Section 467 rental agreements*—(1) *In general.* Except as otherwise provided in paragraph (c)(4) of this section, the term *section 467 rental agreement* means a rental agreement, as defined in paragraph (h)(12) of this section, that has increasing or decreasing rents (as described in paragraph (c)(2) of this section), or deferred or prepaid rents (as described in paragraph (c)(3) of this section).

(2) *Increasing or decreasing rent*—(i) *Fixed rent*—(A) *In general.* A rental agreement has increasing or decreasing rent if the annualized fixed rent, as described in paragraph (j)(3) of this section, allocated to any rental period exceeds the annualized fixed rent allocated to any other rental period in the lease term.

(B) *Certain rent holidays disregarded.* Notwithstanding the provisions of paragraph (c)(2)(i)(A) of this section, a rental agreement does not have increasing or decreasing rent if the increasing or decreasing rent is solely attributable to a rent holiday provision allowing reduced rent (or no rent) for a period of three months or less at the beginning of the lease term.

(ii) *Fixed rent allocated to a rental period*—(A) *Specific allocation*—(*1*) *In general.* If a rental agreement provides a specific allocation of fixed rent, as described in paragraph (c)(2)(ii)(A)(*2*) of this section, the amount of fixed rent allocated to each rental period during the lease term is the amount of fixed rent allocated to that period by the rental agreement.

(*2*) *Rental agreements specifically allocating fixed rent.* A rental agreement specifically allocates fixed rent if the rental agreement unambiguously specifies, for periods no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of the use of the property during that period, and the total amount of fixed rent specified is equal to the total amount of fixed rent payable under the lease. For example, a rental agreement providing that rent is $100,000 per calendar year, and providing for total payments of fixed rent equal to the total amount specified, specifically allocates rent. A rental agreement stating only when rent is payable does not specifically allocate rent.

(B) *No specific allocation.* If a rental agreement does not provide a specific allocation of fixed rent (for example, because the total amount of fixed rent specified is not equal to the total amount of fixed rent payable under the lease), the amount of fixed rent allocated to a rental period is the amount of fixed rent payable during that rental period. If an amount of fixed rent is payable before the beginning of the lease term, it is allocated to the first rental period in the lease term. If an amount of fixed rent is payable after the end of the lease term, it is allocated to the last rental period in the lease term.

(iii) *Contingent rent*—(A) *In general.* A rental agreement has increasing or decreasing rent if it requires (or may require) the payment of contingent rent (as defined in paragraph (h)(2) of this section), other than contingent rent described in paragraph (c)(2)(iii)(B) of this section.

(B) *Certain contingent rent disregarded.* For purposes of this paragraph (c)(2)(iii), rent is disregarded to the extent it is contingent as the result of one or more of the following provisions—

(*1*) A qualified percentage rents provision, as defined in paragraph (h)(8) of this section;

(*2*) An adjustment based on a reasonable price index, as defined in paragraph (h)(10) of this section;

(*3*) A provision requiring the lessee to pay third-party costs, as defined in paragraph (h)(15) of this section;

(*4*) A provision requiring the payment of late payment charges, as defined in paragraph (h)(4) of this section;

(*5*) A loss payment provision, as defined in paragraph (h)(7) of this section;

(*6*) A qualified TRAC provision, as defined in paragraph (h)(9) of this section;

(*7*) A residual condition provision, as defined in paragraph (h)(13) of this section;

(*8*) A tax indemnity provision, as defined in paragraph (h)(14) of this section;

(*9*) A variable interest rate provision, as defined in paragraph (h)(16) of this section; or

(*10*) Any other provision provided in regulations or other published guidance issued by the Commissioner, but only if the provision is designated as contingent rent to be disregarded for purposes of this paragraph (c)(2)(iii).

(3) *Deferred or prepaid rent*—(i) *Deferred rent.* A rental agreement has deferred rent under this paragraph (c)(3) if the cumulative amount of rent allocated as of the close of a calendar year (determined under paragraph (c)(3)(iii) of this section) exceeds the cumulative amount of rent payable as of the close of the succeeding calendar year.

(ii) *Prepaid rent.* A rental agreement has prepaid rent under this paragraph (c)(3) if the cumulative amount of rent payable as of the close of a calendar year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year (determined under paragraph (c)(3)(iii) of this section).

(iii) *Rent allocated to a calendar year.* For purposes of this paragraph (c)(3), the rent allocated to a calendar year is the sum of—

(A) The fixed rent allocated to any rental period (determined under paragraph (c)(2)(ii) of this section) that begins and ends in the calendar year;

(B) A ratable portion of the fixed rent allocated to any other rental period that begins or ends in the calendar year; and (C) Any contingent rent that accrues during the calendar year.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(3):

Example 1. (i) A and B enter into a rental agreement that provides for the lease of property to begin on January 1, 2000, and end on December 31, 2003. The rental agreement provides that rent of $100,000 accrues during each year of the lease term. Under the rental agreement, no rent is payable during calendar year 2000, a payment of $100,000 is to be made on December 31, 2001, and December 31, 2002, and a payment of $200,000 is to be made on December 31, 2003. A and B both select the calendar year as their rental period. Thus, the amount of rent allocated to each rental period under paragraph (c)(2)(ii) of this section is $100,000. Therefore, the rental agreement does not have increasing or decreasing rent as described in paragraph (c)(2)(i) of this section.

(ii) Under paragraph (c)(3)(i) of this section, a rental agreement has deferred rent if, at the close of a calendar year, the cumulative amount of rent allocated under paragraph (c)(3)(iii) of this section exceeds the cumulative amount of rent payable as of the close of the succeeding year. In this example, there is no deferred rent: the rent allocated to 2000 ($100,000) does not exceed the cumulative rent payable as of December 31, 2001 ($100,000); the rent allocated to 2001 and preceding years ($200,000) does not exceed the cumulative rent payable as of December 31, 2002 ($200,000); the rent allocated to 2002 and preceding years ($300,000) does not exceed the cumulative rent payable as of December 31, 2003 ($400,000); and the rent allocated to 2003 and preceding years ($400,000) does not exceed the cumulative rent payable as of December 31, 2004 ($400,000). Therefore, because the rental agreement does not have increasing or decreasing rent and does not have deferred or prepaid rent, the rental agreement is not a section 467 rental agreement.

Example 2. (i) A and B enter into a rental agreement that provides for a 10-year lease of personal property, beginning on January 1, 2000, and ending on December 31, 2009. The rental agreement provides for accruals of rent of $10,000 during each month of the lease term. Under paragraph (c)(3)(iii) of this section, $120,000 is allocated to each calendar year. The rental agreement provides for a $1,200,000 payment on December 31, 2000.

(ii) The rental agreement does not have increasing or decreasing rent as described in paragraph (c)(2)(i) of this section. The rental agreement, however, provides prepaid rent under paragraph (c)(3)(ii) of this section because the cumulative amount of rent payable as of the close of a calendar year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year. For example, the cumulative amount of rent payable as of the close of 2000 ($1,200,000 is payable on December 31, 2000) exceeds the cumulative amount of rent allocated as of the close of 2001, the succeeding calendar year ($240,000). Accordingly, the rental agreement is a section 467 rental agreement.

(4) *Rental agreements involving total payments of $250,000 or less*—(i) *In general.* A rental agreement is not a section 467 rental agreement if, as of the agreement date (as defined in paragraph (h)(1) of this section), it is not reasonably expected that the sum of the aggregate amount of rental payments under the rental agreement and the aggregate value of all other consideration to be received for the use of property (taking into account any payments of contingent rent, and any other contingent consideration) will exceed $250,000.

(ii) *Special rules in computing amount described in paragraph (c)(4)(i) of this section of this section.* The following rules apply in determining the amount described in paragraph (c)(4)(i) of this section:

(A) Stated interest on deferred rent is not taken into account. However, the Commissioner may recharacterize a portion of stated interest as additional rent if a rental agreement provides for interest on deferred rent at a rate that, in light of all of the facts and circumstances, is clearly greater than the arm's-length rate of interest that would have been charged in a lending transaction between the lessor and lessee.

(B) Consideration that does not involve a cash payment is taken into account at its fair market value. A liability that is either assumed or secured by property acquired subject to the liability is taken into account at the sum of its remaining principal amount and accrued interest (if any) thereon or, in the case of an obligation originally issued at a discount, at the sum of its adjusted issue price and accrued qualified stated interest (if any), within the meaning of §1.1273–1(c)(1).

(C) All rental agreements that are part of the same transaction or a series of related transactions involving the same lessee (or any related person) and the same lessor (or any related person) are treated as a single rental agreement. Whether two or more rental agreements are part of the same transaction or a series of related transactions depends on all the facts and circumstances.

(D) If an agreement includes a provision increasing or decreasing rent payable solely as a result of an adjustment based on a reasonable price index, the amount described in paragraph (c)(4)(i) of this section must be determined as if the applicable price index did not change during the lease term.

(E) If an agreement includes a variable interest rate provision (as defined in paragraph (h)(16) of this section), the amount described in paragraph (c)(4)(i) of this section must be determined by using fixed rate substitutes (determined in the same manner as under

§ 1.1275–5(e), treating the agreement date as the issue date) for the variable rates of interest applicable to the lessor's indebtedness.

(F) Contingent rent described in paragraphs (c)(2)(iii)(B)(*3*) through (*8*) of this section is not taken into account.

(d) *Section 467 rent*—(1) *In general.* The section 467 rent for a taxable year is the sum of—

(i) The fixed rent for any rental period (determined under paragraph (d)(2) of this section) that begins and ends in the taxable year;

(ii) A ratable portion of the fixed rent for any other rental period beginning or ending in the taxable year; and

(iii) In the case of a section 467 rental agreement that provides for contingent rent, the contingent rent that accrues during the taxable year.

(2) *Fixed rent for a rental period*—(i) *Constant rental accrual.* In the case of a section 467 rental agreement that is a disqualified leaseback or long-term agreement (as described in § 1.467–3(b)), the fixed rent for a rental period is the constant rental amount (as determined under § 1.467–3(d)).

(ii) *Proportional rental accrual.* In the case of a section 467 rental agreement that is not described in paragraph (d)(2)(i) of this section, and does not provide adequate interest on fixed rent (as determined under § 1.467–2(b)), the fixed rent for a rental period is the proportional rental amount (as determined under § 1.467–2(c)).

(iii) *Section 467 rental agreement accrual.* In the case of a section 467 rental agreement that is not described in either paragraph (d)(2)(i) or (ii) of this section, the fixed rent for a rental period is the amount of fixed rent allocated to the rental period under the rental agreement, as determined under paragraph (c)(2)(ii) of this section.

(e) *Section 467 interest*—(1) *In general.* The section 467 interest for a taxable year is the sum of—

(i) The interest on fixed rent for any rental period that begins and ends in the taxable year;

(ii) A ratable portion of the interest on fixed rent for any other rental period beginning or ending in the taxable year; and

(iii) In the case of a section 467 rental agreement that provides for contingent rent, any interest that accrues on the contingent rent during the taxable year.

(2) *Interest on fixed rent for a rental period*—(i) *In general.* Except as provided in paragraph (e)(2)(ii) of this section and § 1.467–5(b)(1)(ii), the interest on fixed rent for a rental period is equal to the product of—

(A) The principal balance of the section 467 loan (as described in § 1.467–4(b)) at the beginning of the rental period; and

(B) The yield of the section 467 loan (as described in § 1.467–4(c)).

(ii) *Section 467 rental agreements with adequate interest.* Except in the case of a section 467 rental agreement that is a disqualified leaseback or long-term agreement, if a section 467 rental agreement provides adequate interest under § 1.467–2(b)(1)(i) (agreements with no deferred or prepaid rent) or § 1.467–2(b)(1)(ii) (agreements with adequate interest stated at a single fixed rate), the interest on fixed rent for a rental period is the amount of interest provided in the rental agreement for the period.

(3) *Treatment of interest.* If the section 467 interest for a rental period is a positive amount, the lessor has interest income and the lessee has an interest expense. If the section 467 interest for a rental period is a negative amount, the lessee has interest income and the lessor has an interest expense. Section 467 interest is treated as interest for all purposes of the Internal Revenue Code.

(f) *Substantial modification of a rental agreement*—(1) *Treatment as new agreement*—(i) *In general.* If a substantial modification of a rental agreement occurs after June 3, 1996, the post-modification agreement is treated as a new agreement and the date on which the modification occurs is treated as the agreement date in applying section 467 and the regulations thereunder to the post-modification agreement. Thus, for example, the post-modification agreement is treated as a new agreement entered into on the date the modification occurs for purposes of determining whether it is a section 467 rental agreement under this section, whether it is a disqualified leaseback or long-term agreement under § 1.467–3, and whether it is entered into after the applicable effective date in § 1.467–9.

(ii) *Limitation.* In the case of a substantial modification of a rental agreement occurring on or before May 18, 1999, this paragraph (f) applies only if—

(A) The rental agreement was a disqualified leaseback or long-term agreement before the modification and the agreement date, determined without regard to the modification, is after June 3, 1996; or

(B) The post-modification agreement would, after application of the rules in this paragraph (f) (other than the special rule for disqualified agreements in paragraph (f)(4)(iii) of this section), be a disqualified leaseback or long-term agreement.

(2) *Post-modification agreement; in general.* For purposes of determining whether a post-modification agreement is a section 467 rental agreement or a disqualified leaseback or long-term agreement under paragraph (f)(1) of this section, the terms of the post-modification agreement are, except as provided in paragraph (f)(4) of this section, only those terms that provide for rights and obligations relating to post-modification items (within the meaning of paragraph (f)(5)(iv) of this section).

(3) *Other effects of a modification.* For rules relating to amounts that must be taken into account following certain modifications, see § 1.467–7(g).

(4) *Special rules*—(i) *Carryover of character; leasebacks.* If an agreement is a leaseback prior to its modification and the lessee prior to the modification (or a related person) is the lessee after the modification, the post-modification agreement is a leaseback even if the post-modification lessee did not have an interest in the property at any time during the two-year period ending on the date on which the modification occurs.

(ii) *Carryover of character; long-term agreements.* If an agreement is a long-term agreement prior to its modification and the entire agreement (as modified) would be a long-term agreement, the post-modification agreement is a long-term agreement.

(iii) *Carryover of character; disqualified agreements.* If an agreement (as in effect before its modification) is a disqualified leaseback or long-term agreement as the result of a determination (whether occurring before or after the modification) under § 1.467–3(b)(1)(ii) and the post-modification agreement is a section 467 rental agreement (or the entire agreement (as modified) would be a section 467 rental agreement), the post-modification agreement will, notwithstanding its treatment as a new agreement under paragraph (f)(1)(i) of this section, be subject to constant rental accrual unless the Commissioner determines that, because of the absence of tax avoidance potential, the post-modification agreement should not be treated as a disqualified leaseback or long-term agreement.

(iv) *Allocation of rent.* If the entire agreement (as modified) provides a specific allocation of fixed rent, as described in paragraph (c)(2)(ii)(A)(*2*) of this section, the post-modification agreement is treated as an agreement that provides a specific allocation of fixed rent. If the entire agreement (as modified) does not provide a specific allocation of fixed rent, the fixed rent allocated to rental periods during the lease term of the post-modification agreement is determined by applying the rules of paragraph (c)(2)(ii)(B) of this section to the entire agreement (as modified).

(v) *Difference between aggregate rent and interest and aggregate payments*—(A) *In general.* Except as provided in paragraph (f)(4)(v)(B) of this section, a post-modification agreement described in paragraph (f)(4)(v)(C) of this section is treated as a section 467 rental agreement subject to proportional rental accrual (determined under § 1.467–2(c)).

(B) *Constant rental accrual prior to the modification.* A post-modification agreement described in paragraph (f)(4)(v)(C) of this section is treated as a section 467 rental agreement subject to constant rental accrual if—

(*1*) Constant rental accrual is required under paragraph (f)(4)(iii) of this section; or

(*2*) The post-modification agreement involves total payments of more than $250,000 (as described in paragraph (c)(4) of this section), and the Commissioner determines that the post-modification agreement is a disqualified leaseback or long-term agreement.

(C) *Agreements described in this paragraph* (f)(4)(v)(C). A post-modification agreement is described in this paragraph (f)(4)(v)(C) if the aggregate amount of fixed rent and stated interest treated as post-modification items does not equal the aggregate amount of payments treated as post-modification items.

(vi) *Principal purpose of tax avoidance*. If a principal purpose of a substantial modification is to avoid the purpose or intent of section 467 or the regulations thereunder, the Commissioner may treat the entire agreement (as modified) as a single agreement for purposes of section 467 and the regulations thereunder.

(5) *Definitions*. The following definitions apply for purposes of this paragraph (f) and §1.467–7(g):

(i) A *modification* of a rental agreement is any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the lessor or lessee thereunder, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

(ii) A modification is *substantial* only if, based on all of the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically substantial. A modification of a rental agreement will not be treated as substantial solely because it is not described in paragraph (f)(6) of this section.

(iii) A modification *occurs* on the earlier of the first date on which there is a binding contract that substantially sets forth the terms of the modification or the date on which agreement to such terms is otherwise evidenced.

(iv) *Post-modification items* with respect to any modification of a rental agreement are all items (other than pre-modification items) provided under the terms of the entire agreement (as modified).

(v) *Pre-modification items* with respect to any modification of a rental agreement are pre-modification rent, interest thereon, and payments allocable thereto (whether payable before or after the modification.) For this purpose—

(A) Pre-modification rent is rent allocable to periods before the effective date of the modification, but only to the extent such rent is payable under the entire agreement (as modified) at the time such rent was due under the agreement in effect before the modification; and

(B) Pre-modification items are identified by applying payments, in the order payable under the entire agreement (as modified) unless the agreement specifies otherwise, to rent and interest thereon in the order in which amounts accrue.

(vi) The *entire agreement (as modified)* with respect to any modification is the agreement consisting of pre-modification terms providing for rights and obligations that are not affected by the modification and post-modification terms providing for rights and obligations that differ from the rights and obligations under the agreement in effect before the modification. For example, if a 10-year rental agreement that provides for rent of $25,000 per year is modified at the end of the 5th year to provide for rent of $30,000 per year in subsequent years, the entire agreement (as modified) provides for a 10-year lease term and provides for rent of $25,000 per year in years 1 through 5 and rent of $30,000 per year in years 6 through 10. The result would be the same if the modification provided for both the increase in rent and the substitution of a new lessee.

(6) *Safe harbors*. Notwithstanding the provisions of paragraph (f)(5) of this section, a modification of a rental agreement is not a substantial modification if the modification occurs solely as the result of one or more of the following—

(i) The refinancing of any indebtedness incurred by the lessor to acquire the property subject to the rental agreement and secured by such property (or any refinancing thereof) but only if all of the following conditions are met—

(A) Neither the amount, nor the time for payment, of the principal amount of the new indebtedness differs from the amount and time for payment of the remaining principal amount of the refinanced indebtedness, except for de minimis changes;

(B) For each of the remaining rental periods, the rent allocation schedule, the payments of rent and interest, and the amount accrued under section 467 are changed only to the extent necessary to take into account the change in financing costs, and such changes are made pursuant to the terms of the rental agreement in effect before the modification;

(C) The lessor and the lessee are not related persons to each other or to any lender to the lessor with respect to the property (whether under the refinanced indebtedness or the new indebtedness); and

(D) With respect to the indebtedness being refinanced, the lessor was granted a unilateral option (within the meaning of §1.1001–3(c)(3)) by the creditor to repay the refinanced indebtedness, exercisable with or without the lessee's consent;

(ii) A change in the obligation of the lessee to make any of the contingent payments described in paragraphs (c)(2)(iii)(B)(*3*) through (*8*) of this section; or

(iii) A change in the amount of fixed rent allocated to a rental period that, when combined with all previous changes in the amount of fixed rent allocated to the rental period, does not exceed one percent of the fixed rent allocated to that rental period prior to the modification.

(7) *Special rules for certain transfers*—(i) *In general.* For purposes of this paragraph (f), a substitution of a new lessee or a sale, exchange, or other disposition by a lessor of property subject to a rental agreement will not, by itself, be treated as a substantial modification unless a principal purpose of the transaction giving rise to the modification is the avoidance of Federal income tax. In determining whether a principal purpose of the transaction giving rise to the modification is the avoidance of Federal income tax—

(A) The safe harbors and other principles of §1.467–3(c) are taken into account; and

(B) The Commissioner may treat the post-modification agreement as a new agreement or treat the entire agreement (as modified) as a single agreement.

(ii) *Exception.* Notwithstanding the provisions of paragraph (f)(7)(i) of this section, the continuing lessor and the new lessee (in the case of a substitution of a new lessee) or the new lessor and the continuing lessee (in the case of a sale, exchange, or other disposition by a lessor of property subject to a rental agreement) may, in appropriate cases, request the Commissioner to treat the transaction as if it were a substantial modification in order to have the provisions of paragraph (f)(4)(iii) of this section and §1.467–7(g)(1) apply to the transaction.

(g) *Treatment of amounts payable by lessor to lessee*—(1) *Interest.* For purposes of determining present value, any amounts payable by the lessor to the lessee as interest on prepaid rent are treated as negative amounts.

(2) *Other amounts.* [Reserved]

(h) *Meaning of terms.* The following meanings apply for purposes of this section and §§1.467–2 through 1.467–9:

(1) *Agreement date* means the earlier of the lease date or the first date on which there is a binding written contract that substantially sets forth the terms under which the property will be leased.

(2) *Contingent rent* means any rent that is not fixed rent, including any amount reflecting an adjustment based on a reasonable price index (as defined in paragraph (h)(10) of this section) or a variable interest rate provision (as defined in paragraph (h)(16) of this section).

(3) *Fixed rent* means any rent to the extent its amount and the time at which it is required to be paid are fixed and determinable under the terms of the rental agreement as of the lease date. The following rules apply for the purpose of determining the extent to which rent is fixed rent:

(i) The possibility of a breach, default, or other early termination of the rental agreement and any adjustments based on a reasonable price index or a variable interest rate provision are disregarded.

(ii) Rent will not fail to be treated as fixed rent merely because of the possibility of impairment by insolvency, bankruptcy, or other similar circumstances.

(iii) If the lease term (as defined in paragraph (h)(6) of this section) includes one or more periods as to which either the lessor or the lessee has an option to renew or extend the term of the agreement, rent will not fail to be treated as fixed rent merely because the option has not been exercised.

(iv) If the lease term includes one or more periods during which a substitute lessee or lessor may have use of the property, rent will not fail to be treated as fixed rent merely because the contingencies relating to the obligation of the lessee (or a related person) to make payments in the nature of rent have not occurred.

(v) If either the lessor or the lessee has an unconditional option or options, exercisable on one or more dates during the lease term, that, if exercised, require payments of rent to be made under an alternative payment schedule or schedules, the amount of fixed rent and the dates on which such rent is required to be paid are determined on the basis of the payment schedule that, as of the agreement date, is most likely to occur. If payments of rent are made under an alternative payment schedule that differs from the payment schedule assumed in applying the preceding sentence, then, for purposes of paragraph (f) of this section, the rental agreement is treated as having been modified at the time the option to make payments on such alternative schedule is exercised.

(4) *Late payment charge* means any amount required to be paid by the lessee to the lessor as additional compensation for the lessee's failure to make any payment of rent under a rental agreement when due.

(5) *Lease date* means the date on which the lessee first has the right to use of the property that is the subject of the rental agreement.

(6) *Lease term* means the period during which the lessee has use of the property subject to the rental agreement, including any option of the lessor to renew or extend the term of the agreement. An option of the lessee to renew or extend the term of the agreement is included in the lease term only if it is expected, as of the agreement date, that the option will be exercised. For this purpose, a lessee is generally expected to exercise an option if, for example, as of the agreement date the rent for the option period is less than the expected fair market value rental for such period. The lessor's or lessee's determination that an option period is either included in or excluded from the lease term is not binding on the Commissioner. If the lessee (or a related person) agrees that one or both of them will or could be obligated to make payments in the nature of rent (within the meaning of § 1.168(i)–2(b)(2)) for a period when another lessee (the substitute lessee) or the lessor will have use of the property subject to the rental agreement, the Commissioner may, in appropriate cases, treat the period when the substitute lessee or lessor will have use of the property as part of the lease term. See § 1.467–7(f) for special rules applicable to the lessee, substitute lessee, and lessor. This paragraph (h)(6) applies to section 467 rental agreements entered into after March 6, 2001. However, taxpayers may choose to apply this paragraph (h)(6) to any rental agreement that is described in § 1.467–9(a) and is entered into on or before March 6, 2001.

(7) A *loss payment provision* means a provision that requires the lessee to pay the lessor a sum of money (which may be either a stipulated amount or an amount determined by reference to a formula or other objective measure) if the property subject to the rental agreement is lost, stolen, damaged or destroyed, or otherwise rendered unsuitable for any use (other than for scrap purposes).

(8) A *qualified percentage rents provision* means a provision pursuant to which the rent is equal to a fixed percentage of the lessee's receipts or sales (whether or not receipts or sales are adjusted for returned merchandise or Federal, state, or local sales taxes), but only if the percentage does not vary throughout the lease term. A provision will not fail to be treated as a qualified percentage rents provision solely by reason of one or more of the following additional terms:

(i) Differing percentages of receipts or sales apply to different departments or separate floors of a retail store, but only if the percentage applicable to a particular department or floor does not vary throughout the lease term.

(ii) The percentage is applied to receipts or sales in excess of determinable dollar amounts, but only if the determinable dollar amounts are fixed and do not vary throughout the lease term.

(9) A *qualified TRAC provision* means a terminal rental adjustment clause (as defined in section 7701(h)(3)) contained in a qualified motor vehicle operating agreement (as defined in section 7701(h)(2)), but only if the adjustment to the rental price is based on a reasonable estimate, determined as of any date between the agreement date and the lease date (or, in the event the agreement date is the same as or later than the lease date, determined as of the agreement date), of the fair market value of the motor vehicle (including any trailer) at the end of the lease term.

(10) An adjustment is *based on a reasonable price index* if the adjustment reflects inflation or deflation occurring over a period during the lease term and is determined consistently under a generally recognized index for measuring inflation or deflation (for example, the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U), which is published by the Bureau of Labor Statistics of the Department of Labor). An adjustment will not fail to be treated as one that is based on a reasonable price index merely because the adjustment may be limited to a fixed percentage, but only if the parties reasonably expect, as of any date between the agreement date and the lease date (or, in the event the agreement date is the same as the lease date, as of such date), that the fixed percentage will actually limit the amount of the rent payable during less than 50 percent of the lease term.

(11) For purposes of determining whether a section 467 rental agreement is a leaseback within the meaning of §1.467–3(b)(2), two persons are *related persons* if they are related persons within the meaning of section 465(b)(3)(C). In all other cases, two persons are *related persons* if they either have a relationship to each other that is specified in section 267(b) or section 707(b)(1) or are related entities within the meaning of sections 168(h)(4)(A), (B), or (C).

(12) *Rental agreement* includes any agreement, whether written or oral, that provides for the use of tangible property and is treated as a lease for Federal income tax purposes.

(13) A *residual condition provision* means a provision in a rental agreement that requires a payment to be made by either the lessor or the lessee to the other party based on the difference between the actual condition of the property subject to the agreement, determined as of the expiration of the lease term, and the expected condition of the property at the expiration of the lease term, as set forth in the rental agreement. The amount of any such payment may be determined by reference to any objective measure relating to the use or condition of the property, such as miles, hours or other duration of use, units of production, or similar measure. A provision will be treated as a residual condition provision only if the payment represents compensation for the use of, or wear and tear on, the property in excess of, or below, a standard set forth in the rental agreement, and the standard is reasonably expected, as of any date between the agreement date and the lease date (or, in the event the agreement date is the same as or later than the lease date, as of the agreement date), to be met at the expiration of the lease term.

(14) A *tax indemnity provision* means a provision in a rental agreement that may require the lessee to make one or more payments to the lessor in the event that the Federal, foreign, state, or local income tax consequences actually realized by a lessor from owning the property subject to the rental agreement and leasing it to the lessee differ from the consequences reasonably expected by the lessor, but only if the differences in such consequences result from a misrepresentation, act, or failure to act on the part of the lessee, or any other factor not within the control of the lessor or any related person.

(15) *Third-party costs* include any real estate taxes, insurance premiums,

maintenance costs, and any other costs (excluding a debt service cost) that relate to the leased property and are not within the control of the lessor or lessee or any person related to the lessor or lessee.

(16) A *variable interest rate provision* means a provision in a rental agreement that requires the rent payable by the lessee to the lessor to be adjusted by the dollar amount of changes in the amount of interest payable by the lessor on any indebtedness that was incurred to acquire the property subject to the rental agreement (or any refinancing thereof), but—

(i) Only to the extent the changes are attributable to changes in the interest rate; and

(ii) Only if the indebtedness provides for interest at one or more qualified floating rates (within the meaning of §1.1275–5(b)), or the changes are attributable to a refinancing at a fixed rate or one or more qualified floating rates.

(i) [Reserved]

(j) *Computational rules.* For purposes of this section and §§1.467–2 through 1.467–9, the following rules apply—

(1) *Counting conventions.* Any reasonable counting convention may be used (for example, 30 days per month/360 days per year) to determine the length of a rental period or to perform any computation. Rental periods of the same descriptive length, for example annual, semiannual, quarterly, or monthly, may be treated as being of equal length.

(2) *Conventions regarding timing of rent and payments*—(i) *In general.* For purposes of determining present values and yield only, except as otherwise provided in this section and §§1.467–2 through 1.467–8—

(A) The rent allocated to a rental period is taken into account on the last day of the rental period;

(B) Any amount payable during the first half of the first rental period is treated as payable on the first day of that rental period;

(C) Any amount payable during the first half of any other rental period is treated as payable on the last day of the preceding rental period;

(D) Any amount payable during the second half of a rental period is treated as payable on the last day of the rental period; and

(E) Any amount payable at the midpoint of a rental period is treated, in applying this paragraph (j)(2), as an amount payable during the first half of the rental period.

(ii) *Time amount is payable.* For purposes of this section and §§1.467–2 through 1.467–9, an amount is payable on the last day for timely payment (that is, the last day such amount may be paid without incurring interest, computed at an arm's-length rate, a substantial penalty, or other substantial detriment (such as giving the lessor the right to terminate the agreement, bring an action to enforce payment, or exercise other similar remedies under the terms of the agreement or applicable law)). This paragraph (j)(2)(ii) applies to section 467 rental agreements entered into after March 6, 2001. However, taxpayers may choose to apply this paragraph (j)(2)(ii) to any rental agreement that is described in §1.467–9(a) and is entered into on or before March 6, 2001.

(3) *Annualized fixed rent.* Annualized fixed rent is determined by multiplying the fixed rent allocated to the rental period under paragraph (c)(2)(ii) of this section by the number of periods of the rental period's length in a calendar year. Thus, if the fixed rent allocated to a rental period is $10,000 and the rental period is one month, the annualized fixed rent for that rental period is $120,000 ($10,000 times 12).

(4) *Allocation of fixed rent within a period.* A rental agreement that allocates fixed rent to any period is treated as allocating fixed rent ratably within that period. Thus, if a rental agreement provides that $120,000 is allocated to each calendar year in the lease term, $10,000 of rent is allocated to each calendar month.

(5) *Rental period length.* Except as provided in §1.467–3(d)(1) (relating to agreements for which constant rental accrual is required), rental periods may be of any length, may vary in length, and may be different as between the lessor and the lessee as long as—

(i) The rental periods are one year or less, cover the entire lease term, and do not overlap;

(ii) Each scheduled payment under the rental agreement (other than a payment scheduled to occur before or after the lease term) occurs within 30 days of the beginning or end of a rental period; and

(iii) In the case of a rental agreement that does not provide a specific allocation of fixed rent, the rental periods selected do not cause the agreement to be treated as a section 467 rental agreement unless all alternative rental period schedules would result in such treatment.

[T.D. 8820, 64 FR 26853, May 18, 1999, as amended by T.D. 8917, 66 FR 1039, Jan. 5, 2001]

§ 1.467–2 Rent accrual for section 467 rental agreements without adequate interest.

(a) *Section 467 rental agreements for which proportional rental accrual is required.* Under § 1.467–1(d)(2)(ii), the fixed rent for each rental period is the proportional rental amount, computed under paragraph (c) of this section, if—

(1) The section 467 rental agreement is not a disqualified leaseback or long-term agreement under § 1.467–3(b); and

(2) The section 467 rental agreement does not provide adequate interest on fixed rent under paragraph (b) of this section.

(b) *Adequate interest on fixed rent*—(1) *In general.* A section 467 rental agreement provides adequate interest on fixed rent if, disregarding any contingent rent—

(i) The rental agreement has no deferred or prepaid rent as described in § 1.467–1(c)(3);

(ii) The rental agreement has deferred or prepaid rent, and—

(A) The rental agreement provides interest (the stated rate of interest) on deferred or prepaid fixed rent at a single fixed rate (as defined in § 1.1273–1(c)(1)(iii));

(B) The stated rate of interest on fixed rent is no lower than 110 percent of the applicable Federal rate (as defined in paragraph (e)(3) of this section);

(C) The amount of deferred or prepaid fixed rent on which interest is charged is adjusted at least annually to reflect the amount of deferred or prepaid fixed rent as of a date no earlier than the date of the preceding adjustment and no later than the date of the succeeding adjustment; and

(D) The rental agreement requires interest to be paid or compounded at least annually;

(iii) The rental agreement provides for deferred rent but no prepaid rent, and the sum of the present values (within the meaning of paragraph (d) of this section) of all amounts payable by the lessee as fixed rent (and interest, if any, thereon) is equal to or greater than the sum of the present values of the fixed rent allocated to each rental period; or

(iv) The rental agreement provides for prepaid rent but no deferred rent, and the sum of the present values of all amounts payable by the lessee as fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest, if any, on prepaid fixed rent, is equal to or less than the sum of the present values of the fixed rent allocated to each rental period.

(2) *Section 467 rental agreements that provide for a variable rate of interest.* For purposes of the adequate interest test under paragraph (b)(1) of this section, if a section 467 rental agreement provides for variable interest, the rental agreement is treated as providing for fixed rates of interest on deferred or prepaid fixed rent equal to the fixed rate substitutes (determined in the same manner as under § 1.1275–5(e), treating the agreement date as the issue date) for the variable rates called for by the rental agreement. For purposes of this section, a rental agreement provides for variable interest if all stated interest provided by the agreement is paid or compounded at least annually at a rate or rates that meet the requirements of § 1.1275–5(a)(3)(i)(A) or (B) and (a)(4).

(3) *Agreements with both deferred and prepaid rent.* If an agreement has both deferred and prepaid rent, the agreement provides adequate interest under paragraph (b)(1) of this section if the conditions set forth in paragraph (b)(1)(ii)(A) through (D) of this section are met for both the prepaid and the deferred rent. For purposes of this paragraph (b)(3), an agreement will be considered to meet the condition set forth in paragraph (b)(1)(ii)(A) of this

section if the agreement provides a single fixed rate of interest on the deferred rent and a single fixed rate of interest on the prepaid rent, even if those rates are not the same. This paragraph (b)(3) applies to section 467 rental agreements entered into after March 6, 2001. However, taxpayers may choose to apply this paragraph (b)(3) to any rental agreement that is described in §1.467–9(a) and is entered into on or before March 6, 2001.

(c) *Computation of proportional rental amount*—(1) *In general.* The proportional rental amount for a rental period is the amount of fixed rent allocated to the rental period under §1.467–1(c)(2)(ii), multiplied by a fraction. The numerator of the fraction is the sum of the present values of the amounts payable under the terms of the section 467 rental agreement as fixed rent and interest thereon. The denominator of the fraction is the sum of the present values of the fixed rent allocated to each rental period under the rental agreement.

(2) *Section 467 rental agreements that provide for a variable rate of interest.* To calculate the proportional rental amount for a section 467 rental agreement that provides for a variable rate of interest, see §1.467–5.

(d) *Present value.* For purposes of determining adequate interest under paragraph (b) of this section or the proportional rental amount under paragraph (c) of this section, the present value of any amount is determined using a discount rate equal to 110 percent of the applicable Federal rate. In general, present values are determined as of the first day of the first rental period in the lease term. However, if a section 467 rental agreement calls for payments of fixed rent prior to the lease term, present values are determined as of the first day a fixed rent payment is called for by the agreement. For purposes of the present value determination under paragraph (b)(1)(iv) of this section, the fixed rent allocated to a rental period must be discounted from the first day of the rental period. For other conventions and rules relating to the determination of present value, see §1.467–1(g) and (j).

(e) *Applicable Federal rate*—(1) *In general.* The applicable Federal rate for a section 467 rental agreement is the applicable Federal rate in effect on the agreement date. The *applicable Federal rate* for a rental agreement means—

(i) The Federal short-term rate if the term of the rental agreement is not over 3 years;

(ii) The Federal mid-term rate if the term of the rental agreement is over 3 years but not over 9 years; and

(iii) The Federal long-term rate if the term of the rental agreement is over 9 years.

(2) *Source of applicable Federal rates.* The Internal Revenue Service publishes the applicable Federal rates, based on annual, semiannual, quarterly, and monthly compounding, each month in the Internal Revenue Bulletin (see §601.601(d) of this chapter). However, the applicable Federal rates may be based on any compounding assumption. To convert a rate based on one compounding assumption to an equivalent rate based on a different compounding assumption, see §1.1272–1(j), *Example 1.*

(3) *110 percent of applicable Federal rate.* For purposes of §1.467–1, this section and §§1.467–3 through 1.467–9, 110 percent of the applicable Federal rate means 110 percent of the applicable Federal rate based on semiannual compounding or any rate based on a different compounding assumption that is equivalent to 110 percent of the applicable Federal rate based on semiannual compounding. The Internal Revenue Service publishes 110 percent of the applicable Federal rates, based on annual, semiannual, quarterly, and monthly compounding, each month in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(4) *Term of the section 467 rental agreement*—(i) *In general.* For purposes of determining the applicable Federal rate under this paragraph (e), the term of the section 467 rental agreement includes the lease term, any period before the lease term beginning with the first day an amount of fixed rent is payable under the terms of the rental agreement, and any period after the lease term ending with the last day an amount of fixed rent or interest thereon is payable under the rental agreement.

(ii) *Section 467 rental agreements with variable interest.* If a section 467 rental agreement provides variable interest on deferred or prepaid fixed rent, the term of the rental agreement for purposes of calculating the applicable Federal rate is the longest period between interest rate adjustment dates, or, if the rental agreement provides an initial fixed rate of interest on deferred or prepaid fixed rent, the period between the agreement date and the last day the fixed rate applies, if this period is longer. If, as described in §1.1274–4(c)(2)(ii), the rental agreement provides for a qualified floating rate (as defined in §1.1275–5(b)) that in substance resembles a fixed rate, the applicable Federal rate is determined by reference to the lease term.

(f) *Examples.* The following examples illustrate the application of this section. In each of these examples it is assumed that the rental agreement is not a disqualified leaseback or long-term agreement subject to constant rental accrual. The examples are as follows:

Example 1. (i) C agrees to lease property from D for five years beginning on January 1, 2000, and ending on December 31, 2004. The section 467 rental agreement provides that rent of $100,000 accrues in each calendar year in the lease term and that rent of $500,000 plus $120,000 of interest is payable on December 31, 2004. Assume that the parties select the calendar year as the rental period and that 110 percent of the applicable Federal rate is 10 percent, compounded annually.

(ii) The rental agreement has deferred rent under §1.467–1(c)(3)(i) because the fixed rent allocated to calendar years 2000, 2001, and 2002 is not paid until 2004. In addition, because the rental agreement does not state an interest rate, the rental agreement does not satisfy the requirements of paragraph (b)(1)(ii) of this section.

(iii)(A) Because the rental agreement has deferred fixed rent and no prepaid rent, the agreement has adequate interest only if the present value test provided in paragraph (b)(1)(iii) of this section is met. The present value of all fixed rent and interest payable under the rental agreement is $384,971.22, determined as follows: $\$620{,}000/(1.10)^5 = \$384{,}971.22$. The present value of all fixed rent allocated under the rental agreement (discounting the amount of fixed rent allocated to a rental period from the last day of the rental period) is $379,078.68, determined as follows:

$$\$379{,}078.68 = \$100{,}000 \times \frac{1-(1.10)^{-5}}{.10}$$

(B) The rental agreement provides adequate interest on fixed rent because the present value of the single amount payable under the section 467 rental agreement exceeds the sum of the present values of fixed rent allocated.

(iv) For an example illustrating the computation of the yield on the rental agreement and the allocation of the interest and rent provided for under the rental agreement, see §1.467–4(f), *Example 2.*

Example 2. (i) E and F enter into a section 467 rental agreement for the lease of equipment beginning on January 1, 2000, and ending on December 31, 2004. The rental agreement provides that rent of $100,000 accrues for each calendar month during the lease term. All rent is payable on December 31, 2004, together with interest on accrued rent at a qualified floating rate set at a current value (as defined in §1.1275–5(a)(4)) that is compounded at the end of each calendar month and adjusted at the beginning of each calendar month throughout the lease term. Therefore, the rental agreement provides for variable interest within the meaning of paragraph (b)(2) of this section.

(ii) On the agreement date the qualified floating rate is 7.5 percent, and 110 percent of the applicable Federal rate, as defined in paragraph (e)(3) of this section, based on monthly compounding, is 7 percent. Under paragraph (b)(2) of this section, the fixed rate substitute for the qualified floating rate is 7.5 percent and the agreement is treated as providing for interest at this fixed rate for purposes of determining whether adequate interest is provided under paragraph (b) of this section. Accordingly, the requirements of paragraph (b)(1)(ii) of this section are satisfied, and the rental agreement has adequate interest.

Example 3. (i) X and Y enter into a section 467 rental agreement for the lease of real property beginning on January 1, 2000, and ending on December 31, 2002. The rental agreement provides that rent of $800,000 is allocable to 2000, $1,000,000 is allocable to 2001, and $1,200,000 is allocable to 2002. Under the rental agreement, Y must make a $3,000,000 payment on December 31, 2002. Assume that both X and Y choose the calendar year as the rental period, X and Y are calendar year taxpayers, and 110 percent of the applicable Federal rate is 8.5 percent compounded annually.

(ii) The rental agreement fails to provide adequate interest under paragraph (b)(1) of this section. Therefore, under §1.467–1(d)(2)(ii), the fixed rent for each rental period is the proportional rental amount.

(iii)(A) The proportional rental amount is computed under paragraph (c) of this section. Because the rental agreement does not call for any fixed rent payments prior to the lease term, under paragraph (d) of this section, the present value is determined as of the first day of the first rental period in the lease term. The present value of the single amount payable by the lessee under the rental agreement is computed as follows:

$$\$2,348,724.30 = \frac{\$3,000,000}{(1+.085)^3}$$

(B) The sum of the present values of the fixed rent allocated to each rental period (discounting the fixed rent allocated to a rental period from the last day of such rental period) is computed as follows:

$$\$2,526,272.20 = \frac{\$800,000}{(1+.085)} + \frac{\$1,000,000}{(1+.085)^2} + \frac{\$1,200,000}{(1+.085)^3}$$

(C) Thus, the fraction for determining the proportional rental amount is .9297194 ($2,348,724.30/$2,526,272.20). The section 467 interest for each of the taxable years within the lease term is computed and taken into account as provided in §1.467–4. The section 467 rent for each of the taxable years within the lease term is as follows:

Taxable year	Section 467 rent
2000	$743,775.52 ($ 800,000 × .9297194).
2001	929,719.40 ($1,000,000 × .9297194).
2002	1,115,663.28 ($1,200,000 × .9297194).

[T.D. 8820, 64 FR 26859, May 18, 1999, as amended by T.D. 8917, 66 FR 1040, Jan. 5, 2001]

§ 1.467–3 Disqualified leasebacks and long-term agreements.

(a) *General rule.* Under §1.467–1(d)(2)(i), constant rental accrual (as described under paragraph (d) of this section) must be used to determine the fixed rent for each rental period in the lease term if the section 467 rental agreement is a disqualified leaseback or long-term agreement within the meaning of paragraph (b) of this section. Constant rental accrual may not be used in the absence of a determination by the Commissioner, pursuant to paragraph (b)(1)(ii) of this section, that the rental agreement is disqualified. Such determination may be made either on a case-by-case basis or in regulations or other guidance published by the Commissioner (see §601.601(d)(2) of this chapter) providing that a certain type or class of leaseback or long-term agreement will be treated as disqualified and subject to constant rental accrual.

(b) *Disqualified leaseback or long-term agreement*—(1) *In general.* A leaseback (as defined in paragraph (b)(2) of this section) or a long-term agreement (as defined in paragraph (b)(3) of this section) is disqualified only if—

(i) A principal purpose for providing increasing or decreasing rent is the avoidance of Federal income tax (as described in paragraph (c) of this section);

(ii) The Commissioner determines that, because of the tax avoidance purpose, the agreement should be treated as a disqualified leaseback or long-term agreement; and

(iii) For section 467 rental agreements entered into before July 19, 1999, the amount determined with respect to the rental agreement under §1.467–1(c)(4) (relating to the exception for rental agreements involving total payments of $250,000 or less) exceeds $2,000,000.

(2) *Leaseback.* A section 467 rental agreement is a leaseback if the lessee (or a related person) had any interest (other than a de minimis interest) in the property at any time during the two-year period ending on the agreement date. For this purpose, interests in property include options and agreements to purchase the property (whether or not the lessee or related person was considered the owner of the property for Federal income tax purposes) and, in the case of subleased property, any interest as a sublessor.

(3) *Long-term agreement*—(i) *In general.* A section 467 rental agreement is a long-term agreement if the lease term exceeds 75 percent of the property's statutory recovery period.

(ii) *Statutory recovery period*—(A) *In general.* The term statutory recovery period means—

(*1*) In the case of property depreciable under section 168, the applicable period determined under section 467(e)(3)(A);

(*2*) In the case of land, 19 years; and

(*3*) In the case of any other tangible property, the period that would apply under section 467(e)(3)(A) if the property were property to which section 168 applied.

(B) *Special rule for rental agreements relating to properties having different statutory recovery periods.* In the case of a rental agreement relating to two or more related properties that have different statutory recovery periods, the statutory recovery period for purposes of paragraph (b)(3)(ii)(A) of this section is the weighted average, based on the fair market values of the properties on the agreement date, of the statutory recovery periods of each of the properties.

(c) *Tax avoidance as principal purpose for increasing or decreasing rent*—(1) *In general.* In determining whether a principal purpose for providing increasing or decreasing rent is the avoidance of Federal income tax, all relevant facts and circumstances are taken into account. However, an agreement will not be treated as a disqualified leaseback or long-term agreement if either of the safe harbors set forth in paragraph (c)(3) of this section is met. The mere failure of a leaseback or long-term agreement to meet one of these safe harbors will not, by itself, cause the agreement to be treated as one in which tax avoidance was a principal purpose for providing increasing or decreasing rent.

(2) *Tax avoidance*—(i) *In general.* If, as of the agreement date, a significant difference between the marginal tax rates of the lessor and lessee can reasonably be expected at some time during the lease term, the agreement will be closely scrutinized and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing or decreasing rent. The term ''marginal tax rate'' means the percentage determined by dividing one dollar into the amount of the increase or decrease in the Federal income tax liability of the taxpayer that would result from an additional dollar of rental income or deduction.

(ii) *Significant difference in tax rates.* A significant difference between the marginal tax rates of the lessor and lessee is reasonably expected if—

(A) The rental agreement has increasing rents and the lessor's marginal tax rate is reasonably expected to exceed the lessee's marginal tax rate by more than 10 percentage points during any rental period to which the rental agreement allocates annualized fixed rent that is less than the average rent allocated to all calendar years (determined by taking into account the rules set forth in paragraph (c)(4)(iii) of this section); or

(B) The rental agreement has decreasing rents and the lessee's marginal tax rate is reasonably expected to exceed the lessor's marginal tax rate by more than 10 percentage points during any rental period to which the rental agreement allocates annualized fixed rent that is greater than the average rent allocated to all calendar years (determined by taking into account the rules set forth in paragraph (c)(4)(iii) of this section).

(iii) *Special circumstances.* In determining the expected marginal tax rates of the lessor and lessee, net operating loss and credit carryovers and any other attributes or special circumstances reasonably expected to affect the Federal income tax liability of the taxpayer (including the alternative minimum tax) are taken into account. For example, in the case of a partnership or S corporation, the amount of rental income or deduction that would be allocable to the partners or shareholders, respectively, is taken into account.

(3) *Safe harbors.* Tax avoidance will not be considered a principal purpose for providing increasing or decreasing rent if—

(i) The uneven rent test (as defined in paragraph (c)(4) of this section) is met; or

(ii) The increase or decrease in rent is wholly attributable to one or more of the following provisions—

(A) A contingent rent provision set forth in §1.467–1(c)(2)(iii)(B); or

(B) A single rent holiday provision allowing reduced rent (or no rent) for one consecutive period during the lease term, but only if—

(*1*) The rent holiday is for a period of three months or less at the beginning of the lease term and for no other period; or

(*2*) The duration of the rent holiday is reasonable, determined by reference to commercial practice (as of the agreement date) in the locality where the use of the property occurs, and does not exceed the lesser of 24 months or 10 percent of the lease term.

(4) *Uneven rent test*—(i) *In general.* The uneven rent test is met if the rent allocated to each calendar year does not vary from the average rent allocated to all calendar years (determined in accordance with the rules set forth in paragraph (c)(4)(iii) of this section) by more than 10 percent.

(ii) *Special rule for real estate.* Paragraph (c)(4)(i) of this section is applied by substituting ''15 percent'' for ''10 percent'' if the rental agreement is a long-term agreement and at least 90 percent of the property subject to the agreement (determined on the basis of fair market value as of the agreement date) consists of real property (as defined in §1.856–3(d)).

(iii) *Operating rules.* In determining whether the uneven rent test has been met, the following rules apply:

(A) Any contingent rent attributable to a provision set forth in §1.467–1(c)(2)(iii)(B)(*3*) through (*9*) is disregarded.

(B) If the lease term includes one or more partial calendar years (a period less than a complete calendar year), the average rent allocated to each calendar year is the total rent allocated under the rental agreement, divided by the actual length (in years) of the lease term. The rent allocated to a partial calendar year is annualized by multiplying the allocated rent by the number of periods of the partial calendar year's length in a full calendar year and the annualized rent is treated as the amount of rent allocated to that year in determining whether the uneven rent test is met.

(C) In the case of a rental agreement not described in paragraph (c)(4)(ii) of this section, an initial rent holiday period and any rent allocated to such period are disregarded for purposes of this paragraph (c)(4) if taking such period and rent into account would cause the agreement to fail to meet the uneven rent test. For purposes of this paragraph (c)(4), an initial rent holiday period is any period of three months or less at the beginning of the lease term during which annualized fixed rent (determined by treating such period as a rental period for purposes of §1.467–1(j)(3)) is less than the average rent allocated to all calendar years (determined before the application of this paragraph (c)(4)(iii)(C)).

(D) In the case of a rental agreement described in paragraph (c)(4)(ii) of this section, one qualified rent holiday period and any rent allocated to such period are disregarded for purposes of this paragraph (c)(4) if taking such period and rent into account would cause the agreement to fail the uneven rent test. For this purpose, a qualified rent holiday period is a consecutive period that is an initial rent holiday period or that meets the following conditions:

(*1*) The period does not exceed the lesser of 24 months or 10 percent of the lease term (determined before the application of this paragraph (c)(4)(iii)(D)).

(*2*) Annualized fixed rent during the period (determined by treating the period as a rental period for purposes of §1.467–1(j)(3)) is less than the average rent allocated to all calendar years (determined before the application of this paragraph (c)(4)(iii)(D)).

(*3*) Providing less than average rent for the period is reasonable, determined by reference to commercial practice (as of the agreement date) in the locality where the use of the property occurs.

(E) If the rental agreement contains a variable interest rate provision, the uneven rent test is applied by treating the rent as having been fixed under the terms of the rental agreement for the entire lease term using fixed rate substitutes (determined in the same manner as §1.1275–5(e), treating the agreement date as the issue date) for the variable rates of interest provided under the terms of the lessor's indebtedness.

(d) *Calculating constant rental amount*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, the constant rental amount is the amount that, if paid at the end of each rental period, would result in a present value equal to the present value of all amounts payable under the disqualified leaseback or long-term agreement as rent and interest. In computing the constant rental amount, the rules for determining present value are the same as those provided in § 1.467–2(d) for computing the proportional rental amount. If constant rental accrual is required, all rental periods (other than an initial or final short period of not more than one month) must be equal in length and satisfy the requirements of § 1.467–1(j)(5).

(2) *Initial or final short periods.* If a disqualified leaseback or long-term agreement has an initial or final short rental period, the constant rental amount for the initial or final short period may be determined under any reasonable method. However, the sum of the present values of all the constant rental amounts must equal the present values of all amounts payable under the disqualified leaseback or long-term agreement as rent and interest. Any adjustment necessary to eliminate the section 467 loan balance because of the method used to determine the constant rental amount for short periods must be taken into account as section 467 rent for the final rental period.

(3) *Method to determine constant rental amount; no short periods*—(i) *Step 1.* Determine the present value of amounts payable under the disqualified leaseback or long-term agreement as rent or interest.

(ii) *Step 2.* Determine the present value of $1 to be received at the end of each rental period during the lease term as of the first day of the first rental period during the lease term (or, if earlier, the first day a rent payment is required under the rental agreement).

(iii) *Step 3.* Divide the amount determined in paragraph (d)(3)(i) of this section (Step 1) by the number of dollars determined in paragraph (d)(3)(ii) of this section (Step 2).

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

Example 1. (i) K, lessor, and L, lessee, enter into a long-term agreement for a 10-year lease of personal property beginning on January 1, 2000. K and L are C corporations that use the calendar year as their taxable year. K does not have any unused losses or credits from taxable years preceding 2000. In addition, as of the agreement date, K expects that it will be subject to the maximum rate of tax imposed by section 11 in 2000 and that it will not be limited in its ability to use any losses or credits. As of the agreement date, L expects that it will be subject to the alternative minimum tax imposed by section 55 in 2000. The rental agreement provides for rent allocations in each year of the lease term, as follows:

Year	Amount
2000	$427,500
2001	442,500
2002	457,500
2003	472,500
2004	487,500
2005	502,500
2006	517,500
2007	532,500
2008	547,500
2009	562,500

(ii) As described in paragraph (c)(2) of this section, as of the agreement date, a significant difference between the marginal tax rates of the lessor and lessee can reasonably be expected at some time during the lease term. First, the rental agreement has increasing rents. Second, the lessor's marginal tax rate exceeds the lessee's marginal tax rate by more than 10 percentage points during a rental period to which the rental agreement allocates less than a ratable portion of the aggregate amount of rent payable under the agreement. For example, for the year 2000, the lessor's expected marginal tax rate is 35 percent, the percentage determined by dividing the increase in the Federal income tax liability of K that would result from an additional dollar of rental income ($.35) by $1. Because the lessee is subject to the alternative minimum tax, the lessee's expected marginal tax rate for 2000 is 20 percent, the percentage determined by dividing the decrease in the Federal income tax liability (taking into account both the decrease in the lessee's regular tax and the increase in the lessee's alternative minimum tax) that would result from an additional dollar of rental deduction ($.20) by $1. Further, for the year 2000, the rent allocated in accordance with the rental agreement is $427,500, which is less than a ratable portion of the aggregate amount of rental payments, $495,000, determined by dividing the total rents payable under the agreement ($4,950,000) by the number of years in the lease term (10). Thus, because a significant difference between the marginal tax rates of the lessor and lessee can reasonably be expected during the lease term, the agreement will be closely scrutinized and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing rent.

Example 2. (i) A and B enter into a long-term agreement for a 5-year lease of personal property beginning on July 1, 2000, and ending on June 30, 2005. The rental agreement provides that the rent is allocated to the calendar years in the lease term in accordance with the following schedule and is paid at successive six-month intervals (on December 31 and June 30) during the lease term:

Year	Amount
2000	$450,000
2001	900,000
2002	900,000
2003	1,100,000
2004	1,100,000
2005	550,000

(ii) In determining whether the uneven rent test described in paragraph (c)(4)(i) of this section is met, the total amount of rent allocated under the rental agreement is $5,000,000, and the lease term is five years. The average rent for each year is $1,000,000 (see paragraph (c)(4)(iii)(B) of this section), and the uneven rent test is met if the rent for each year is not less than $900,000 and not more than $1,100,000. The test is met for 2000 because the annualized rent for that year is $900,000. The test is met for 2005 because the annualized rent for that year is $1,100,000. The test is met for each of the years 2001 through 2004 because the rent for each of these years is not less than $900,000 and not more than $1,100,000. Accordingly, because the uneven rent test of paragraph (c)(4)(i) of this section is met, the long-term agreement will not be treated as disqualified.

Example 3. (i) C and D enter into a long-term agreement for a lease of personal property beginning on October 1, 1999, and ending on December 31, 2005. The rental agreement provides that the rent is allocated to the calendar years in the lease term in accordance with the following schedule and is paid at successive six-month intervals (on December 31 and June 30) during the lease term:

Year	Amount
1999	$0
2000	900,000
2001	900,000
2002	900,000
2003	1,100,000
2004	1,100,000
2005	1,100,000

(ii) The three-month rent holiday period at the beginning of the lease term is an initial rent holiday within the meaning of paragraph (c)(4)(iii)(C) of this section. Moreover, the agreement would fail the uneven rent test if the rent holiday period and the rent allocated to the period were taken into account. Thus, under paragraph (c)(4)(iii)(C) of this section, the period and the rent allocated to the period are disregarded for purposes of applying the uneven rent test. In that case, the lease term is six years, and the uneven rent test is met because the average rent for each year in the lease term is $1,000,000 and the rent for each calendar year in the lease term is not less than $900,000 nor more than $1,100,000. Accordingly, the long-term agreement will not be treated as disqualified.

Example 4. (i) E and F enter into a long-term agreement for a 6-year lease of personal property beginning on January 1, 2000, and ending on December 31, 2005. The rental agreement provides that the rent allocated to the calendar years in the lease term and paid at successive six-month intervals (on June 30 and December 31) during the lease term is the sum of the interest on the lessor's indebtedness, in the amount of $4,637,577, and an amount determined in accordance with the following schedule:

Year	Amount
2000	$539,574
2001	583,603
2002	631,225
2003	886,733
2004	959,090
2005	1,037,352

(ii) Assume further that the lessor's indebtedness bears interest at the rate of 2 percent in excess of the 6-month London Interbank Offered Rate (LIBOR) in effect on the first day of the 6-month period for each rental period and that, on the agreement date, the interest rate under this formula would be 8 percent. If the interest rate remained fixed during the entire lease term, the formula for determining the rent payable by the lessee would result in payments of rent in the amount of $450,000 for each six-month period in 2000, 2001, and 2002, and $550,000 for each six-month period in 2003, 2004, and 2005.

(iii) Under paragraph (c)(4)(iii)(E) of this section, the fixed rate substitute for the variable interest rate provision produces a schedule of fixed rents that meets the uneven rent test of paragraph (c)(4)(i) of this section. Thus, even if the actual rents payable under the rental agreement do not meet the uneven rent test because of fluctuations in the 6-month LIBOR, the uneven rent test will be treated as having been met, and the long-term agreement will not be treated as disqualified.

Example 5. (i) G and H enter into a long-term agreement for a 5-year lease of personal property beginning on January 1, 2000, and ending on December 31, 2004. The rental agreement provides that the rent is payable to G at the rate of $40,000 per month in arrears, subject to an adjustment based on changes in prevailing interest rates during the lease term. Under this adjustment, the lessor is entitled to receive an amount equal to the sum of a specified dollar amount, which increases each month as payments of rent are made, and interest on a notional principal amount (as defined in §1.446–3(c)(3)) at a qualified floating rate (as defined in §1.1275–5(b)). The notional principal amount is initially established at 80 percent of the cost of the property. As each payment of rent is made, the notional principal amount is reduced (but not below zero) to an amount that would represent the outstanding principal balance of a loan the payments on which are equal to the monthly payments of rent. As of the agreement date, the value of the qualified floating rate is 9 percent. Although G did not incur indebtedness specifically for the purpose of acquiring the property, the parties agreed to the adjustment provisions in order to compensate G for its general costs of borrowing.

(ii) The adjustment provision produces a schedule of rent payments that is virtually identical to the schedule that would have resulted if G had actually borrowed money in an amount and on terms identical to the terms used in determining interest on the notional principal amount and the adjustment were based on that indebtedness. An adjustment based on actual indebtedness of the lessor would have been a variable interest rate provision eligible for a safe harbor under paragraph (c)(3)(ii)(A) of this section. Accordingly, based on all the facts and circumstances, the adjustment provision did not have as one of its principal purposes the avoidance of Federal income tax, and thus the long-term agreement will not be treated as disqualified.

Example 6. (i) X and Y enter into a leaseback for a 5-year lease of personal property beginning on January 1, 1998, and ending on December 31, 2002. The rental agreement provides that $0 of rent is allocated to years 1998, 1999, and 2000, and that rent of $17,500,000 is allocated to years 2001 and 2002. The rental agreement provides that the rent allocated to each year is payable on December 31 of that year. Assume all rental periods are the calendar year. Assume also that 110 percent of the applicable Federal rate based on annual compounding is 12 percent.

(ii)(A) If the Commissioner determines that the leaseback is disqualified, the constant rental amount is computed as follows:

(B) Step 1 in calculating the constant rental amount is to determine the present value of the two payments due under the rental agreement as follows:

$$\$21{,}051{,}536 = \frac{\$17{,}500{,}000}{(1.12)^4} + \frac{\$17{,}500{,}000}{(1.12)^5}$$

(iii) Because no amounts of rent are payable before the lease term, Step 2 in calculating the constant rental amount is to determine the present value as of the first day of the lease term of $1 to be received at the end of each rental period during the lease term. This results in a present value of $3.6047762. In Step 3 the amount determined in Step 1 is divided by the number of dollars determined in Step 2. Thus, the constant rental amount is $5,839,901 for each calendar year during the lease term computed as follows:

$$\$5{,}839{,}901 = \frac{\$21{,}051{,}536}{3.6047762}$$

[T.D. 8820, 64 FR 26860, May 18, 1999, as amended by T.D. 8917, 66 FR 1040, Jan. 5, 2001]

§ 1.467–4 Section 467 loan.

(a) *In general*—(1) *Overview.* Except as provided in paragraph (a)(2) of this section, the section 467 loan rules of this section apply to a section 467 rental agreement if, as of the first day of a rental period, there is a difference between the amount of fixed rent payable under the rental agreement on or before the first day and the amount of fixed rent required to be accrued in accordance with §1.467–1(d)(2) before the first day. Paragraph (b) of this section provides rules for computing the principal balance of a section 467 loan at the beginning of any rental period. The principal balance of a section 467 loan may be positive or negative. For Federal tax purposes, if the principal balance is positive, the amount represents a loan from the lessor to the lessee, and if the principal balance is negative, the amount represents a loan from the lessee to the lessor.

(2) *No section 467 loan in the case of certain section 467 rental agreements.* Except as provided in paragraphs (a)(3) and (4) of this section, this section does not apply to section 467 rental agreements that provide adequate interest under §1.467–2(b)(1)(i) (agreements with no deferred or prepaid rent) or §1.467–2(b)(1)(ii) (agreements with deferred or prepaid rent that provide adequate stated interest at a single fixed rate).

(3) *Rental agreements subject to constant rental accrual.* Notwithstanding the provisions of paragraph (a)(2) of this section, this section applies to rental agreements subject to constant rental accrual under §1.467–3 (relating to disqualified leasebacks or long-term agreements).

(4) *Special rule in applying the provisions of §1.467–7(e), (f), or (g).* Notwithstanding the provisions of paragraph (a)(2) of this section, section 467 loan balances must be computed for section 467 rental agreements that are not subject to constant rental accrual under §1.467–3 and that provide adequate interest under §1.467–2(b)(1)(i) or (ii), but only for purposes of applying the provisions of §1.467–7(e) (relating to dispositions of property subject to a section 467 rental agreement), §1.467–7(f) (relating to assignments by lessees and lessee-financed renewals), and §1.467–7(g) (relating to modifications of rental agreements).

(b) *Principal balance*—(1) *In general.* Except as provided in paragraph (b)(2) of this section or in §1.467–7(e), (f), or (g), the principal balance of the section 467 loan at the beginning of a rental period equals—

(i) The fixed rent accrued in preceding rental periods;

(ii) Increased by the sum of—

(A) The interest on fixed rent includible in the gross income of the lessor for preceding rental periods; and

(B) Any amount payable by the lessor on or before the first day of the rental period as interest on prepaid fixed rent; and

(iii) Decreased by the sum of—

(A) The interest on prepaid fixed rent includible in the gross income of the lessee for preceding rental periods; and

(B) Any amount payable by the lessee on or before the first day of the rental period as fixed rent or interest thereon.

(2) *Section 467 rental agreements that provide for prepaid fixed rent and adequate interest.* If a section 467 rental agreement calls for prepaid fixed rent and provides adequate interest under §1.467–2(b)(1)(iv), the principal balance of the section 467 loan at the beginning of a rental period equals the principal balance determined under paragraph (b)(1) of this section, plus the fixed rent accrued for that rental period.

(3) *Timing of payments.* For purposes of this paragraph (b), the day on which an amount is payable is determined under the rules of §1.467–1(j)(2)(i)(B) through (E) and §1.467–1(j)(2)(ii).

(c) *Yield*—(1) *In general*—(i) *Method of determining yield.* Except as provided in paragraphs (c)(2) and (3) of this section, the yield of a section 467 loan is the discount rate at which the sum of the present values of all amounts payable by the lessee as fixed rent and interest on fixed rent, plus the sum of the present values of all amounts payable by the lessor as interest on prepaid fixed rent, equals the sum of the present values of the fixed rent that accrues in accordance with §1.467–1(d)(2). The yield must be constant over the term of the section 467 rental agreement and, when expressed as a percentage, must be calculated to at least two decimal places.

(ii) *Method of stating yield.* In determining the section 467 interest for a rental period, the yield of the section 467 loan must be stated appropriately by taking into account the length of the rental period. Section 1.1272–1(j), *Example 1,* provides a formula for converting a yield based on a period of one length to an equivalent yield based on a period of a different length.

(iii) *Rounding adjustments.* Any adjustment necessary to eliminate the section 467 loan because of rounding the yield to two or more decimal places must be taken into account as an adjustment to the section 467 interest for the final rental period determined as provided in paragraph (e) of this section.

(2) *Yield of section 467 rental agreements for which constant rental amount or proportional rental amount is computed.* In the case of a section 467 rental agreement to which §1.467–1(d)(2)(i) or (ii) applies, the yield of the section 467 loan equals 110 percent of the applicable Federal rate (based on a compounding period equal to the length of the rental period).

(3) *Yield for purposes of applying paragraph (a)(4) of this section.* For purposes of applying paragraph (a)(4) of this section, the yield of the section 467 loan balance of any party, or prior party, to a section 467 rental agreement for a period is the same for all parties and is

the yield that results in the net accrual of positive or negative interest for that period equal to the amount of such interest that accrues under the terms of the rental agreement for that period. For example, if property subject to a section 467 rental agreement is sold (transferred) and the beginning section 467 loan balance of the transferor (as described in § 1.467–7(e)(2)(i)) is positive and the beginning section 467 loan balance of the transferee (as described in § 1.467–7(e)(2)(ii)) is negative, the yield on each of these loan balances for any period is the same for all parties and is the yield that results in the net accrual of positive or negative interest, taking into account the aggregate positive or negative interest on the section 467 loan balances of both the transferor and transferee, equal to the amount of such interest that accrues under the terms of the rental agreement for that period.

(4) *Determination of present values.* The rules for determining present value in computing the yield of a section 467 loan are the same as those provided in § 1.467–2(d) for computing the proportional rental amount.

(d) *Contingent payments.* Except as otherwise required, contingent payments are not taken into account in calculating either the yield or the principal balance of a section 467 loan.

(e) *Section 467 rental agreements that call for payments before or after the lease term.* If a section 467 rental agreement calls for the payment of fixed rent or interest thereon before the beginning of the lease term, this section is applied by treating the period beginning on the first day an amount is payable and ending on the day before the beginning of the first rental period of the lease term as one or more rental periods. If a rental agreement calls for the payment of fixed rent or interest thereon after the end of the lease term, this section is applied by treating the period beginning on the day after the end of the last rental period of the lease term and ending on the last day an amount of fixed rent or interest thereon is payable as one or more rental periods. Rental period length for the period before the lease term or after the lease term is determined in accordance with the rules of § 1.467–1(j)(5).

(f) *Examples.* The following examples illustrate the application of this section:

Example 1. (i)(A) A leases property to B for a three-year period beginning on January 1, 2000, and ending on December 31, 2002. The section 467 rental agreement has the following rent allocation schedule and payment schedule:

	Rent allocation	Payment
2000	$400,000	
2001	600,000	
2002	800,000	$1,800,000

(B) The rental agreement requires a $1.8 million payment to be made on December 31, 2002, but does not provide for interest on deferred rent. Assume A and B choose the calendar year as the rental period length and that 110 percent of the applicable Federal rate based on annual compounding is 10 percent. Assume also that the agreement is not a leaseback or long-term agreement and, therefore, is not subject to constant rental accrual.

(ii) Because the section 467 rental agreement does not provide adequate interest under § 1.467–2(b) and is not subject to constant rental accrual, the fixed rent that accrues during each rental period is the proportional rental amount as described in § 1.467–2(c). The proportional rental amounts for each rental period are as follows:

2000	$370,370.37
2001	555,555.56
2002	740,740.73

(iii) A section 467 loan arises at the beginning of the second rental period because the rent payable on or before that day (zero) is less than the fixed rent accrued under § 1.467–1(d)(2) in all preceding rental periods ($370,370.37). Under paragraph (c)(2) of this section, the yield of the loan is equal to 110 percent of the applicable Federal rate (10 percent compounded annually). Because no payments are treated as made on or before the first day of the second rental period, the principal balance of the loan at the beginning of the second rental period is $370,370.37. The interest for the second rental period on fixed rent is $37,037.04 (.10 × $370,370.37) and, under § 1.467–1(e)(3), is treated as interest income of the lessor and as an interest expense of the lessee.

(iv) Because no payments are made on or before the first day of the third rental period, the principal balance of the loan at the beginning of the third rental period is equal to the fixed rent accrued during the first and second rental periods plus the lessor's interest income on fixed rent for the second rental period ($962,962.97 = $370,370.37 + $555,555.56 + $37,037.04). The interest for the third rental period on fixed rent is $96,296.30 (.10 × $962,962.97). Thus, the sum of the fixed rent and interest on fixed rent for the three rental periods is equal to the total amount paid over the lease term (first year fixed rent accrual, $370,370.37, plus second year fixed rent and interest accrual, $555,555.56 + $37,037.04, plus third year fixed rent and interest accrual, $740,740.73 + $96,296.30, equals $1,800,000). B takes the amounts of interest and rent into account as interest and rent expense, respectively, and A takes such amounts into account as interest and rent income, respectively, for the calendar years identified above, regardless of their respective overall methods of accounting.

Example 2. (i) The facts are the same as in *Example 1*, §1.467–2(f). C agrees to lease property from D for five years beginning on January 1, 2000, and ending on December 31, 2004. The section 467 rental agreement provides that rent of $100,000 accrues in each calendar year in the lease term and that rent of $500,000 plus $120,000 of interest is payable on December 31, 2004. The parties select the calendar year as the rental period, and 110 percent of the applicable Federal rate is 10 percent, compounded annually. The rental agreement has deferred rent but provides adequate interest on fixed rent.

(ii)(A) Pursuant to paragraph (c)(1) of this section, the yield of the section 467 loan is 10.775078%, compounded annually. The following is a schedule of the rent allocable to each rental period during the lease term, the balance of the section 467 loan as of the end of each rental period (determined, in the case of the calendar year 2004, without regard to the single payment of rent and interest in the amount of $620,000 payable on the last day of the lease term), and the interest on the section 467 loan allocable to each rental period:

Calendar year	Section 467 interest	Section 467 rent	Section 467 loan balance
2000	$0	$100,000.00	$100,000.00
2001	10,775.08	100,000.00	210,775.08
2002	22,711.18	100,000.00	333,486.26
2003	35,933.41	100,000.00	469,419.67
2004	50,580.33	100,000.00	620,000.00

(B) C takes the amounts of interest and rent into account as expense and D takes such amounts into account as income for the calendar years identified above, regardless of their respective overall methods of accounting.

[T.D. 8820, 64 FR 26863, May 18, 1999]

§ 1.467–5 Section 467 rental agreements with variable interest.

(a) *Variable interest on deferred or prepaid rent*—(1) *In general.* This section provides rules for computing section 467 rent and interest in the case of section 467 rental agreements providing variable interest. For purposes of this section, a rental agreement provides for variable interest if the rental agreement provides for stated interest that is paid or compounded at least annually at a rate or rates that meet the requirements of §1.1275–5(a)(3)(i)(A) or (B) and (a)(4). If a section 467 rental agreement provides for interest that is neither variable interest nor fixed interest, the agreement provides for contingent payments.

(2) *Exceptions.* This section is not applicable to section 467 rental agreements that provide adequate interest under §1.467–2(b)(1)(i) (agreements with no deferred or prepaid rent) or (b)(1)(ii) (rental agreements with stated interest at a single fixed rate). The exceptions in this paragraph (a)(2) do not apply to rental agreements subject to constant rental accrual under §1.467–3.

(b) *Variable rate treated as fixed*—(1) *In general.* If a section 467 rental agreement provides variable interest—

(i) The fixed rate substitutes (determined in the same manner as under §1.1275–5(e), treating the agreement date as the issue date) for the variable rates of interest on deferred or prepaid fixed rent provided by the rental agreement must be used in computing the proportional rental amount under §1.467–2(c), the constant rental amount under §1.467–3(d), the principal balance of a section 467 loan under §1.467–4(b), and the yield of a section 467 loan under §1.467–4(c); and

(ii) The interest on fixed rent for any rental period is equal to the amount that would be determined under §1.467–1(e)(2) if the section 467 rental agreement did not provide variable interest, using the fixed rate substitutes determined under paragraph (b)(1)(i) of this section in place of the variable rates called for by the rental agreement, plus the variable interest adjustment amount provided in paragraph (b)(2) of this section.

(2) *Variable interest adjustment amount*—(i) *In general.* The variable interest adjustment amount for a rental period equals the difference between—

(A) The amount of interest that, without regard to section 467, would have accrued during the rental period under the terms of the section 467 rental agreement; and

(B) The amount of interest that, without regard to section 467, would have accrued during the rental period under the terms of the section 467 rental agreement using the fixed rate substitutes determined under paragraph (b)(1)(i) of this section in place of the variable interest rates called for by the rental agreement.

(ii) *Positive or negative adjustment.* If the amount determined under paragraph (b)(2)(i)(A) of this section is greater than the amount determined under paragraph (b)(2)(i)(B) of this section, the variable interest adjustment amount is positive. If the amount determined under paragraph (b)(2)(i)(A) of this section is less than the amount determined under paragraph (b)(2)(i)(B) of this section, the variable interest adjustment amount is negative.

(3) *Section 467 loan balance.* The variable interest adjustment amount is not taken into account in determining the principal balance of a section 467 loan under §1.467–4(b). Instead, the section 467 loan balance is computed as if all amounts payable under the section 467 rental agreement were based on the fixed rate substitutes determined under paragraph (b)(1)(i) of this section.

(c) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) X and Y enter into a section 467 rental agreement for the lease of personal property beginning on January 1, 2000, and ending on December 31, 2002. The rental agreement allocates $100,000 of rent to 2000, $200,000 to 2001, and $100,000 to 2002, and requires the lessee to pay all $400,000 of rent on December 31, 2002. The rental agreement requires the accrual of interest on unpaid accrued rent at two different qualified floating rates (as defined in §1.1275–5(b)), one for 2001 and the other for 2002, such interest to be paid on December 31 of the year it accrues. The rental agreement provides that the qualified floating rate is set at a current value within the meaning of §1.1275–5(a)(4). Assume that on the agreement date, 110 percent of the applicable Federal rate is 10 percent, compounded annually. Assume also that the agreement is not a leaseback or long-term agreement and, therefore, is not subject to constant rental accrual.

(ii) To determine if the section 467 rental agreement provides for adequate interest under §1.467–2(b), §1.467–2(b)(2) requires the use of fixed rate substitutes (in this example determined in the same manner as under §1.1275–5(e)(3)(i) treating the agreement date as the issue date) in place of the variable rates called for by the rental agreement. Assume that on the agreement date the qualified floating rates, and therefore the fixed rate substitutes, relating to 2001 and 2002 are 10 and 15 percent compounded annually. Taking into account the fixed rate substitutes, the sum of the present values of all amounts payable by the lessee as fixed rent and interest thereon is greater than the sum of the present values of the fixed rent allocated to each rental period. Accordingly, the rental agreement provides adequate interest under §1.467–2(b)(1)(iii) and the fixed rent accruing in each calendar year during the rental agreement is the fixed rent allocated under the rental agreement.

(iii) Because the section 467 rental agreement provides for variable interest on unpaid accrued fixed rent at qualified floating rates and the qualified floating rates are set at a current value, the requirements of §1.1275–5(a)(3)(i)(A) and (4) are met and the rental agreement provides for variable interest within the meaning of paragraph (a)(1) of this section. Therefore, under paragraph (b)(1)(i) of this section, the yield of the section 467 loan is computed based on the fixed rate substitutes. Under §1.467–4(c), the constant yield (rounded to two decimal places) equals 13.63 percent compounded annually. Based on the fixed rate substitutes, the fixed rent, interest on fixed rent, and the principal balance of the section 467 loan, for each calendar year during the lease term, are as follows:

	Accrued rent	Accrued interest	Projected payment	Cumulative loan
2000	$100,000	$0	$0	$100,000
2001	200,000	13,630	(10,000)	303,630
2002	100,000	41,370	(445,000)	0

(iv) To compute the actual reported interest on fixed rent for each calendar year, the variable interest adjustment amount, as described in paragraph (b)(2) of this section, must be added to the accrued interest determined in paragraph (iii) of this *Example 1*. Assume that the variable rates for 2001 and 2002 are actually 11 and 14 percent, respectively. Without regard to section 467, the interest that would have accrued during each calendar year under the terms of the section 467 rental agreement, and the interest that would have accrued under the terms of the rental agreement using the fixed rate substitutes determined under paragraph (b)(1)(i) of this section are as follows:

	Accrued interest under rental agreement	Accrued interest using fixed rate substitutes
2000	$0	$0
2001	11,000	10,000
2002	42,000	45,000

(v) Under paragraph (b)(2) of this section, the variable interest adjustment amount is $1,000 ($11,000 − $10,000) for 2001 and is −$3,000 ($42,000 − $45,000) for 2002. Thus, under paragraph (b)(1)(ii) of this section, the actual interest on fixed rent for 2001 is $14,630 ($13,630 + $1,000) and for 2002 is $38,370 ($41,370 − $3,000).

Example 2. (i) The facts are the same as in *Example 1* except that 110 percent of the applicable Federal rate is 15 percent compounded annually and the section 467 rental agreement does not provide adequate interest under § 1.467–2(b). Consequently, the fixed rent for each calendar year during the lease is the proportional rental amount.

(ii) The sum of the present values of the fixed rent provided for each calendar year during the lease term, discounted at 15 percent compounded annually, equals $303,936.87.

(iii)(A) Paragraph (b)(1)(i) of this section requires the proportional rental amount to be computed based on the assumption that interest will accrue and be paid based on the fixed rate substitutes. Thus, the sum of the present values of the projected payments under the section 467 rental agreement equals $300,156.16, computed as follows:

$$\begin{aligned} \$\ 10{,}000/(1.15)^2 &= \$\quad 7{,}561.44 \\ 445{,}000/(1.15)^3 &= \underline{292{,}594.72} \\ &\quad \$300{,}156.16 \end{aligned}$$

(B) The fraction for computing the proportional rental amount equals .9875609 ($300,156.16/$303,936.87).

(iv) Based on the fixed rate substitutes, the fixed rent, interest on fixed rent, and the balance of the section 467 loan for each calendar year during the lease term are as follows:

	Proportional rent	Accrued interest	Projected payment	Cumulative loan
2000	$98,756.09	$0.00	$0	$98,756.09
2001	197,512.18	14,813.41	(10,000)	301,081.68
2002	98,756.09	45,162.23	(445,000)	0.00

(v) The variable interest adjustment amount in this example is the same as in *Example 1*. Under paragraph (b)(1)(ii) of this section, the actual interest on fixed rent for 2001 is $15,813.41 ($14,813.41 + $1,000) and for 2002 is $42,162.23 ($45,162.23 − $3,000).

[T.D. 8820, 64 FR 26865, May 18, 1999]

§ 1.467–6 Section 467 rental agreements with contingent payments. [Reserved]

§ 1.467–7 Section 467 recapture and other rules relating to dispositions and modifications.

(a) *Section 467 recapture.* Notwithstanding any other provision of the Internal Revenue Code, except as provided in paragraph (c) of this section, a lessor disposing of property in a transaction to which this paragraph (a) applies must recognize the recapture amount (determined under paragraph (b) of this section) and treat that amount as ordinary income. This paragraph (a) applies to any disposition of property subject to a section 467 rental agreement that—

(1) Is a leaseback (as defined in § 1.467–3(b)(2)) or a long-term agreement (as defined in § 1.467–3(b)(3));

(2) Is not disqualified under § 1.467–3(b)(1); and

(3) Allocates to any rental period fixed rent that, when annualized, exceeds the annualized fixed rent allocated to any preceding rental period.

(b) *Recapture amount*—(1) *In general.* The recapture amount for a disposition is the lesser of—

(i) The prior understated inclusion (determined under paragraph (b)(2) of this section); or

(ii) The section 467 gain (determined under paragraph (b)(3) of this section).

(2) *Prior understated inclusion.* The prior understated inclusion is the excess (if any) of—

(i) The aggregate amount of section 467 rent and section 467 interest for the period during which the lessor held the property, determined as if the section 467 rental agreement were a disqualified leaseback or long-term agreement subject to constant rental accrual under § 1.467–3; over

(ii) The aggregate amount of section 467 rent and section 467 interest accrued by the lessor during that period.

(3) *Section 467 gain*—(i) *In general.* Except as otherwise provided in paragraph (b)(3)(ii) of this section, the section 467 gain is the excess (if any) of—

(A) The amount realized from the disposition; over

(B) The sum of the adjusted basis of the property and the amount of any gain from the disposition that is treated as ordinary income under any provision of subtitle A of the Internal Revenue Code other than section 467(c) (for example, section 1245 or 1250).

(ii) *Certain dispositions.* In the case of a disposition that is not a sale or exchange, the section 467 gain is the excess (if any) of the fair market value of the property on the date of disposition over the amount determined under paragraph (b)(3)(i)(B) of this section.

(c) *Special rules*—(1) *Gifts.* Paragraph (a) of this section does not apply to a disposition by gift. However, see paragraph (c)(4) of this section for dispositions by transferees. If a disposition is in part a sale or exchange and in part a gift, paragraph (a) of this section applies to the disposition but the prior understated inclusion is determined by taking into account only section 467 rent and section 467 interest properly allocable to the portion of the property not disposed of by gift.

(2) *Dispositions at death.* Paragraph (a) of this section does not apply to a disposition if the basis of the property in the hands of the transferee is determined under section 1014(a). This paragraph (c)(2) does not apply to property which constitutes a right to receive an item of income in respect of a decedent. See sections 691 and 1014(c).

(3) *Certain tax-free exchanges*—(i) *In general.* The recapture amount in the case of a disposition to which this paragraph (c)(3) applies is limited to the amount of gain recognized to the transferor (determined without regard to paragraph (a) of this section), reduced by the amount of any gain from the disposition that is treated as ordinary income under any provision of subtitle A of the Internal Revenue Code other than section 467(c). However, see paragraph (c)(4) of this section for dispositions by transferees.

(ii) *Dispositions covered*—(A) *In general.* Except as provided in paragraph (c)(3)(ii)(B) of this section, this paragraph (c)(3) applies to a disposition of property if the basis of the 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 section 332, 351, 361, 721, or 731.

(B) *Transfers to certain tax-exempt organizations.* This paragraph (c)(3) does not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from tax imposed by chapter 1, subtitle A of the Internal Revenue Code (a tax-exempt entity) except to the extent the property is used in an activity the income from which is subject to tax under section 511(a) (a section 511(a) activity). However, if assets used to any extent in a section 511(a) activity are disposed of by the tax-exempt entity, then, notwithstanding any other provision of law (except section 1031 or section 1033) the recapture amount with respect to such disposition, to the extent attributable under paragraph (c)(4) of this section to the period of the transferor's ownership of the property prior to the first disposition, shall be included in the tax-exempt entity's unrelated business taxable income. To the extent that the tax-exempt entity ceases to use the property in a section 511(a) activity, the entity will be treated for purposes of this paragraph (c)(3) and paragraph (c)(4) of this section as having disposed of the property to such extent on the date of the cessation.

(4) *Dispositions by transferee.* If the recapture amount with respect to a disposition of property (the first disposition) is limited under paragraph (c)(1)

or (3) of this section and the transferee subsequently disposes of the property in a transaction to which paragraph (a) of this section applies, the prior understated inclusion determined under paragraph (b)(2) of this section is computed by taking into account the amounts attributable to the period of the transferor's ownership of the property prior to the first disposition. Thus, for example, the section 467 rent and section 467 interest that would have been taken into account by the transferee if the section 467 rental agreement were a disqualified leaseback or long-term agreement subject to constant rental accrual include the amounts that would have been taken into account by the transferor, and the aggregate amount of section 467 rent and section 467 interest accrued by the transferee includes the aggregate amount of section 467 rent and section 467 interest that was taken into account by the transferor. The prior understated inclusion determined under this paragraph (c)(4) must be reduced by any recapture amount taken into account under paragraph (a) of this section by the transferor.

(5) *Like-kind exchanges and involuntary conversions.* If property is disposed of or converted and, before the application of paragraph (a) of this section, gain is not recognized in whole or in part under section 1031 or 1033, then the amount of section 467 gain taken into account by the lessor is limited to the sum of—

(i) The amount of gain recognized on the disposition or conversion of the property (determined without regard to paragraph (a) of this section); and

(ii) The fair market value of property acquired that is not subject to the same section 467 rental agreement and that is not taken into account under paragraph (c)(5)(i) of this section.

(6) *Installment sales.* In the case of an installment sale of property to which paragraph (a) of this section applies—

(i) The recapture amount is recognized and treated as ordinary income in the year of the disposition; and

(ii) Any gain in excess of the recapture amount is reported under the installment method of accounting if and to the extent that method is otherwise available under section 453.

(7) *Dispositions covered by section 170(e), 341(e)(12), or 751(c).* For purposes of sections 170(e), 341(e)(12), and 751(c), amounts treated as ordinary income under paragraph (a) of this section must be treated in the same manner as amounts treated as ordinary income under section 1245 or 1250.

(d) *Examples.* The following examples illustrate the application of paragraphs (a), (b), and (c) of this section. In each of these examples the transferor of property subject to a section 467 rental agreement is entitled to the rent for the day of the disposition. The examples are as follows:

Example 1. (i)(A) X and Y enter into a section 467 rental agreement for a 5-year lease of personal property beginning on January 1, 2000, and ending on December 31, 2004. The rental agreement provides that the calendar year will be the rental period and that rents accrue and are paid in the following pattern:

	Allocation	Payment
2000	$0	$0
2001	87,500	0
2002	87,500	175,000
2003	87,500	175,000
2004	87,500	0

(B) Assume that both X and Y are calendar year taxpayers and that 110 percent of the applicable Federal rate is 11 percent, compounded annually. Assume also that the rental agreement is a long-term agreement (as defined in §1.467–3(b)(3)), but it is not a disqualified leaseback or long-term agreement. Further, because the agreement does not provide prepaid or deferred rent, proportional rental accrual is not applicable. (See §1.467–2(b)(1)(i)). Therefore, the rent taken into account under §1.467–1(d)(2) is the fixed rent allocated to the rental periods under §1.467–1(c)(2)(ii).

(ii) On December 31, 2000, X sells the property subject to the section 467 rental agreement to an unrelated person for $575,000. At the time of the sale, X's adjusted basis in the property is $175,000. Thus, X's gain on the sale of the property is $400,000. Assume that $175,000 of this gain would be treated as ordinary income under provisions of the Internal Revenue Code other than section 467(c). Under paragraph (a) of this section, X is required to take the recapture amount into account as ordinary income. Under paragraph (b) of this section, the recapture amount is the lesser of the prior understated inclusion or the section 467 gain.

(iii)(A) In computing the prior understated inclusion under paragraph (b)(2) of this section, assume that the section 467 rent and section 467 interest (based on constant rental accrual) would be taken into account as follows if the section 467 rental agreement were a disqualified long-term agreement:

	Section 467 rent	Section 467 interest
2000	$65,812.55	$0
2001	65,812.55	7,239.38
2002	65,812.55	15,275.09
2003	65,812.55	4,944.73
2004	65,812.55	(6,521.95)

(B) The total amount of section 467 rent and section 467 interest for 2000, based on constant rental accrual, is $65,812.55. Since X did not take any section 467 rent or section 467 interest into account in 2000, the prior understated inclusion is also $65,812.55. X's section 467 gain is $225,000, which is the excess of the gain realized ($400,000) over the amount of that gain treated as ordinary income under non-section 467 provisions ($175,000). Accordingly, the recapture amount (the lesser of the prior understated inclusion or the section 467 gain) treated as ordinary income is $65,812.55.

Example 2. (i) The facts are the same as in *Example 1*, except that the section 467 rental agreement specifies that rents accrue and are paid in the following pattern:

	Allocation	Payment
2000	$60,000	$0
2001	65,000	0
2002	70,000	175,000
2003	75,000	175,000
2004	80,000	0

(ii)(A) Assume the section 467 rental agreement does not provide for adequate interest under §1.467–2(b), and, therefore, the fixed rent for a rental period is the proportional rental amount. See §1.467–1(d)(2)(ii). Under §1.467–2(c), the following amounts would be required to be taken into account:

	Section 467 rent	Section 467 interest
2000	$57,260.43	$ 0
2001	62,032.13	6,298.65
2002	66,803.83	13,815.03
2003	71,575.53	3,433.11
2004	76,347.23	(7,565.94)

(B) The amount of section 467 rent and section 467 interest taken into account by X for 2000 is $57,260.43. Thus, the prior understated inclusion is $8,552.12 (the excess of the amount of section 467 rent and section 467 interest based on constant rental accrual for 2000, $65,812.55, over the amount of section 467 rent and section 467 interest actually taken into account, $57,260.43). Since the prior understated inclusion is less than the section 467 gain ($225,000, as determined in *Example 1*(iii)(B)), the recapture amount treated as ordinary income is also $8,552.12.

Example 3. (i) The facts are the same as in *Example 1*, except that, instead of selling the property, X transfers the property to S on December 31, 2002, in exchange for stock of S in a transaction that meets the requirements of section 351(a). Under paragraph (c)(3) of this section, because of the application of section 351, X is not required to take into account any section 467 recapture.

(ii) On December 31, 2003, S sells the property subject to the section 467 rental agreement to an unrelated person for $450,000. At the time of the sale, S's adjusted basis in the property is $105,000. Thus, S's gain on the sale of the property is $345,000. Assume that $245,000 of this gain would be treated as ordinary income under provisions of the Internal Revenue Code other than section 467(c). Under paragraph (a) of this section, S is required to take the recapture amount into account as ordinary income which, under paragraph (b) of this section, is the lesser of the prior understated inclusion or the section 467 gain.

(iii) S owned the property in 2003 and, under paragraph (c)(4) of this section, for purposes of determining S's prior understated inclusion, S is treated as if it had owned the property during the years 2000 through 2002. In computing S's prior understated inclusion under paragraph (b)(2) of this section, the section 467 rent and section 467 interest based on constant rental accrual are the same as the amounts set forth in the schedule in *Example 1*(iii)(A). Thus, the constant rental amount for 2000, 2001, 2002, and 2003 is $290,709.40 ((4 × $65,812.55) + $7,239.38 + $15,275.09 + $4,944.73). The section 467 rent and section 467 interest actually taken into account prior to the disposition is $262,500. Thus, S's prior understated inclusion is $28,209.40 ($290,709.40 minus $262,500 (3 × $87,500)). S's section 467 gain is $100,000, the difference between the gain realized on the disposition ($345,000) and the amount of gain that is treated as ordinary income under non-section 467 Code provisions ($245,000). Accordingly, S's recapture amount, the lesser of the prior understated inclusion or the section 467 gain, is $28,209.40.

(e) *Other rules relating to dispositions*—(1) *In general.* If there is a sale, exchange, or other disposition of property subject to a section 467 rental agreement (the transfer), the section 467 rent and, if applicable, section 467 interest for a period are taken into account by the owner of the property during the period. The following rules apply in determining the section 467 rent and section 467 interest for the portion of the rental period ending immediately prior to the transfer:

(i) The section 467 rent and section 467 interest for the portion of the rental period ending immediately prior to the transfer are a pro rata portion of the section 467 rent and the section 467 interest, respectively, for the rental period. Such amounts are also taken into account in determining the transferor's section 467 loan balance, prior to any adjustment thereof that may be required under paragraph (h) of this section, immediately before the transfer.

(ii) If the transferor of the property is entitled to the rent for the day of transfer, the transfer is treated as occurring at the end of the day of the transfer.

(iii) If the transferee of the property is entitled to the rent for the day of transfer, the transfer is treated as occurring at the beginning of the day of the transfer.

(2) *Treatment of section 467 loan.* If there is a transfer described in paragraph (e)(1) of this section, the following rules apply in determining the transferor's and the transferee's section 467 loans for the period after the transfer, the amount realized by the transferor, and the transferee's basis in the property:

(i) The beginning balance of the transferor's section 467 loan is equal to the net present value at the time of the transfer (but after giving effect to the transfer) of all subsequent amounts payable as fixed rent and interest on fixed rent to the transferor and all subsequent amounts payable as interest on prepaid fixed rent by the transferor. The transferor must continue to take into account interest on the transferor's section 467 loan balance after the date of the transfer.

(ii) The beginning balance of the transferee's section 467 loan is equal to the principal balance of the transferor's section 467 loan immediately before the transfer reduced (below zero, if appropriate) by the beginning balance of the transferor's section 467 loan. Amounts payable to the transferor are not taken into account in adjusting the transferee's section 467 loan balance.

(iii) If the beginning balance of the transferee's section 467 loan is negative, the transferor and transferee must treat the balance as a liability that is either assumed in connection with the transfer of the property or secured by the property acquired subject to the liability. If the beginning balance of the transferee's section 467 loan is positive, the transferor and transferee must treat the balance as an additional asset acquired in connection with the transfer of the property. In the case of a positive beginning balance of the transferee's section 467 loan, the transferee will have an initial cost basis in the section 467 loan equal to the lesser of the beginning balance of the loan or the aggregate consideration for the transfer of the property subject to the section 467 rental agreement and the transfer of the transferor's interest in the section 467 loan.

(3) [Reserved]

(4) *Examples.* The following examples illustrate the application of this paragraph (e). In each of these examples the transferor of property subject to a section 467 rental agreement is entitled to the rent for the day of the transfer. The examples are as follows:

Example 1. (i) Q and R enter into a section 467 rental agreement for a 5-year lease of personal property beginning on January 1, 2000, and ending on December 31, 2004. The rental agreement provides that $0 of rent is allocated to 2000, 2001, and 2002, and $1,750,000 is allocated to each of the years 2003 and 2004. The rental agreement provides that the calendar year will be the rental period and that the rent allocated to each calendar year is payable on the last day of that calendar year. Assume that both Q and R are calendar year taxpayers and that 110 percent of the applicable Federal rate is 11 percent, compounded annually. Assume further that the rental agreement is a disqualified long-term agreement (as defined in §1.467–3(b)(3)) and that the section 467 rent, the section 467 interest, and the section 467 loan balance would be the following amounts:

Calendar year	Payment	Section 467 interest	Section 467 rent	Section 467 loan balance
2000	$0	$0	$592,905.87	$592,905.87
2001	0	65,219.65	592,905.87	1,251,031.39
2002	0	137,613.45	592,905.87	1,981,550.71
2003	1,750,000.00	217,970.58	592,905.87	1,042,427.16
2004	1,750,000.00	114,666.97	592,905.87	0

(ii) On December 31, 2002, Q sells the property subject to the section 467 rental agreement to P, an unrelated person, for $3,000,000. Q does not retain the right to receive any amounts payable by R under the rental agreement after the date of sale, but the agreement is not otherwise modified. At the time of the sale, Q's adjusted basis in the property is $975,000. Assume that, under §1.467–1(f)(7), the disposition is not a substantial modification. Further, the Commissioner does not determine that the treatment of the agreement as a disqualified long-term agreement should be changed and, under §1.467–1(f)(4)(iii), the agreement remains subject to constant rental accrual. Thus, under paragraph (g)(2)(iii) of this section, section 467 rent and section 467 interest for periods after the disposition will be taken into account on the basis of constant rental accrual applied to the terms of the entire agreement (as modified).

(iii) Under paragraph (e)(2)(ii) of this section, the beginning balance of P's section 467 loan is $1,981,550.71. P's section 467 loan balance is computed by reducing the balance of the section 467 loan immediately before the transfer ($1,981,550.71) by the beginning balance of the transferor's section 467 loan ($0 because Q does not retain the right to receive any amounts payable under the rental agreement subsequent to the transfer).

(iv) Q will be treated as if it had received $1,981,550.71 from the disposition of the section 467 loan and $1,018,449.29 from the sale of the property subject to the rental agreement. Thus, Q's gain on the sale of the property is $43,449.29 ($1,018,449.29 amount realized less $975,000 adjusted basis). Q's gain is not subject to the recapture provisions of section 467(c) and paragraph (a) of this section because the rental agreement was disqualified under §1.467–3(b)(1) and, thus, the requirement of paragraph (a)(2) of this section is not met. Q recognizes no gain on the disposition of the section 467 loan because Q's basis in the loan equals the amount considered received for the loan. Further, Q does not take into account any of the section 467 rent or section 467 interest attributable to periods after the transfer of the property.

(v) P is treated as if it had acquired the property and the positive balance in the transferee's section 467 loan. P's cost basis in the property is $1,018,449.29, and its cost basis in the section 467 loan immediately following the transfer is $1,981,550.71. P takes section 467 rent and section 467 interest into account for the calendar years 2002 and 2003 under the constant rental accrual method and, accordingly, treats payments received under the rental agreement as recoveries of the principal balance of the section 467 loan (as adjusted from time to time).

Example 2. (i) The facts are the same as *Example 1*, except that on December 31, 2002, Q transfers the property to P in exchange for stock of P having a fair market value of $3,000,000 and the transaction meets the requirements of section 351(a).

(ii) Q is treated as having transferred two assets to P, the property subject to the rental agreement and the positive balance of the section 467 loan. Under section 351(a), because only stock of P is received by Q, Q does not recognize any of the gain realized on the transaction. Pursuant to section 358(a), the basis of Q in the P stock received in the exchange is the same as the aggregate basis of the property exchanged, or $2,956,550.71 (the sum of the balance of the section 467 loan, $1,981,550.71, and the adjusted basis of the property, $975,000). Q does not take into account any of the section 467 rent or section 467 interest attributable to periods after the transfer of the property.

(iii) P is treated as if it had acquired the property and the positive balance in the transferee's section 467 loan in the transaction. Pursuant to section 362(a), P's basis in each asset is the same as the basis of Q immediately preceding the transfer. Thus, the basis of P in the property subject to the rental agreement is $975,000, and the basis of P in the section 467 loan immediately following the transfer is $1,981,550.71. P takes section 467 rent and section 467 interest into account for the calendar years 2003 and 2004 under the constant rental accrual method and, accordingly, treats payments received under the rental agreement as recoveries of the principal balance of the section 467 loan (as adjusted from time to time).

(f) *Treatment of assignments by lessee and lessee-financed renewals*—(1) *Substitute lessee use.* If a lessee assigns its interest in a section 467 rental agreement to a substitute lessee, or if a period when a substitute lessee has the use of property subject to a section 467 rental agreement is otherwise included in the lease term under §1.467–1(h)(6), the section 467 rent for a period is taken into account by the person having the use of the property during the period. The following rules apply in determining the section 467 rent and section 467 interest for the portion of the rental period ending immediately prior to the assignment:

(i) The section 467 rent and section 467 interest for the portion of the rental period ending immediately prior to the assignment are a pro rata portion of the section 467 rent and the section 467 interest, respectively, for the rental period. Such amounts are also taken into account in determining the lessee's section 467 loan balance, prior to any adjustment thereof that may be required under paragraph (h) of this section, immediately before the substitute lessee first has use of the property.

(ii) If the lessee is liable for the rent for the day that the substitute lessee first has use of the property, the substitute lessee's use shall be treated as beginning at the end of that day.

(iii) If the substitute lessee is liable for the rent for the day that the substitute lessee first has use of the property, the substitute lessee's use shall be treated as beginning at the beginning of that day.

(2) *Treatment of section 467 loan.* If, as described in paragraph (f)(1) of this section, a lessee assigns its interest in a section 467 rental agreement to a substitute lessee or a period when a substitute lessee has the use of property subject to a section 467 rental agreement is otherwise included in the lease term under §1.467–1(h)(6), the following rules apply in determining the amount of the lessee's and the substitute lessee's section 467 loans for the period when the substitute lessee has use of the property and in computing the taxable income of the lessee and substitute lessee:

(i) The beginning balance of the lessee's section 467 loan is equal to the net present value, as of the time the substitute lessee first has use of the property (but after giving effect to the transfer of the right to use the property), of all amounts subsequently payable by the lessee as fixed rent and interest on fixed rent and all amounts subsequently payable as interest on prepaid fixed rent to the lessee. For purposes of this paragraph (f), any amount otherwise payable by the lessee is not treated as an amount subsequently payable by the lessee to the extent that such payment, if made by the lessee, would give rise to a right of contribution or other similar claim against the substitute lessee or any other person. The lessee must continue to take into account interest on the lessee's section 467 loan balance after the substitute lessee first has use of the property.

(ii) The beginning balance of the substitute lessee's section 467 loan is equal to the principal balance of the lessee's section 467 loan immediately before the substitute lessee first has use of the property reduced (below zero, if appropriate) by the beginning balance of the lessee's section 467 loan. Amounts payable by the lessee to any person other than the substitute lessee (or a related person) or payable to the lessee by any person other than the substitute lessee (or a related person) are not taken into account in adjusting the substitute lessee's section 467 loan balance.

(iii) If the beginning balance of the substitute lessee's section 467 loan is positive, the beginning balance is treated as—

(A) Gross receipts of the lessee for the taxable year in which the substitute lessee first has use of the property; and

(B) A liability that is either assumed in connection with the transfer of the leasehold interest to the substitute lessee or secured by property acquired subject to the liability.

(iv) If the beginning balance of the substitute lessee's section 467 loan is negative, the following rules apply:

(A) If the principal balance of the lessee's section 467 loan immediately before the substitute lessee first has use of the property was negative, any consideration paid by the substitute lessee to the lessee in conjunction with the transfer of the use of the property shall be treated as a nontaxable return of capital to the lessee to the extent that—

(*1*) The consideration does not exceed the amount owed to the lessee under the lessee's section 467 loan balance immediately before the substitute lessee first has use of the property; and

(*2*) The lessee has basis in the principal balance of the lessee's section 467 loan immediately before the substitute lessee first has use of the property.

(B) Except as provided in paragraph (f)(2)(iv)(D) of this section, the excess, if any, of the beginning balance of the amount owed to the substitute lessee under the section 467 loan, over any consideration paid by the substitute lessee to the lessee in conjunction with the transfer of the use of the property, is treated as an amount incurred by the lessee for the taxable year in which the substitute lessee first has use of the property.

(C) To the extent the beginning balance of the amount owed to the substitute lessee under the section 467 loan exceeds any consideration paid by the substitute lessee to the lessee in conjunction with the transfer of the use of the property, repayments of the beginning balance are items of gross income of the substitute lessee in the taxable year in which repayment occurs (determined by applying any repayment first to the beginning balance of the substitute lessee's section 467 loan).

(D) Any amount incurred by the lessee under paragraph (f)(2)(iv)(B) of this section with respect to a transfer of the use of property (the current transfer) shall be reduced (but not below zero) to the extent that the lessee, in its capacity, if any, as a substitute lessee with respect to an earlier transfer of the use of the property would have recognized additional gross income under paragraph (f)(2)(iv)(C) of this section if the current transfer had not occurred.

(v) For purposes of paragraph (f)(2)(iv)(C) of this section, repayments occur as the negative balance is amortized through the net accrual of rent and negative interest.

(3) *Lessor use.* If a period when the lessor has the use of property subject to a section 467 rental agreement is included in the lease term under §1.467–1(h)(6), the section 467 rent for the period is not taken into account and the lessor is treated as a substitute lessee for purposes of this paragraph (f).

(4) *Examples.* The following examples illustrate the application of this paragraph (f). In each of these examples, the substitute lessee is liable for the rent for the day on which the substitute lessee first has use of the property subject to the section 467 rental agreement. Further, assume that in each example the lessee assignment is not a substantial modification under §1.467–1(f). The examples are as follows:

Example 1. (i) The facts are the same as in *Example 1* of paragraph (e)(4) of this section, except that on December 31, 2001, R, the lessee, contracts to assign its entire remaining interest in the leasehold to S, a calendar year taxpayer. The assignment becomes effective at the beginning of January 1, 2002. Pursuant to the terms of the assignment, R agrees with S that R will make $1,400,000 of the $1,750,000 rental payment required on December 31, 2003.

(ii) Under paragraph (f)(2)(i) of this section, R's section 467 loan balance as of the beginning of January 1, 2002, the time S first has use of the property, is $1,136,271.41 ($1,400,000/(1.11)2). Under paragraph (f)(2)(ii) of this section, S's section 467 loan balance as of the beginning of January 1, 2002, is $114,759.98 (the principal balance of R's section 467 loan immediately before S has use of the property ($1,251,031.39), less R's section 467 loan balance at the beginning of January 1, 2002 ($1,136,271.41)).

(iii) Because S's $114,759.98 section 467 loan balance is positive, under paragraph (f)(2)(iii)(A) of this section, such amount is treated as gross receipts of R for 2002, R's taxable year in which S first has use of the property. R will treat the $114,759.98 as an amount received in exchange for the transfer of the leasehold interest. Under paragraph (f)(2)(iii)(B) of this section, S will treat that amount as a liability assumed in acquiring the leasehold interest. Thus, S's cost basis in the leasehold interest is $114,759.98.

(iv) Under paragraph (f)(1) of this section, S takes the section 467 rent attributable to the property into account for the period beginning on January 1, 2002. For 2002, S takes section 467 interest into account based on S's section 467 loan balance at the beginning of 2002. S's amounts payable, section 467 rent, section 467 interest, and end-of-year section 467 loan balances for calendar years 2002 through 2004 are as follows:

Calendar year	Payment	Section 467 interest	Section 467 rent	Section 467 loan balance
Beginning				$114,759.98
2002	$0	$12,623.60	$592,905.87	720,289.45
2003	350,000.00	79,231.83	592,905.87	1,042,427.15
2004	1,750,000.00	114,666.98	592,905.87	0

(v) Under paragraph (f)(2)(i) of this section, R must continue to take into account section 467 interest on R's section 467 loan balance after S first has use of the property. R's section 467 loan balance beginning when S first has use of the property is $1,136,271.41. R's section 467 interest and end-of-year section 467 loan balances for calendar years 2002 through 2003 are as follows:

Calendar year	Payment	Section 467 interest	Section 467 loan balance
Beginning			$1,136,271.41
2002	$0	$124,989.85	1,261,261.26
2003	1,400,000.00	138,738.74	0

Example 2. (i) On January 1, 2000, B leases tangible personal property from C for a period of five years. The rental agreement provides that the rental period is the calendar year and that rent payments are due at the end of the calendar year. The rental agreement does not provide for interest on prepaid rent. Assume that B and C are both calendar year taxpayers and that 110 percent of the applicable Federal rate is 10 percent, compounded annually. The rental agreement allocates rents and provides for payments of rent as follows:

Calendar year	Rent	Payments
2000	$200,000	$400,000
2001	200,000	300,000
2002	200,000	200,000
2003	200,000	100,000
2004	200,000	0

(ii) The rental agreement has prepaid rent within the meaning of §1.467–1(c)(3)(ii) because the cumulative amount of rent payable through the end of 2001 ($700,000) exceeds the cumulative amount of rent allocated to calendar years 2000 through 2002 ($600,000). Because the rental agreement does not provide for adequate interest on prepaid fixed rent, the rent for each calendar year during the lease term is the proportional rental amount, as described in §1.467–2(c). The amounts payable, section 467 rent, section 467 interest, and end-of-year section 467 loan balances for each calendar year are as follows:

Calendar year	Payment	Section 467 interest	Section 467 rent	Section 467 loan balance
2000	$400,000	$0	$218,987.40	($181,012.60)
2001	300,000	(18,101.26)	218,987.40	(280,126.46)
2002	200,000	(28,012.64)	218,987.40	(289,151.70)
2003	100,000	(28,915.17)	218,987.40	(199,079.47)
2004	0	(19,907.93)	218,987.40	0

(iii) On December 31, 2001, B contracts to assign its entire remaining interest in the leasehold to D, a calendar year taxpayer. The assignment becomes effective at the beginning of January 1, 2002. D pays B $278,000 on January 1, 2002, in conjunction with the assignment of the leasehold interest. Under the terms of the assignment, B is not obligated to make any rental payments due after the assignment.

(iv) Under paragraph (f)(2)(i) of this section, B's section 467 loan balance as of the beginning of January 1, 2002, the time D first has use of the property, is zero because D is obligated to make all rent payments due after the assignment of the leasehold interest. Under paragraph (f)(2)(ii) of this section, D's section 467 loan balance as of the beginning of January 1, 2002, is negative $280,126.46 (the principal balance of B's section 467 loan immediately before D has use of the property (negative $280,126.46), less B's section 467 loan balance when D first has use of the property (zero)). Because D's beginning section 467 loan balance is negative, paragraph (f)(2)(iv) of this section applies.

(v) Because B's $280,126.46 section 467 loan balance at the end of 2001 (that is, immediately before D has use of the property) is negative, paragraph (f)(2)(iv)(A) of this section applies. B's loan balance is the amount owed to B under the section 467 loan and consists of the excess of B's payments to C over the net amount of rent and negative interest B has taken into account through the end of 2001. Thus, B's basis in the negative section 467 loan balance at the end of 2001 is $280,126.46. Because the $278,000 paid by D to B in conjunction with the transfer of the leasehold interest does not exceed the amount owed to B under the section 467 loan at the end of 2001, and does not exceed B's basis in that loan balance, under paragraph (f)(2)(iv)(A) of this section B treats the $278,000 payment from D as a nontaxable return of capital.

(vi) The beginning balance of the amount owed to D under the section 467 loan ($280,126.46) exceeds by $2,126.46 the $278,000 paid by D to B in conjunction with the transfer of the leasehold interest. Paragraph (f)(2)(iv)(B) of this section treats the $2,126.46 as an amount incurred by B in 2002, B's taxable year in which D first has use of the property. Paragraph (f)(2)(iv)(D) of this section does not apply to reduce the amount incurred by B because B is the original lessee under the section 467 rental agreement.

(vii) Under paragraph (f)(1) of this section, D takes the section 467 rent into account for the period beginning when D first has use of the property. D takes section 467 interest into account based on a beginning section 467 loan balance of negative $280,126.46.

(viii) The beginning balance of the amount owed to D under the section 467 loan ($280,126.46) exceeds by $2,126.46 the $278,000 paid by D to B in conjunction with the transfer of the leasehold interest. Under paragraph (f)(2)(iv)(C) of this section, D must include this amount in gross income in 2002, the year in which this amount of D's beginning section 467 loan balance is paid through the net accrual of rent and negative interest. This inclusion in gross income ensures that the reductions in D's taxable income attributable to the section 467 rental agreement will not exceed the actual amount of D's expenditures.

(g) *Application of section 467 following a rental agreement modification*—(1) *Substantial modifications.* The following rules apply to any substantial modification of a rental agreement occurring after May 18, 1999 unless the entire agreement (as modified) is treated as a single agreement under §1.467–1(f)(4)(vi):

(i) *Treatment of pre-modification items.* The lessor and lessee must take pre-modification items (within the meaning of §1.467–1(f)(5)(v)) into account under their method of accounting used before the modification to report income and expense attributable to the rental agreement.

(ii) *Computations with respect to post-modification items.* In computing section 467 rent, section 467 interest, and the amount of the section 467 loan with respect to post-modification items—

(A) Post-modification items are treated as provided under a rental agreement (the post-modification agreement) separate from the agreement under which pre-modification items are provided;

(B) The lease term of the post-modification agreement begins at the beginning of the first period for which rent other than pre-modification rent is provided; and

(C) The applicable Federal rate for the post-modification agreement is the applicable Federal rate in effect on the day on which the modification occurs.

(iii) *Adjustments*—(A) *Adjustment relating to certain prepayments.* If any payments before the beginning of the lease term of the post-modification agreement are post-modification items, the lessor and lessee must take into account, in the taxable year in which the modification occurs, any adjustment necessary to prevent duplication with respect to such payments or the omission of interest thereon for periods before the beginning of the lease term.

(B) *Adjustment relating to retroactive beginning of lease term.* If the lease term of a post-modification agreement begins before the date on which the modification occurs, the lessor and lessee must take into account in the taxable year in which the modification occurs any amount necessary to prevent the duplication or omission of rent or interest for the period after the beginning of the lease term of the post-modification agreement and before the beginning of the taxable year in which the modification occurs. For this purpose, the amount necessary to prevent duplication or omission is determined after taking into account any adjustments required by the Commissioner for taxable years ending prior to the beginning of the taxable year in which the modification occurs. In determining any adjustments required by the Commissioner for taxable years ending prior to the beginning of the taxable year in which the modification occurs, the Commissioner will disregard the modification.

(iv) *Coordination with rules relating to dispositions and assignments*—(A) *Dispositions.* If the modification involves a sale, exchange, or other disposition of the property subject to the rental agreement—

(*1*) Adjustments required under this paragraph (g) are taken into account before applying paragraphs (a), (b), (c), and (e) of this section;

(*2*) The prior understated inclusion for purposes of paragraph (b) of this section is the sum of the prior understated inclusion with respect to pre-modification items and the prior understated inclusion with respect to post-modification items; and

(*3*) Paragraph (e) of this section applies separately with respect to pre-modification items and post-modification items.

(B) *Assignments.* If the modification involves an assignment of the lessee's interest in the rental agreement to a substitute lessee or a substitute lessee having use of the property during a period otherwise included in the lease term—

(*1*) Adjustments required under this paragraph (g) are taken into account before applying paragraph (f) of this section; and

(*2*) Paragraph (f) of this section applies separately with respect to pre-modification items and post-modification items.

(2) *Other modifications.* The following rules apply to a modification (other than a substantial modification) of a rental agreement occurring after May 18, 1999:

(i) *Computation of section 467 loan for modified agreement.* The amount of the section 467 loan relating to the agreement is computed as of the effective date of the modification. The section 467 rent and section 467 interest for periods before the effective date of the modification are determined, solely for purposes of computing the amount of the section 467 loan, under the terms of the entire agreement (as modified).

(ii) *Change in balance of section 467 loan.* (A) If the balance of the section 467 loan determined under paragraph (g)(2)(i) of this section is greater than the balance of the section 467 loan immediately before the effective date of the modification, the difference is taken into account, in the taxable year in which the modification occurs, as additional rent.

(B) If the balance of the section 467 loan determined under paragraph (g)(2)(i) of this section is less than the balance of the section 467 loan immediately before the effective date of the modification, the difference is taken into account, in the taxable year in which the modification occurs, as a reduction of the rent previously taken into account by the lessor and lessee.

(C) For purposes of this paragraph (g)(2)(ii), a negative balance is less than a positive balance, a zero balance, or any other negative balance that is closer to a zero balance.

(iii) *Section 467 rent and interest after the modification.* The section 467 rent and section 467 interest for periods after the effective date of the modification are determined under the terms of the entire agreement (as modified).

(iv) *Applicable Federal rate.* The applicable Federal rate for the agreement does not change as a result of the modification.

(v) *Modification effective within a rental period.* If the effective date of a modification does not coincide with the beginning or end of a rental period under the agreement in effect before the modification, the section 467 rent and section 467 interest for the portion of the rental period ending immediately prior to the effective date of the modification are a pro rata portion of the section 467 rent and the section 467 interest, respectively, for the rental period. Such amounts are also taken into account in determining the section 467 loan balance, prior to any adjustment thereof that may be required under paragraph (h) of this section, immediately before the effective date of the modification. Similar rules apply with respect to the section 467 rent and section 467 interest determined under the terms of the entire agreement (as modified) for purposes of computing the amount of the section 467 loan under paragraph (g)(2)(i) of this section and the section 467 rent and section 467 interest for a partial rental period beginning on the effective date of the modification.

(vi) *Other adjustments.* The lessor and lessee must take into account, in the taxable year in which a retroactive modification occurs, any amount necessary to prevent the duplication or omission of rent or interest for the period before the beginning of the taxable year in which the modification occurs.

(vii) *Coordination with rules relating to dispositions and assignments.* If the modification involves a sale, exchange, or other disposition of the property subject to the rental agreement, an assignment of the lessee's interest in the rental agreement to a substitute lessee or a substitute lessee having use of the property during a period otherwise included in the lease term, adjustments required under this paragraph (g) are taken into account before applying paragraphs (a), (b), (c), (e), and (f) of this section.

(viii) *Exception for agreements entered into prior to effective date of section 467.*

This paragraph (g)(2) does not apply to a modification of a rental agreement that is not subject to section 467 because of the effective date provisions of section 92(c) of the Tax Reform Act of 1984 (Public Law 98–369 (98 Stat. 612)).

(3) *Adjustment by Commissioner.* If the entire agreement (as modified) is treated as a single agreement under §1.467–1(f)(4)(vi), the Commissioner may require adjustments to taxable income to reflect the effect of the modification, including adjustments that are similar to those required under paragraph (g)(2) of this section.

(4) *Effective date of modification.* The effective date of a modification of a rental agreement occurs at the earliest of—

(i) The date on which the modification occurs;

(ii) The beginning of the first period for which the amount of rent or interest provided under the entire agreement (as modified) differs from the amount of rent or interest provided under the agreement in effect before the modification;

(iii) The due date of the first payment, under either the entire agreement (as modified) or the agreement in effect before the modification, that is not identical, in due date and amount, under both such agreements;

(iv) The date, in the case of a modification involving the substitution of a new lessor, on which the property subject to the rental agreement is transferred; or

(v) The date, in the case of a modification involving the substitution of a new lessee, on which the substitute lessee first has use of the property subject to the rental agreement.

(5) *Examples.* The following examples illustrate the application of this paragraph (g):

Example 1. (i) F, a cash method lessor, and G, an accrual method lessee, agree to a 7-year lease of tangible personal property for the period beginning on January 1, 1998, and ending on December 31, 2004. The rental agreement allocates $100,000 of rent to each calendar year during the lease term, such rent to be paid December 31 following the close of the calendar year to which it is allocated. Because the rental agreement does not provide for increasing rent, or deferred rent within the meaning of section 467(d)(1)(A), section 467 does not apply to the rental agreement.

(ii) Prior to January 1, 2001, G timely makes the $100,000 rental payments required as of December 31, 1999, and December 31, 2000. On January 1, 2001, F and G modify the rental agreement payment schedule to provide for a single final payment of $500,000 on December 31, 2004. Assume that the change is a substantial modification within the meaning of §1.467–1(f)(5)(ii). Because the modification occurs after May 18, 1999, the post-modification agreement is treated, under §1.467–1(f)(1), as a new agreement for purposes of determining whether it is a section 467 rental agreement.

(iii) Under §1.467–1(f)(5)(v), the $200,000 of rent allocated to calendar years 1998 and 1999 (periods prior to the modification) constitutes pre-modification rent, and the $100,000 rent payments made on December 31, 1999, and December 31, 2000, constitute pre-modification payments. Although calendar year 2000 is also prior to the modification, the rent allocated to calendar year 2000 is not pre-modification rent and the related payment is not a pre-modification payment because the modification changed the time at which that rent is payable. See §1.467–1(f)(5)(v)(A).

(iv) Under paragraph (g)(1)(i) of this section, F and G take pre-modification rent and pre-modification payments into account under the method of accounting they used to report income and deductions attributable to the pre-modification agreement.

(v) Under §1.467–1(f)(1)(i), the post-modification agreement providing rent for the period beginning on January 1, 2000, and ending on December 31, 2004, is treated as a new rental agreement. This rental agreement allocates $100,000 of rent to each of the calendar years 2000 through 2004 and provides for a single rental payment of $500,000 on December 31, 2004. Because the post-modification agreement provides for deferred rent under §1.467–1(c)(3)(i), section 467 applies. Further, the post-modification agreement does not provide for adequate interest on fixed rent, and therefore F and G must account for fixed rent and interest on fixed rent using proportional rental accrual. Under paragraph (g)(1)(iii) of this section, for their taxable years which include January 1, 2001, F and G must adjust reported rent for the difference between the rent taken into account for the calendar year 2000 under the unmodified agreement and the proportional rental amount for that year under the post-modification agreement.

Example 2. (i) On January 1, 2000, X, lessee, and Y, lessor, enter into a rental agreement for a 6-year lease of tangible personal property beginning January 1, 2000, and endingDecember 31, 2005. The agreement provides that the calendar year is the rental period and all rent payments are due on July 15 of all years in which a payment is required. Assume the agreement is not a disqualified leaseback or long-term agreement within the meaning of §1.467–3(b), and has the following allocation schedule and payment schedule:

Year	Allocation	Payment
2000	$800,000	$0
2001	900,000	0
2002	1,000,000	1,500,000
2003	1,000,000	1,500,000
2004	1,100,000	1,500,000
2005	1,200,000	1,500,000

(ii) The rental agreement has deferred rent within the meaning of §1.467–1(c)(3)(i) because the rent allocated to 2000 is not payable until 2002 and some of the rent allocable to 2001 is not payable until 2003. Further, the rental agreement does not provide adequate interest on fixed rent within the meaning of §1.467–2(b). Therefore, the rent amount to be accrued by X and Y for each rental period is the proportional rental amount, as described in §1.467–2(c). Assuming 110 percent of the applicableFederal rate is 10 percent compounded annually, the section 467 rent, interest, and loan balances are as follows:

Year	Rent	Interest	Loan balance
2000	$736,949.55	$0	$736,949.55
2001	829,068.24	73,694.96	1,639,712.75
2002	921,186.94	163,971.28	1,224,870.97
2003	921,186.94	122,487.10	768,545.01
2004	1,013,305.63	76,854.50	358,705.14
2005	1,105,424.33	35,870.53	0

(iii)(A) On January 1, 2004, X and Y agree that the $1,500,000 payment scheduled for July 15, 2005, will be made in three equal installments on June 15, 2005, July 15, 2005, and August 15, 2005. Under §1.467–1(j)(2)(i)(C) (relating to timing conventions), the payment to be made on June 15, 2005, is treated as if it were payable on December 31, 2004, for purposes of determining present values and yield of the section 467 loan. Assume that this change, which results in the following allocation schedule and payment schedule, is not a substantial modification within the meaning of §1.467–1(f)(5)(ii):

Year	Allocation	Payment
2000	$800,000	$0
2001	900,000	0
2002	1,000,000	1,500,000
2003	1,000,000	1,500,000
2004	1,100,000	2,000,000
2005	1,200,000	1,000,000

(B) The agreement remains subject to proportional rental accrual after the modification because it has deferred rent and does not provide adequate interest on fixed rent within the meaning of §1.467–2(b).

(iv) Because the modification occurs after May 18, 1999, and is not substantial within the meaning of §1.467–1(f)(5)(ii), paragraph (g)(2) of this section applies. Under paragraph (g)(2)(i) of this section, the amount of the section 467 loan relating to the modified agreement is computed as of the effective date of the modification, and, solely for purposes of recomputing the amount of the section 467 loan, the section 467 rent and section 467 interest for periods before the modification are determined under the terms of the entire agreement (as modified). In addition, the applicable Federal rate does not change as a result of the modification. Thus, the recomputed section 467 rent, interest, and loan balances are as follows:

Year	Rent	Interest	Loan balance
2000	$ 742,242.59	$ 0	$ 742,242.59
2001	835,022.91	74,224.26	1,651,489.76
2002	927,803.24	165,148.98	1,244,441.98
2003	927,803.24	124,444.20	796,689.42
2004	1,020,583.56	79,668.94	(103,058.08)
2005	1,113,363.88	(10,305.80)	0

(v) Under paragraph (g)(2)(ii) of this section, the difference between the section 467 loan balance immediately before the effective date of the modification and the recomputed section 467 loan balance as of the effective date of the modification is taken into account. In this example, the loan balance immediately before the effective date of the modification is $768,545.01 and the recomputed loan balance as of the effective date of the modification is $796,689.42. Thus, because the recomputed loan balance exceeds the original loan balance, the difference ($28,144.41) is taken into account, in the taxable year in which the modification occurs, as additional rent. Beginning on January 1, 2004, section 467 rent and interest are taken into account by X and Y in accordance with the recomputed rent schedule set forth in paragraph (iv) of this example.

(h) *Omissions or duplications*—(1) *In general*. In applying the rules of this section in conjunction with the rules of §§ 1.467–1 through 1.467–5, adjustments must be made to the extent necessary to prevent the omission or duplication of items of income, deduction, gain, or loss. For example, if a transferee lessor acquires property subject to a section 467 rental agreement at other than the beginning or end of a rental period, and the transferee lessor's beginning section 467 loan balance differs from the transferor lessor's section 467 loan balance immediately prior to the transfer, it will be necessary to treat the rental period that includes the day of transfer as consisting of two rental periods, one beginning at the beginning of the rental period that includes the day of transfer and ending with or immediately prior to the transfer and one beginning with or immediately after the transfer and ending immediately prior to the beginning of the succeeding rental period. Because the substitution of two rental periods for one rental period may change the proportional rental amount or constant rental amount, the change in rental periods should be treated as a modification of the rental agreement that occurs immediately prior to the transfer. The change in rental periods, by itself, is not treated as a substantial modification of the rental agreement although the substitution of a new lessor may constitute a substantial modification of the rental agreement. Likewise, § 1.467–1(j)(2), which provides rules regarding when amounts are treated as payable, is designed to simplify calculations of present values, section 467 loan balances, and proportional and constant rental amounts. These simplifying conventions assume that there will be no change in the lessor or lessee under a section 467 rental agreement and that the terms of the section 467 rental agreement will not be modified. Therefore, as illustrated in the example in paragraph (h)(2) of this section, when actual events do not reflect these assumptions, it may be necessary to alter the application of these rules to properly reflect taxable income.

(2) *Example*. The following example illustrates an application of this paragraph (h):

Example. (i) J leases tangible personal property from K for five years beginning on January 1, 2000, and ending on December 31, 2004. Under the rental agreement, rent is payable on July 15 of the calendar year to which it is allocated. Both J and K treat the calendar year as the rental period. The allocation of rent and payments of rent required under the rental agreement are as follows:

Calendar year	Rent	Payments
2000	$200,000	$450,000
2001	200,000	250,000
2002	200,000	200,000
2003	200,000	100,000
2004	200,000	0

(ii) The rental agreement does not provide for interest on prepaid rent. The rental agreement has prepaid rent under § 1.467–1(c)(3)(ii) because the rent payable at the end of 2000 exceeds the cumulative amount of rent allocated to 2000 and 2001. Therefore, J and K must take section 467 rent into account under the proportional rental method of § 1.467–2(c). Assume that 110 percent of the applicable Federal rate is 10 percent, compounded annually. The section 467 rent, section 467 interest, amounts payable, and section 467 loan balances for each of the calendar years under the terms of the rental agreement are as follows:

Calendar Year	Section 467 rent	Section 467 interest	Payments	Section 467 loan balance
2000	$220,077.48	$0	$450,000	$(229,922.52)
2001	220,077.48	(22,992.25)	250,000	(282,837.29)
2002	220,077.48	(28,283.73)	200,000	(291,043.54)
2003	220,077.48	(29,104.35)	100,000	(200,070.41)
2004	220,077.48	(20,007.07)	0	0

(iii) On January 1, 2002, J and K amend the terms of the rental agreement to advance the due date of the $200,000 payment originally due on July 15, 2002, to June 15, 2002. This change in the payment schedule constitutes a modification of the terms of the rental agreement within the meaning of § 1.467–1(f)(5)(i). Assume, however, that the change is not a substantial modification within the meaning of §1.467–1(f)(5)(ii). Because the modification occurs after May 18, 1999, and is not substantial, paragraph (g)(2) of this section applies. Thus, the section 467 loan balance at the beginning of 2002 must be recomputed as if the June 15, 2002, payment date had been included in the terms of the pre-modification rental agreement. If this had been the case, the section 467 rent, section 467 interest, amounts payable, and section 467 loan balances for each of the calendar years under the terms of the rental agreement would have been as follows:

Calendar	Section 467 rent	Section 467 interest	Payments	Section 467 loan balance
2000	$224,041.38	$0	$450,000	$(225,958.62)
2001	224,041.38	(22,595.86)	450,000	(474,513.10)
2002	224,041.38	(47,451.31)	0	(297,923.03)
2003	224,041.38	(29,792.30)	100,000	(203,673.95)
2004	224,041.38	(20,367.43)	0	0

(iv) Section 1.467–4(b)(3) incorporates the conventions of §1.467–1(j)(2) in determining when amounts are treated as payable for purposes of determining the section 467 loan balance. Section 1.467–1(j)(2)(i)(C) treats amounts payable during the first half of any rental period except the first rental period as payable on the last day of the preceding rental period. Therefore, because June 15, 2002, occurs in the first half of 2002, in determining the section 467 loan balance at the beginning of 2002 under the amended terms of the rental agreement, the $200,000 payment due on June 15, 2002, is treated as payable on December 31, 2001.

(v) Under paragraph (g)(2)(ii)(B) of this section, if the recomputed section 467 loan balance is less than the section 467 loan balance immediately before the modification, the difference is taken into account as a reduction of the rent previously taken into account by the lessor and the lessee. In this example, the recomputed section 467 loan balance immediately after the modification is negative $474,513.10 and the section 467 loan balance immediately before the modification is negative $282,837.29. However, the section 467 loan balance immediately before the modification does not take into account the $200,000 payment originally payable on July 15, 2002, whereas, under the conventions of §1.467–1(j)(2)(i)(C), the recomputed section 467 loan balance immediately after the modification takes into account that $200,000 payment because it is now payable in the first half of the rental period (June 15). Under these circumstances, if the recomputed section 467 loan balance immediately after the modification is treated as negative $474,513.10 for purposes of applying paragraph (g)(2)(ii)(B) of this section, K's gross income and J's deductions attributable to the section 467 rental agreement will be understated by $200,000. Therefore, under paragraph (h)(1) of this section, only for purposes of applying paragraph (g)(2)(ii)(B) of this section, the $200,000 payment due on June 15, 2002, should not be taken into account in determining the recomputed section 467 loan balance immediately after the modification.

[T.D. 8820, 64 FR 26867, May 18, 1999]

§ 1.467–8 Automatic consent to change to constant rental accrual for certain rental agreements.

(a) *General rule.* For the first taxable year ending after May 18, 1999, a taxpayer may change to the constant rental accrual method, as described in §1.467–3, for all of its section 467 rental agreements described in paragraph (b) of this section. A change to the constant rental accrual method is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. A taxpayer changing its method of accounting in accordance with this section must follow the automatic change in accounting method provisions of Rev. Proc. 98–60 (see §601.601(d)(2) of this chapter) except, for purposes of this paragraph (a), the scope limitations in section 4.02 of Rev. Proc. 98–60 are not applicable. Taxpayers changing their method of accounting in accordance with this section must do so for all of their section 467 rental agreements described in paragraph (b) of this section.

(b) *Agreements to which automatic consent applies.* A section 467 rental agreement is described in this paragraph (b) if—

(1) The property subject to the section 467 rental agreement is financed with an ‘‘exempt facility bond’’ within the meaning of section 142;

(2) The facility subject to the section 467 rental agreement is described in section 142(a)(1), (2), (3), or (12);

(3) The section 467 rental agreement does not include a specific allocation of fixed rent within the meaning of § 1.467–1(c)(2)(ii)(A)(*2*); and

(4) The section 467 rental agreement was entered into on or before May 18, 1999.

[T.D. 8820, 64 FR 26875, May 18, 1999]

§ 1.467–9 Effective dates and automatic method changes for certain agreements.

(a) *In general.* Sections 1.467–1 through 1.467–7 are applicable for—

(1) Disqualified leasebacks and long-term agreements entered into after June 3, 1996; and

(2) Rental agreements not described in paragraph (a)(1) of this section that are entered into after May 18, 1999.

(b) *Automatic consent for certain rental agreements.* Section 1.467–8 applies only to rental agreements described in § 1.467–8.

(c) *Application of regulation project IA–292–84 to certain leasebacks and long-term agreements.* In the case of any leaseback or long-term agreement (other than a disqualified leaseback or long-term agreement) entered into after June 3, 1996, and on or before May 18, 1999, a taxpayer may choose to apply the provisions of regulation project IA–292–84 (1996–2 C.B. 462)(see § 601.601(d)(2) of this chapter).

(d) *Entered into.* For purposes of this section and § 1.467–8, a rental agreement is entered into on its agreement date (within the meaning of § 1.467–1(h)(1) and, if applicable, § 1.467–1(f)(1)(i)).

(e) *Change in method of accounting*—(1) *In general.* For the first taxable year ending after May 18, 1999, a taxpayer is granted consent of the Commissioner to change its method of accounting for rental agreements described in paragraph (a)(2) of this section to comply with the provisions of §§ 1.467–1 through 1.467–7.

(2) *Application of regulation project IA–292–84.* For the first taxable year ending after May 18, 1999, a taxpayer is granted consent of the Commissioner to change its method of accounting for any rental agreement described in paragraph (c) of this section to comply with the provisions of regulation project IA–292–84 (1996–2 C.B. 462) (see § 601.601(d)(2) of this chapter).

(3) *Automatic change procedures.* A taxpayer changing its method of accounting in accordance with this paragraph (e) must follow the automatic change in accounting method provisions of Rev. Proc. 98–60 (see § 601.601(d)(2) of this chapter) except, for purposes of this paragraph (e), the scope limitations in section 4.02 of Rev. Proc. 98–60 are not applicable. A method change in accordance with paragraph (e)(1) of this section is made on a cut-off basis so no adjustment under section 481(a) is required.

[T.D. 8820, 64 FR 26875, May 18, 1999]

§ 1.468A–0 Nuclear decommissioning costs; table of contents.

This section lists the paragraphs contained in §§ 1.468A–1 through 1.468A–9.

§ 1.468A–1 Nuclear decommissioning costs; general rules.

§ 1.468A–2 Treatment of electing taxpayer.

§ 1.468A–3 Ruling amount.

§ 1.468A–9 Effective/applicability date.

[T.D. 9512, 75 FR 80701, Dec. 23, 2010]

§ 1.468A–1 Nuclear decommissioning costs; general rules.

(a) *Introduction.* Section 468A provides an elective method for taking into account nuclear decommissioning costs for Federal income tax purposes. In general, an eligible taxpayer that elects the application of section 468A pursuant to the rules contained in § 1.468A–7 is allowed a deduction (as determined under § 1.468A–2) for the taxable year in which the taxpayer makes a cash payment to a nuclear decommissioning fund. Taxpayers using an accrual method of accounting that do not elect the application of section 468A are not allowed a deduction for nuclear decommissioning costs prior to the taxable year in which economic performance occurs with respect to such costs (*see* section 461(h)).

(b) *Definitions.* The following terms are defined for purposes of section 468A and §§ 1.468A–1 through 1.468A–9:

(1) The term *eligible taxpayer* means any taxpayer that possesses a qualifying interest in a nuclear power plant (including a nuclear power plant that is under construction).

(2) The term *qualifying interest* means—

(i) A direct ownership interest; and

(ii) A leasehold interest in any portion of a nuclear power plant if—

(A) The holder of the leasehold interest is primarily liable under Federal or State law for decommissioning such portion of the nuclear power plant; and

(B) No other person establishes a nuclear decommissioning fund with respect to such portion of the nuclear power plant.

(3) The term *direct ownership interest* includes an interest held as a tenant in common or joint tenant, but does not include stock in a corporation that owns a nuclear power plant or an interest in a partnership that owns a nuclear power plant. Thus, in the case of a partnership that owns a nuclear power plant, the election under section 468A must be made by the partnership and not by the partners. In the case of an unincorporated organization described in § 1.761–2(a)(3) that elects under section 761(a) to be excluded from the application of subchapter K, each taxpayer that is a co-owner of the nuclear power plant is eligible to make a separate election under section 468A.

(4) The terms *nuclear decommissioning fund* and *qualified nuclear decommissioning fund* mean a fund that satisfies the requirements of § 1.468A–5. The term *nonqualified fund* means a fund that does not satisfy those requirements.

(5) The term *nuclear power plant* means any nuclear power reactor that is used predominantly in the trade or business of the furnishing or sale of electric energy. Each unit (that is, nuclear reactor) located on a multi-unit site is a separate nuclear power plant. The term *nuclear power plant* also includes the portion of the common facilities of a multi-unit site allocable to a unit on that site.

(6) The term *nuclear decommissioning costs* or *decommissioning costs* includes all otherwise deductible expenses to be incurred in connection with the entombment, decontamination, dismantlement, removal and disposal of the structures, systems and components of a nuclear power plant, whether that nuclear power plant will continue to produce electric energy or has permanently ceased to produce electric energy. Such term includes all otherwise deductible expenses to be incurred in connection with the preparation for decommissioning, such as engineering and other planning expenses, and all otherwise deductible expenses to be incurred with respect to the plant after the actual decommissioning occurs, such as physical security and radiation monitoring expenses. Such term also includes costs incurred in connection with the construction, operation, and ultimate decommissioning of a facility used solely to store, pending acceptance by the government for permanent storage or disposal, spent nuclear fuel generated by the nuclear power plant or plants located on the same site as the storage facility. Such term does not include otherwise deductible expenses to be incurred in connection with the disposal of spent nuclear fuel under the Nuclear Waste Policy Act of 1982 (Pub. L. 97–425). An expense is otherwise deductible for purposes of this

paragraph (b)(6) if it would be deductible under chapter 1 of the Internal Revenue Code without regard to section 280B.

(7) The term *public utility commission* means any State or political subdivision thereof, any agency, instrumentality or judicial body of the United States, or any judicial body, commission or other similar body of the District of Columbia or of any State or any political subdivision thereof that establishes or approves rates for the furnishing or sale of electric energy.

(8) The term *ratemaking proceeding* means any proceeding before a public utility commission in which rates for the furnishing or sale of electric energy are established or approved. Such term includes a generic proceeding that applies to two or more taxpayers that are subject to the jurisdiction of a single public utility commission.

(9) The term *special transfer* means any transfer of funds to a qualified nuclear decommissioning fund pursuant to §1.468A–8.

(c) *Special rules applicable to certain experimental nuclear facilities.* (1) The owner of a qualifying interest in an experimental nuclear facility possesses a qualifying interest in a nuclear power plant for purposes of paragraph (b) of this section if such person is engaged in the trade or business of the furnishing or sale of electric energy.

(2) An owner of stock in a corporation that owns an experimental nuclear facility possesses a qualifying interest in a nuclear power plant for purposes of paragraph (b)(1) of this section if—

(i) Such stockholder satisfies the conditions of paragraph (c)(1) of this section; and

(ii) The corporation that directly owns the facility is not engaged in the trade or business of the furnishing or sale of electric energy.

(3) For purposes of this paragraph (c), an experimental nuclear facility is a nuclear power reactor that is used predominantly for the purpose of conducting experimentation and research.

[T.D. 9512, 75 FR 80701, Dec. 23, 2010]

§ 1.468A–2 Treatment of electing taxpayer.

(a) *In general.* An eligible taxpayer that elects the application of section 468A pursuant to the rules contained in §1.468A–7 (an electing taxpayer) is allowed a deduction for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment as provided in paragraph (c) of this section) to a nuclear decommissioning fund and for any taxable year in which a deduction is allowed for a special transfer described in §1.468A–8. The amount of the deduction for any taxable year equals the total amount of cash payments made (or deemed made) by the electing taxpayer to a nuclear decommissioning fund (or nuclear decommissioning funds) during such taxable year under this section, plus any amount allowable as a deduction in that taxable year for a special transfer described in §1.468A–8. The amount of a special transfer permitted under §1.468A–8 is not treated as a cash payment for purposes of this paragraph (a), and a taxpayer making a special transfer is allowed a ratable deduction in each taxable year during the remaining useful life of the nuclear power plant for the special transfer. A payment may not be made (or deemed made) to a nuclear decommissioning fund before the first taxable year in which all of the following conditions are satisfied:

(1) The construction of the nuclear power plant to which the nuclear decommissioning fund relates has commenced.

(2) A ruling amount is applicable to the nuclear decommissioning fund (*see* §1.468A–3).

(b) *Limitation on payments to a nuclear decommissioning fund*—(1) *In general.* For purposes of paragraph (a) of this section, the maximum amount of cash payments made (or deemed made) to a nuclear decommissioning fund under paragraph (a) of this section during any taxable year shall not exceed the ruling amount applicable to the nuclear decommissioning fund for such taxable year (as determined under §1.468A–3).

(2) *Excess contributions not deductible.* If the amount of cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceeds the limitation of paragraph (b)(1) of this section, the excess is not deductible by the electing taxpayer. In addition, *see* paragraph (c) of

§ 1.468A–5 for rules which provide that the Internal Revenue Service may disqualify a nuclear decommissioning fund if the amount of cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceeds the limitation of paragraph (b)(1) of this section.

(3) *Special transfer disregarded.* The amount of a special transfer permitted under § 1.468A–8 is not treated as a cash payment for purposes of this paragraph (b).

(c) *Deemed payment rules*—(1) *In general.* The amount of any cash payment made by an electing taxpayer to a nuclear decommissioning fund on or before the 15th day of the third calendar month after the close of any taxable year (the deemed payment deadline date) shall be deemed made during such taxable year if the electing taxpayer irrevocably designates the amount as relating to such taxable year on its timely filed Federal income tax return for such taxable year (*see* § 1.468A–7(b)(4)(iii) and (iv) for rules relating to such designation).

(2) *Cash payment by customer.* The amount of any cash payment made by a customer of an electing taxpayer to a nuclear decommissioning fund of such electing taxpayer shall be deemed made by the electing taxpayer if the amount is included in the gross income of the electing taxpayer in the manner prescribed by section 88 and § 1.88–1.

(d) *Treatment of distributions*—(1) *In general.* Except as otherwise provided in paragraph (d)(2) of this section, the amount of any actual or deemed distribution from a nuclear decommissioning fund shall be included in the gross income of the electing taxpayer for the taxable year in which the distribution occurs. The amount of any distribution of property equals the fair market value of the property on the date of the distribution. *See* § 1.468A–5(c) and (d) for rules relating to the deemed distribution of the assets of a nuclear decommissioning fund in the case of a disqualification or termination of the fund. A distribution from a nuclear decommissioning fund shall include an expenditure from the fund or the use of the fund's assets—

(i) To satisfy, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the fund relates; and

(ii) To pay administrative costs and other incidental expenses of the fund.

(2) *Exceptions to inclusion in gross income*—(i) *Payment of administrative costs and incidental expenses.* The amount of any payment by a nuclear decommissioning fund for administrative costs or other incidental expenses of such fund (as defined in § 1.468A–5(a)(3)(ii)) shall not be included in the gross income of the electing taxpayer unless such amount is paid to the electing taxpayer (in which case the amount of the payment is included in the gross income of the electing taxpayer under section 61).

(ii) *Withdrawals of excess contributions.* The amount of a withdrawal of an excess contribution (as defined in § 1.468A–5(c)(2)(ii)) by an electing taxpayer pursuant to the rules of § 1.468A–5(c)(2) shall not be included in the gross income of the electing taxpayer. *See* paragraph (b)(2) of this section, which provides that the payment of such amount to the nuclear decommissioning fund is not deductible by the electing taxpayer.

(iii) *Actual distributions of amounts included in gross income as deemed distributions.* If the amount of a deemed distribution is included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurs, no further amount is required to be included in gross income when the amount of the deemed distribution is actually distributed by the nuclear decommissioning fund. The amount of a deemed distribution is actually distributed by a nuclear decommissioning fund as the first actual distributions are made by the nuclear decommissioning fund on or after the date of the deemed distribution.

(e) *Deduction when economic performance occurs.* An electing taxpayer using an accrual method of accounting is allowed a deduction for nuclear decommissioning costs no earlier than the taxable year in which economic performance occurs with respect to such costs (*see* section 461(h)(2)). The amount of nuclear decommissioning costs that is deductible under this paragraph (e) is determined without regard to section 280B (*see* § 1.468A–1(b)(6)). A deduction is allowed under this paragraph (e) whether or not a deduction was allowed with respect to such costs under section 468A(a) and paragraph (a) of this section for an earlier taxable year.

[T.D. 9512, 75 FR 80701, Dec. 23, 2010]

§ 1.468A–3 Ruling amount.

(a) *In general.* (1) Except as otherwise provided in paragraph (g) of this section or in § 1.468A–8 (relating to deductions for special transfers into a nuclear decommissioning fund), an electing taxpayer is allowed a deduction under section 468A(a) for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment) to a nuclear decommissioning fund only if the taxpayer has received a schedule of ruling amounts for the nuclear decommissioning fund that includes a ruling amount for such taxable year. Except as provided in paragraph (a)(4) or (5) of this section, a schedule of ruling amounts for a nuclear decommissioning fund (*schedule of ruling amounts*) is a ruling (within the meaning of § 601.201(a)(2) of this chapter) specifying the annual payments (ruling amounts) that, over the taxable years remaining in the funding period as of the date the schedule first applies, will result in a projected balance of the nuclear decommissioning fund as of the last day of the funding period equal to (and in no event greater than) the amount of decommissioning costs allocable to the fund. The projected balance of a nuclear decommissioning fund as of the last day of the funding period shall be calculated by taking into account the fair market value of the assets of the fund as of the first day of the first taxable year to which the schedule of ruling amounts applies and the estimated rate of return to be earned by the assets of the fund after payment of the estimated administrative costs and incidental expenses to be incurred by the fund (as defined in § 1.468A–5(a)(3)(ii)), including all Federal, State and local income taxes to be incurred by the fund (the after-tax rate of return). *See* paragraph (c) of this section for a definition of funding period and paragraph (d) of this section for guidance with respect to the amount of decommissioning costs allocable to a fund.

(2) Each schedule of ruling amounts must be consistent with the principles and provisions of this section and must be based on reasonable assumptions concerning—

(i) The after-tax rate of return to be earned by the assets of the qualified nuclear decommissioning fund;

(ii) The total estimated cost of decommissioning the nuclear power plant (*see* paragraph (d)(2) of this section); and

(iii) The frequency of contributions to a nuclear decommissioning fund for a taxable year (for example, monthly, quarterly, semi-annual or annual contributions).

(3) The Internal Revenue Service (IRS) shall provide a schedule of ruling amounts that is identical to the schedule of ruling amounts proposed by the taxpayer in connection with the taxpayer's request for a schedule of ruling amounts (*see* paragraph (e)(2)(viii) of this section), but no schedule of ruling amounts shall be provided unless the taxpayer's proposed schedule of ruling amounts is consistent with the principles and provisions of this section and is based on reasonable assumptions. If a proposed schedule of ruling amounts is not consistent with the principles and provisions of this section or is not based on reasonable assumptions, the taxpayer may propose an amended schedule of ruling amounts that is consistent with such principles and provisions and is based on reasonable assumptions.

(4) The taxpayer bears the burden of demonstrating that the proposed schedule of ruling amounts is consistent with the principles and provisions of this section and is based on reasonable assumptions. If a public utility commission established or approved the currently applicable rates for the furnishing or sale by the taxpayer of electricity from the plant, the taxpayer can generally satisfy this burden of proof by demonstrating that the schedule of ruling amounts is calculated using the assumptions used by the public utility commission in its

most recent order. In addition, a taxpayer that owns an interest in a deregulated nuclear plant may submit assumptions used by a public utility commission that formerly had regulatory jurisdiction over the plant as support for the assumptions used in calculating the taxpayer's proposed schedule of ruling amounts, with the understanding that the assumptions used by the public utility commission may be given less weight if they are out of date or were developed in a proceeding for a different taxpayer. The use of other industry standards, such as the assumptions underlying the taxpayer's most recent financial assurance filing with the NRC, are an alternative means of demonstrating that the taxpayer has calculated its proposed schedule of ruling amounts on a reasonable basis. Consistency with financial accounting statements is not sufficient, in the absence of other supporting evidence, to meet the taxpayer's burden of proof under this paragraph (a)(4).

(5) The IRS will approve, at the request of the taxpayer, a formula or method for determining a schedule of ruling amounts (rather than providing a schedule specifying a dollar amount for each taxable year) if the formula or method is consistent with the principles and provisions of this section and is based on reasonable assumptions. *See* paragraph (f)(1)(ii) of this section for a special rule relating to the mandatory review of ruling amounts that are determined pursuant to a formula or method.

(6) The IRS may, in its discretion, provide a schedule of ruling amounts that is determined on a basis other than the rules of paragraphs (a) through (d) of this section if—

(i) In connection with its request for a schedule of ruling amounts, the taxpayer explains the need for special treatment and sets forth an alternative basis for determining the schedule of ruling amounts; and

(ii) The IRS determines that special treatment is consistent with the purpose of section 468A.

(b) *Level funding limitation.* (1) Except as otherwise provided in paragraph (b)(3) of this section, the ruling amount specified in a schedule of ruling amounts for any taxable year in the funding period (as defined in paragraph (c) of this section) shall not be less than the ruling amount specified in such schedule for any earlier taxable year.

(2) The ruling amount specified in a schedule of ruling amounts for a taxable year after the end of the funding period may be less than the ruling amount specified in such schedule for an earlier taxable year.

(3) The ruling amount specified in a schedule of ruling amounts for the last taxable year in the funding period may be less than the ruling amount specified in such schedule for an earlier taxable year if, when annualized, the amount specified for the last taxable year is not less than the amount specified for such earlier taxable year. The amount specified for the last taxable year is annualized by—

(i) Determining the number of days between the beginning of the taxable year and the end of the plant's estimated useful life;

(ii) Dividing the amount specified for the last taxable year by such number of days; and

(iii) Multiplying the result by the number of days in the last taxable year (generally 365).

(c) *Funding period*—(1) *In general.* For purposes of this section, the funding period for a nuclear decommissioning fund is the period that—

(i) Begins on the first day of the first taxable year for which a deductible payment is made (or deemed made) to such nuclear decommissioning fund (*see* §1.468A–2(a) for rules relating to the first taxable year for which a payment may be made (or deemed made) to a nuclear decommissioning fund); and

(ii) Ends on the last day of the taxable year that includes the last day of the estimated useful life of the nuclear power plant to which the nuclear decommissioning fund relates.

(2) *Estimated useful life.* The last day of the estimated useful life of a nuclear power plant is determined under the following rules:

(i) Except as provided in paragraph (c)(2)(ii) of this section—

(A) The last day of the estimated useful life of a nuclear power plant that has been included in rate base for ratemaking purposes in any ratemaking proceeding that established rates for a period before January 1, 2006, is the date used in the first such ratemaking proceeding as the estimated date on which the nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes;

(B) The last day of the estimated useful life of a nuclear power plant that is not described in paragraph (c)(2)(i)(A) of this section is the last day of the estimated useful life of the plant determined as of the date it is placed in service;

(C) A taxpayer with an interest in a plant that is not described in paragraph (c)(2)(i)(A) of this section may use any reasonable method for determining the last day of such estimated useful life; and

(D) A reasonable method for purposes of paragraph (c)(2)(i)(C) of this section may include use of the period for which a public utility commission has included a comparable nuclear power plant in rate base for ratemaking purposes.

(ii) If it can be established that the estimated useful life of the nuclear power plant will end on a date other than the date determined under paragraph (c)(2)(i) of this section, the taxpayer may use such other date as the last day of the estimated useful life but is not required to do so. If the last day of the estimated useful life was determined under paragraph (c)(2)(i)(A) of this section and the most recent ratemaking proceeding used an alternative date as the estimated date on which the nuclear power plant will no longer be included rate base, the most recent ratemaking proceeding will generally be treated as establishing such alternative date as the last day of the estimated useful life.

(iii) The estimated useful life of a nuclear power plant determined for purposes of paragraph (c)(1) of this section may end on a different date from the estimated useful life of a nuclear power plant determined for purposes of §1.468A–8(b)(1) and (c)(1).

(d) *Decommissioning costs allocable to a fund.* The amount of decommissioning costs allocable to a nuclear decommissioning fund is determined for purposes of this section by applying the following rules and definitions:

(1) *General rule.* The amount of decommissioning costs allocable to a nuclear decommissioning fund is the taxpayer's share of the total estimated cost of decommissioning the nuclear power plant to which the fund relates.

(2) *Total estimated cost of decommissioning.* Under paragraph (a)(2) of this section, the taxpayer must demonstrate the reasonableness of the assumptions concerning the total estimated cost of decommissioning the nuclear power plant.

(3) *Taxpayer's share.* The taxpayer's share of the total estimated cost of decommissioning a nuclear power plant equals the total estimated cost of decommissioning such nuclear power plant multiplied by the percentage of such nuclear power plant that the qualifying interest of the taxpayer represents. (*See* §1.468A–1(b)(2) for circumstances in which a taxpayer possesses a qualifying interest in a nuclear power plant).

(e) *Manner of requesting schedule of ruling amounts*—(1) *In general.* (i) In order to receive a ruling amount for any taxable year, a taxpayer must file a request for a schedule of ruling amounts that complies with the requirements of this paragraph (e), the applicable procedural rules set forth in §601.201(e) of this chapter (Statement of Procedural Rules), and the requirements of any applicable revenue procedure that is in effect on the date the request is filed.

(ii) A separate request for a schedule of ruling amounts is required for each nuclear decommissioning fund established by a taxpayer. (*See* paragraph (a) of §1.468A–5 for rules relating to the number of nuclear decommissioning funds that a taxpayer can establish.)

(iii) Except as provided by §§1.468A–5(a)(1)(iv) (relating to certain unincorporated organizations that may be taxable as corporations) and 1.468A–8 (relating to a special transfer under section 468A(f)(1)), a request for a schedule of ruling amounts must not contain a request for a ruling on any other issue, whether the issue involves section 468A or another section of the Internal Revenue Code.

(iv) In the case of an affiliated group of corporations that join in the filing of a consolidated return, the common parent of the group may request a schedule of ruling amounts for each member of the group that possesses a qualifying interest in the same nuclear power plant by filing a single submission with the IRS.

(v) The IRS will not provide or revise a ruling amount applicable to a taxable year in response to a request for a schedule of ruling amounts that is filed after the deemed payment deadline date (as defined in §1.468A–2(c)(1)) for such taxable year. In determining the date when a request is filed, the principles of sections 7502 and 7503 shall apply.

(vi) Except as provided in paragraph (e)(1)(vii) of this section, a request for a schedule of ruling amounts shall be considered filed only if such request complies substantially with the requirements of this paragraph (e).

(vii) If a request does not comply substantially with the requirements of this paragraph (e), the IRS will notify the taxpayer of that fact. If the information or materials necessary to comply substantially with the requirements of this paragraph (e) are provided to the IRS within 30 days after this notification, the request will be considered filed on the date of the original submission. In addition, the request will be considered filed on the date of the original submission in a case in which the information and materials are provided more than 30 days after the notification if the IRS determines that the electing taxpayer made a good faith effort to provide the applicable information or materials within 30 days after notification and also determines that treating the request as filed on the date of the original submission is consistent with the purposes of section 468A. In any other case in which the information or materials necessary to comply substantially with the requirements of this paragraph (e) are not provided within 30 days after the notification, the request will be considered filed on the date that all information or materials necessary to comply with the requirements of this paragraph (e) are provided.

(2) *Information required.* A request for a schedule of ruling amounts must contain the following information:

(i) The taxpayer's name, address, and taxpayer identification number.

(ii) Whether the request is for an initial schedule of ruling amounts, a mandatory review of the schedule of ruling amounts (*see* paragraph (f)(1) of this section), or an elective review of the schedule of ruling amounts (*see* paragraph (f)(2) of this section).

(iii) The name and location of the nuclear power plant with respect to which a schedule of ruling amounts is requested.

(iv) A description of the taxpayer's qualifying interest in the nuclear power plant and the percentage of such nuclear power plant that the qualifying interest of the taxpayer represents.

(v) Where applicable, an identification of each public utility commission that establishes or approves rates for the furnishing or sale by the taxpayer of electric energy generated by the nuclear power plant, and, for each public utility commission identified—

(A) Whether the public utility commission has determined the amount of decommissioning costs to be included in the taxpayer's cost of service for ratemaking purposes;

(B) The amount of decommissioning costs that are to be included in the taxpayer's cost of service for each taxable year under the current determination and amounts that otherwise are required to be included in the taxpayer's income under section 88 and the regulations thereunder;

(C) A description of the assumptions, estimates and other factors used by the public utility commission to determine the amount of decommissioning costs;

(D) A copy of such portions of any order or opinion of the public utility commission as pertain to the public utility commission's most recent determination of the amount of decommissioning costs to be included in cost of service; and

(E) A copy of each engineering or cost study that was relied on or used by the public utility commission in determining the amount of decommissioning costs to be included in the taxpayer's cost of service under the current determination.

(vi) A description of the assumptions, estimates and other factors that were used by the taxpayer to determine the amount of decommissioning costs, including each of the following if applicable:

(A) A description of the proposed method of decommissioning the nuclear power plant (for example, prompt removal/dismantlement, safe storage entombment with delayed dismantlement, or safe storage mothballing with delayed dismantlement).

(B) The estimated year in which substantial decommissioning costs will first be incurred.

(C) The estimated year in which the decommissioning of the nuclear power plant will be substantially complete (*see* §1.468A–5(d)(3) for a definition of substantial completion of decommissioning).

(D) The total estimated cost of decommissioning expressed in current dollars (that is, based on price levels in effect at the time of the current determination).

(E) The total estimated cost of decommissioning expressed in future dollars (that is, based on anticipated price levels when expenses are expected to be paid).

(F) For each taxable year in the period that begins with the year specified in paragraph (e)(2)(vi)(B) of this section (the estimated year in which substantial decommissioning costs will first be incurred) and ends with the year specified in paragraph (e)(2)(vi)(C) of this section (the estimated year in which the decommissioning of the nuclear power plant will be substantially complete), the estimated cost of decommissioning expressed in future dollars.

(G) A description of the methodology used in converting the estimated cost of decommissioning expressed in current dollars to the estimated cost of decommissioning expressed in future dollars.

(H) The assumed after-tax rate of return to be earned by the assets of the qualified nuclear decommissioning fund.

(I) A copy of each engineering or cost study that was relied on or used by the taxpayer in determining the amount of decommissioning costs.

(vii) A proposed schedule of ruling amounts for each taxable year remaining in the funding period as of the date the schedule of ruling amounts will first apply.

(viii) A description of the assumptions, estimates and other factors that were used in determining the proposed schedule of ruling amounts, including, if applicable—

(A) The funding period (as such term is defined in paragraph (c) of this section);

(B) The assumed after-tax rate of return to be earned by the assets of the nuclear decommissioning fund;

(C) The fair market value of the assets (if any) of the nuclear decommissioning fund as of the first day of the first taxable year to which the schedule of ruling amounts will apply;

(D) The amount expected to be earned by the assets of the nuclear decommissioning fund (based on the after-tax rate of return applicable to the fund) over the period that begins on the first day of the first taxable year to which the schedule of ruling amounts will apply and ends on the last day of the funding period;

(E) The amount of decommissioning costs allocable to the nuclear decommissioning fund (as determined under paragraph (d) of this section);

(F) The total estimated cost of decommissioning (as determined under paragraph (d)(2) of this section); and

(G) The taxpayer's share of the total estimated cost of decommissioning (as such term is defined in paragraph (d)(3) of this section).

(ix) If the request is for a revised schedule of ruling amounts, the after-tax rate of return earned by the assets of the nuclear decommissioning fund for each taxable year in the period that begins with the date of the initial contribution to the fund and ends with the first day of the first taxable year to which the revised schedule of ruling amounts applies.

(x) If applicable, an explanation of the need for a schedule of ruling amounts determined on a basis other than the rules of paragraphs (a) through (d) of this section and a description of an alternative basis for determining a schedule of ruling amounts (*see* paragraph (a)(5) of this section).

(xi) A chart or table, based upon the assumed after-tax rate of return to be earned by the assets of the nuclear decommissioning fund, setting forth the years the fund will be in existence, the annual contribution to the fund, the estimated annual earnings of the fund and the cumulative total balance in the fund.

(xii) If the request is for a revised schedule of ruling amounts, a copy of the schedule of ruling amounts that the revised schedule would replace.

(xiii) If the request for a schedule of ruling amounts contains a request, pursuant to §1.468A–5(a)(1)(iv), that the IRS rule whether an unincorporated organization through which the assets of the fund are invested is an association taxable as a corporation for Federal tax purposes, a copy of the legal documents establishing or otherwise governing the organization.

(xiv) Any other information required by the IRS that may be necessary or useful in determining the schedule of ruling amounts.

(3) *Administrative procedures.* The IRS may prescribe administrative procedures that supplement the provisions of paragraph (e)(1) and (2) of this section. In addition, the IRS may, in its discretion, waive the requirements of paragraph (e)(1) and (2) of this section under appropriate circumstances.

(f) *Review and revision of schedule of ruling amounts*—(1) *Mandatory review.* (i) Any taxpayer that has obtained a schedule of ruling amounts pursuant to paragraph (e) of this section must file a request for a revised schedule of ruling amounts on or before the deemed payment deadline date for the 10th taxable year that begins after the taxable year in which the most recent schedule of ruling amounts was received. If the taxpayer calculated its most recent schedule of ruling amounts on any basis other than an order issued by a public utility commission, the taxpayer must file a request for a revised schedule of ruling amounts on or before the deemed payment deadline date for the 5th taxable year that begins after the taxable year in which the most recent schedule of ruling amounts was received.

(ii)(A) Any taxpayer that has obtained a formula or method for determining a schedule of ruling amounts for any taxable year under paragraph (a)(5) of this section must file a request for a revised schedule on or before the earlier of the deemed payment deadline for the 5th taxable year that begins after its taxable year in which the most recent formula or method was approved or the deemed payment deadline for the first taxable year that begins after a taxable year in which there is a substantial variation in the ruling amount determined under the most recent formula or method. There is a substantial variation in the ruling amount determined under the formula or method in effect for a taxable year if the ruling amount for the year and the ruling amount for any earlier year since the most recent formula or method was approved differ by more than 50 percent of the smaller amount.

(B) Any taxpayer that has determined its ruling amount for any taxable year under a formula prescribed by §1.468A–6 (which prescribes ruling amounts for the taxable year in which there is a disposition of a qualifying interest in a nuclear power plant) must file a request for a revised schedule of ruling amounts on or before the deemed payment deadline for its first taxable year that begins after the disposition.

(iii) A taxpayer requesting a schedule of deduction amounts for a nuclear decommissioning fund under §1.468A–8 must also request a revised schedule of ruling amounts for the fund. The revised schedule of ruling amounts must apply beginning with the first taxable year following the first year in which a deduction is allowed under the schedule of deduction amounts.

(iv) If the operating license of the nuclear power plant to which a nuclear decommissioning fund relates is renewed, the taxpayer maintaining the fund must request a revised schedule of ruling amounts. The request for the revised schedule must be submitted on or before the deemed payment deadline for the taxable year that includes the date on which the operating license is renewed.

(v) A request for a schedule of ruling amounts required by this paragraph (f)(1) must be made in accordance with the rules of paragraph (e) of this section. If a taxpayer does not properly file a request for a revised schedule of ruling amounts by the date provided in paragraph (f)(1)(i), (ii) or (iv) of this section (whichever is applicable), the taxpayer's ruling amount for the first taxable year to which the revised schedule of ruling amounts would have applied and for all succeeding taxable years until a new schedule is obtained shall be zero dollars, unless, in its discretion, the IRS provides otherwise in such new schedule of ruling amounts. Thus, if a taxpayer is required to request a revised schedule of ruling amounts under any provision of this section, and each ruling amount in the revised schedule would equal zero dollars, the taxpayer may, instead of requesting a new schedule of ruling amounts, begin treating the ruling amounts under its most recent schedule as equal to zero dollars.

(2) *Elective review.* Any taxpayer that has obtained a schedule of ruling amounts pursuant to paragraph (e) of this section can request a revised schedule of ruling amounts. Such a request must be made in accordance with the rules of paragraph (e) of this section; thus, the IRS will not provide a revised ruling amount applicable to a taxable year in response to a request for a schedule of ruling amounts that is filed after the deemed payment deadline date for such taxable year (*see* paragraph (e)(1)(vi) of this section).

(3) *Determination of revised schedule of ruling amounts.* A revised schedule of ruling amounts for a nuclear decommissioning fund shall be determined under this section without regard to any schedule of ruling amounts for such nuclear decommissioning fund that was issued prior to such revised schedule. Thus, a ruling amount specified in a revised schedule of ruling amounts for any taxable year in the funding period can be less than one or more ruling amounts specified in a prior schedule of ruling amounts for a prior taxable year.

(g) *Special rule permitting payments to a nuclear decommissioning fund before receipt of an initial or revised ruling amount applicable to a taxable year.* (1) If an electing taxpayer has filed a timely request for an initial or revised ruling amount for a taxable year beginning on or after January 1, 2006, and does not receive the ruling amount on or before the deemed payment deadline date for such taxable year, the taxpayer may make a payment to a nuclear decommissioning fund on the basis of the ruling amount proposed in the taxpayer's request. Thus, under the preceding sentence, an electing taxpayer may make a payment to a nuclear decommissioning fund for such taxable year that does not exceed the ruling amount proposed by the taxpayer for such taxable year in a timely filed request for a schedule of ruling amounts.

(2) If an electing taxpayer makes a payment to a nuclear decommissioning fund for any taxable year pursuant to paragraph (g)(1) of this section and the ruling amount that is provided by the IRS is greater than the ruling amount proposed by the taxpayer for such taxable year, the taxpayer is not allowed to make an additional payment to the fund for such taxable year after the deemed payment deadline date for such taxable year.

(3) If the payment or transfer that an electing taxpayer makes to a nuclear decommissioning fund for any taxable year pursuant to paragraph (g)(1) of this section exceeds the ruling amount that is provided by the IRS for such taxable year, the following rules apply:

(i) The amount of the excess is an excess contribution (as defined in § 1.468A–5(c)(2)(ii)) for such taxable year.

(ii) The amount of the excess contribution is not deductible (*see* § 1.468A–2(b)(2)) and must be withdrawn by the taxpayer pursuant to the rules of § 1.468A–5(c)(2)(i).

(iii) The taxpayer must withdraw the after-tax earnings on the excess contribution.

(iv) If the taxpayer claimed a deduction for the excess contribution, the taxpayer should file an amended return for the taxable year.

[T.D. 9512, 75 FR 80701, Dec. 23, 2010]

§ 1.468A–4 Treatment of nuclear decommissioning fund.

(a) *In general.* A nuclear decommissioning fund is subject to tax on all of its modified gross income (as defined in paragraph (b) of this section). The rate of tax is 20 percent for taxable years beginning after December 31, 1995. This tax is in lieu of any other tax that may be imposed under subtitle A of the Internal Revenue Code (Code) on the income earned by the assets of the nuclear decommissioning fund.

(b) *Modified gross income*. For purposes of this section, the term *modified gross income* means gross income as defined under section 61 computed with the following modifications:

(1) The amount of any payment or special transfer to the nuclear decommissioning fund with respect to which a deduction is allowed under section 468A(a) or section 468A(f) is excluded from gross income.

(2) A deduction is allowed for the amount of administrative costs and other incidental expenses of the nuclear decommissioning fund (including taxes, legal expenses, accounting expenses, actuarial expenses and trustee expenses, but not including decommissioning costs) that are otherwise deductible and that are paid by the nuclear decommissioning fund to any person other than the electing taxpayer. An expense is otherwise deductible for purposes of this paragraph (b)(2) if it would be deductible under chapter 1 of the Code in determining the taxable income of a corporation. For example, because Federal income taxes are not deductible under chapter 1 of the Code in determining the taxable income of a corporation, the tax imposed by section 468A(e)(2) and paragraph (a) of this section is not deductible in determining the modified gross income of a nuclear decommissioning fund. Similarly, because certain expenses allocable to tax-exempt interest income are not deductible under section 265 in determining the taxable income of a corporation, such expenses are not deductible in determining the modified gross income of a nuclear decommissioning fund.

(3) A deduction is allowed for the amount of an otherwise deductible loss that is sustained by the nuclear decommissioning fund in connection with the sale, exchange or worthlessness of any investment. A loss is otherwise deductible for purposes of this paragraph (b)(3) if such loss would be deductible by a corporation under section 165(f) or (g) and sections 1211(a) and 1212(a).

(4) A deduction is allowed for the amount of an otherwise deductible net operating loss of the nuclear decommissioning fund. For purposes of this paragraph (b), the net operating loss of a nuclear decommissioning fund for a taxable year is the amount by which the deductions allowable under paragraphs (b)(2) and (3) of this section exceed the gross income of the nuclear decommissioning fund computed with the modification described in paragraph (b)(1) of this section. A net operating loss is otherwise deductible for purposes of this paragraph (b)(4) if such a net operating loss would be deductible by a corporation under section 172(a).

(c) *Special rules*—(1) *Period for computation of modified gross income*. The modified gross income of a nuclear decommissioning fund must be computed on the basis of the taxable year of the electing taxpayer. If an electing taxpayer changes its taxable year, each nuclear decommissioning fund of the electing taxpayer must change to the new taxable year. *See* section 442 and §1.442–1 for rules relating to the change to a new taxable year.

(2) *Gain or loss upon distribution of property by a fund*. A distribution of property by a nuclear decommissioning fund (whether an actual distribution or a deemed distribution) shall be considered a disposition of property by the nuclear decommissioning fund for purposes of section 1001. In determining the amount of gain or loss from such disposition, the amount realized by the nuclear decommissioning fund shall be the fair market value of the property on the date of disposition.

(3) *Denial of credits against tax*. The tax imposed on the modified gross income of a nuclear decommissioning fund under paragraph (a) of this section is not to be reduced or offset by any credits against tax provided by part IV of subchapter A of chapter 1 of the Code other than the credit provided by section 31(c) for amounts withheld under section 3406 (back-up withholding).

(4) *Other corporate taxes inapplicable*. Although the modified gross income of

a nuclear decommissioning fund is subject to tax at the rate specified by section 468A(e)(2) and paragraph (a) of this section, a nuclear decommissioning fund is not subject to the other taxes imposed on corporations under subtitle A of the Code. For example, a nuclear decommissioning fund is not subject to the alternative minimum tax imposed by section 55, the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, and the alternative tax imposed on a corporation under section 1201(a).

(d) *Treatment as corporation for purposes of subtitle F.* For purposes of subtitle F of the Code and §§1.468A–1 through 1.468A–9, a nuclear decommissioning fund is to be treated as if it were a corporation and the tax imposed by section 468A(e)(2) and paragraph (a) of this section is to be treated as a tax imposed by section 11. Thus, for example, the following rules apply:

(1) A nuclear decommissioning fund must file a return with respect to the tax imposed by section 468A(e)(2) and paragraph (a) of this section for each taxable year (or portion thereof) that the fund is in existence even though no amount is included in the gross income of the fund for such taxable year. The return is to be made on Form 1120–ND in accordance with the instructions relating to such form. For purposes of this paragraph (d)(1), a nuclear decommissioning fund is in existence for the period that—

(i) Begins on the date that the first deductible payment is actually made to such nuclear decommissioning fund; and

(ii) Ends on the date of termination (*see* §1.468A–5(d)), the date that the entire fund is disqualified (*see* §1.468A–5(c)), or the date that the electing taxpayer disposes of its entire qualifying interest in the nuclear power plant to which the nuclear decommissioning fund relates (other than in connection with the transfer of the entire fund to the person acquiring such interest), whichever is applicable.

(2) For each taxable year of the nuclear decommissioning fund, the return described in paragraph (d)(1) of this section must be filed on or before the 15th day of the third month following the close of such taxable year unless the nuclear decommissioning fund is granted an extension of time for filing under section 6081. If such an extension is granted for any taxable year, the return for such taxable year must be filed on or before the extended due date for such taxable year.

(3) A nuclear decommissioning fund must provide its employer identification number on returns, statements and other documents as required by the forms and instructions relating thereto. The employer identification number is obtained by filing a Form SS–4, Application for Employer Identification Number, in accordance with the instructions relating thereto.

(4) A nuclear decommissioning fund must deposit all payments of tax imposed by section 468A(e)(2) and paragraph (a) of this section (including any payments of estimated tax) with an authorized government depositary in accordance with §1.6302–1.

(5) A nuclear decommissioning fund is subject to the addition to tax imposed by section 6655 in case of a failure to pay estimated income tax. For purposes of section 6655 and this section—

(i) The tax with respect to which the amount of the underpayment is computed in the case of a nuclear decommissioning fund is the tax imposed by section 468A(e)(2) and paragraph (a) of this section; and

(ii) The taxable income with respect to which the nuclear decommissioning fund's status as a large corporation is measured is modified gross income (as defined by paragraph (b) of this section).

[T.D. 9512, 75 FR 80701, Dec. 23, 2010]

§ 1.468A–5 Nuclear decommissioning fund qualification requirements; prohibitions against self-dealing; disqualification of nuclear decommissioning fund; termination of fund upon substantial completion of decommissioning.

(a) *Qualification requirements*—(1) *In general.* (i) A nuclear decommissioning fund must be established and maintained at all times in the United States pursuant to an arrangement that qualifies as a trust under State law. Such trust must be established for the exclusive purpose of providing funds for the decommissioning of one or more nuclear power plants, but a single trust agreement may establish multiple funds for such purpose. Thus, for example—

(A) Two or more nuclear decommissioning funds can be established and maintained pursuant to a single trust agreement; and

(B) One or more funds that are to be used for the decommissioning of a nuclear power plant and that do not qualify as nuclear decommissioning funds under this paragraph (a) can be established and maintained pursuant to a trust agreement that governs one or more nuclear decommissioning funds.

(ii) A separate nuclear decommissioning fund is required for each electing taxpayer and for each nuclear power plant with respect to which an electing taxpayer possesses a qualifying interest. The Internal Revenue Service (IRS) will issue a separate schedule of ruling amounts with respect to each nuclear decommissioning fund, and each nuclear decommissioning fund must file a separate income tax return even if other nuclear decommissioning funds or nonqualified funds are established and maintained pursuant to the trust agreement governing such fund or the assets of other nuclear decommissioning funds or nonqualified funds are pooled with the assets of such fund.

(iii) An electing taxpayer can maintain only one nuclear decommissioning fund for each nuclear power plant with respect to which the taxpayer elects the application of section 468A. If a nuclear power plant is subject to the ratemaking jurisdiction of two or more public utility commissions and any such public utility commission requires a separate fund to be maintained for the benefit of ratepayers whose rates are established or approved by the public utility commission, the separate funds maintained for such plant (whether or not established and maintained pursuant to a single trust agreement) shall be considered a single nuclear decommissioning fund for purposes of section 468A and §§1.468A–1 through 1.468A–4, this section and §§1.468A–7 through 1.468A–9. Thus, for example, the IRS will issue one schedule of ruling amounts with respect to such nuclear power plant, the nuclear decommissioning fund must file a single income tax return (*see* §1.468A–4(d)(1)), and, if the IRS disqualifies the nuclear decommissioning fund, the assets of each separate fund are treated as distributed on the date of disqualification (*see* paragraph (c)(3) of this section).

(iv) If assets of a nuclear decommissioning fund are (or will be) invested through an unincorporated organization, within the meaning of §301.7701–2 of this chapter, the IRS will rule, if requested, whether the organization is an association taxable as a corporation for Federal tax purposes. A request for this ruling may be made by the electing taxpayer as part of its request for a schedule of ruling amounts or as part of a request under §1.468A–8 for a schedule of deduction amounts.

(2) *Limitation on contributions.* Except as otherwise provided in §1.468A–8 (relating to special transfers under section 468A(f)), a nuclear decommissioning fund is not permitted to accept any contributions in cash or property other than cash payments with respect to which a deduction is allowed under section 468A(a) and §1.468A–2(a). Thus, for example, except in the case of a special transfer pursuant to §1.468A–8, securities may not be contributed to a nuclear decommissioning fund even if the taxpayer or a fund established by the taxpayer previously held such securities for the purpose of providing funds for the decommissioning of a nuclear power plant.

(3) *Limitation on use of fund*—(i) *In general.* The assets of a nuclear decommissioning fund are to be used exclusively—

(A) To satisfy, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates;

(B) To pay administrative costs and other incidental expenses of the nuclear decommissioning fund; and

(C) To the extent that the assets of the nuclear decommissioning fund are not currently required for the purposes described in paragraph (a)(3)(i)(A) or

(B) of this section, to make investments.

(ii) *Definition of administrative costs and expenses.* For purposes of paragraph (a)(3)(i) of this section, the term *administrative costs and other incidental expenses of a nuclear decommissioning fund* means all ordinary and necessary expenses incurred in connection with the operation of the nuclear decommissioning fund. Such term includes the tax imposed by section 468A(e)(2) and § 1.468A–4(a), any State or local tax imposed on the income or the assets of the fund, legal expenses, accounting expenses, actuarial expenses and trustee expenses. Such term does not include decommissioning costs or the payment of insurance premiums on a policy to pay for the nuclear decommissioning costs of a nuclear power plant. Such term also does not include the excise tax imposed on the trustee or other disqualified person under section 4951 or the reimbursement of any expenses incurred in connection with the assertion of such tax unless such expenses are considered reasonable and necessary under section 4951(d)(2)(C) and it is determined that the trustee or other disqualified person is not liable for the excise tax.

(4) *Trust provisions.* Each qualified nuclear decommissioning fund trust agreement must provide that assets in the fund must be used as authorized by section 468A and §§ 1.468A–1 through 1.468A–9 and that the agreement may not be amended so as to violate section 468A or §§ 1.468A–1 through 1.468A–9.

(b) *Prohibitions against self-dealing*—(1) *In general.* Except as otherwise provided in this paragraph (b), the excise taxes imposed by section 4951 shall apply to each act of self-dealing between a disqualified person and a nuclear decommissioning fund.

(2) *Self-dealing defined.* For purposes of this paragraph (b), the term *self-dealing* means any act described in section 4951(d), except—

(i) A payment by a nuclear decommissioning fund for the purpose of satisfying, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates;

(ii) A withdrawal of an excess contribution by the electing taxpayer pursuant to the rules of paragraph (c)(2) of this section;

(iii) A withdrawal by the electing taxpayer of amounts that have been treated as distributed under paragraph (c)(3) of this section;

(iv) A payment of amounts remaining in a nuclear decommissioning fund to the electing taxpayer after the termination of such fund (as determined under paragraph (d) of this section);

(v) Any act described in section 4951(d)(2)(B) or (C);

(vi) Any act that is described in § 53.4951–1(c) of this chapter and is undertaken to facilitate the temporary investment of assets or the payment of reasonable administrative expenses of the nuclear decommissioning fund; or

(vii) A payment by a nuclear decommissioning fund for the performance of trust functions and certain general banking services by a bank or trust company that is a disqualified person if the banking services are reasonable and necessary to carry out the purposes of the fund and the compensation paid to the bank or trust company for such services, taking into account the fair interest rate for the use of the funds by the bank or trust company, is not excessive.

(3) *Disqualified person defined.* For purposes of this paragraph (b), the term *disqualified person* includes each person described in section 4951(e)(4) and § 53.4951–1(d).

(4) *General banking services.* The general banking services allowed by paragraph (b)(2)(vii) of this section are—

(i) Checking accounts, as long as the bank does not charge interest on any overwithdrawals;

(ii) Savings accounts, as long as the fund may withdraw its funds on no more than 30 days' notice without subjecting itself to a loss of interest on its money for the time during which the money was on deposit; and

(iii) Safekeeping activities (*see* § 53.4941(d)–3(c)(2), *Example 3,* of this chapter).

(c) *Disqualification of nuclear decommissioning fund*—(1) *In general*—(i) *Disqualification events.* Except as otherwise provided in paragraph (c)(2) of this section, the IRS may, in its discretion, disqualify all or any portion of a nuclear decommissioning fund if at any time during a taxable year of the fund—

(A) The fund does not satisfy the requirements of paragraph (a) of this section; or

(B) The fund and a disqualified person engage in an act of self-dealing (as defined in paragraph (b)(2) of this section).

(ii) *Date of disqualification.* (A) Except as otherwise provided in this paragraph (c)(1)(ii), the date on which a disqualification under this paragraph (c) will take effect (date of disqualification) is the date that the fund does not satisfy the requirements of paragraph (a) of this section or the date on which the act of self-dealing occurs, whichever is applicable.

(B) If the IRS determines, in its discretion, that the disqualification should take effect on a date subsequent to the date specified in paragraph (c)(1)(ii)(A) of this section, the date of disqualification is such subsequent date.

(iii) *Notice of disqualification.* The IRS will notify the electing taxpayer of the disqualification of a nuclear decommissioning fund and the date of disqualification by registered or certified mail to the last known address of the electing taxpayer (the notice of disqualification). For further guidance regarding the definition of last known address, *see* §301.6212–2 of this chapter.

(2) *Exception to disqualification*—(i) *In general.* A nuclear decommissioning fund will not be disqualified under paragraph (c)(1) of this section by reason of an excess contribution or the withdrawal of such excess contribution by an electing taxpayer if the amount of the excess contribution is withdrawn by the electing taxpayer on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the taxable year to which the excess contribution relates. In the case of an excess contribution that is the result of a payment made pursuant to §1.468A–3(g)(1), a nuclear decommissioning fund will not be disqualified under paragraph (c)(1) of this section if the amount of the excess contribution is withdrawn by the electing taxpayer on or before the later of—

(A) The date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the taxable year to which the excess contribution relates; or

(B) The date that is 30 days after the date that the taxpayer receives the ruling amount for such taxable year.

(ii) *Excess contribution defined.* For purposes of this section, an excess contribution is the amount by which cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceed the payment limitation contained in section 468A(b) and §1.468A–2(b). The amount of a special transfer permitted under §1.468A–8 is not treated as a cash payment for this purpose.

(iii) *Taxation of income attributable to an excess contribution.* The income of a nuclear decommissioning fund attributable to an excess contribution is required to be included in the gross income of the nuclear decommissioning fund under §1.468A–4(b).

(3) *Disqualification treated as distribution.* If all or any portion of a nuclear decommissioning fund is disqualified under paragraph (c)(1) of this section, the portion of the nuclear decommissioning fund that is disqualified is treated as distributed to the electing taxpayer on the date of disqualification. Such a distribution shall be treated for purposes of section 1001 as a disposition of property held by the nuclear decommissioning fund (*see* §1.468A–4(c)(2)). In addition, the electing taxpayer must include in gross income for the taxable year that includes the date of disqualification an amount equal to the fair market value of the distributable assets of the nuclear decommissioning fund multiplied by the fraction of the nuclear decommissioning fund that was disqualified under paragraph (c)(1) of this section. For this purpose, the fair market value of the distributable assets of the nuclear decommissioning fund is equal to the fair market value of the assets of the fund determined as of the date of disqualification, reduced by—

(i) The amount of any excess contribution that was not withdrawn before the date of disqualification if no deduction was allowed with respect to such excess contribution;

(ii) The amount of any deemed distribution that was not actually distributed before the date of disqualification (as determined under § 1.468A–2(d)(2)(iii)) if the amount of the deemed distribution was included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurred; and

(iii) The amount of any tax that—

(A) Is imposed on the income of the fund;

(B) Is attributable to income taken into account before the date of disqualification or as a result of the disqualification; and

(C) Has not been paid as of the date of disqualification.

(4) *Further effects of disqualification.* Contributions made to a disqualified fund after the date of disqualification are not deductible under section 468A(a) and § 1.468A–2(a), or, if the fund is disqualified only in part, are deductible only to the extent provided in the notice of disqualification. In addition, if any assets of the fund that are deemed distributed under paragraph (c)(3) of this section are held by the fund after the date of disqualification (or if additional assets are acquired with nondeductible contributions made to the fund after the date of disqualification), the income earned by such assets after the date of disqualification must be included in the gross income of the electing taxpayer (*see* section 671) to the extent that such income is otherwise includible under chapter 1 of the Internal Revenue Code (Code). An electing taxpayer can establish a nuclear decommissioning fund to replace a fund that has been disqualified in its entirety only if the IRS specifically consents to the establishment of a replacement fund in connection with the issuance of an initial schedule of ruling amounts for such replacement fund.

(d) *Termination of nuclear decommissioning fund upon substantial completion of decommissioning*—(1) *In general.* Upon substantial completion of the decommissioning of a nuclear power plant to which a nuclear decommissioning fund relates, such nuclear decommissioning fund shall be considered terminated and treated as having distributed all of its assets on the date the termination occurs (the termination date). Such a distribution shall be treated for purposes of section 1001 as a disposition of property held by the nuclear decommissioning fund (*see* § 1.468A–4(c)(2)). In addition, the electing taxpayer shall include in gross income for the taxable year in which the termination occurs an amount equal to the fair market value of the assets of the fund determined as of the termination date, reduced by—

(i) The amount of any deemed distribution that was not actually distributed before the termination date if the amount of the deemed distribution was included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurred; and

(ii) The amount of any tax that—

(A) Is imposed on the income of the fund;

(B) Is attributable to income taken into account before the termination date or as a result of the termination; and

(C) Has not been paid as of the termination date.

(2) *Additional rules.* Contributions made to a nuclear decommissioning fund after the termination date are not deductible under section 468A(a) and § 1.468A–2(a). In addition, if any assets are held by the fund after the termination date, the income earned by such assets after the termination date must be included in the gross income of the electing taxpayer (*see* section 671) to the extent that such income is otherwise includible under chapter 1 of the Code. Finally, under § 1.468A–2(e), an electing taxpayer using an accrual method of accounting is allowed a deduction for nuclear decommissioning costs that are incurred during any taxable year even if such costs are incurred after substantial completion of decommissioning (for example, expenses incurred to monitor or safeguard the plant site).

(3) *Substantial completion of decommissioning and termination date.* (i) The substantial completion of the decommissioning of a nuclear power plant occurs on the date that the maximum acceptable radioactivity levels mandated by the Nuclear Regulatory Commission

with respect to a decommissioned nuclear power plant are satisfied (the substantial completion date). Except as otherwise provided in paragraph (d)(3)(ii) of this section, the substantial completion date is also the termination date.

(ii) If a significant portion of the total estimated decommissioning costs with respect to a nuclear power plant are not incurred on or before the substantial completion date, an electing taxpayer may request, and the IRS will issue, a ruling that designates a date subsequent to the substantial completion date as the termination date. The termination date designated in the ruling will not be later than the last day of the third taxable year after the taxable year that includes the substantial completion date. The request for a ruling under this paragraph (d)(3)(ii) must be filed during the taxable year that includes the substantial completion date and must comply with the procedural rules in effect at the time of the request.

[T.D. 9512, 75 FR 80701, Dec. 23, 2010]

§ 1.468A–6 Disposition of an interest in a nuclear power plant.

(a) *In general.* This section describes the Federal income tax consequences of a transfer of the assets of a nuclear decommissioning fund (Fund) within the meaning of § 1.468A–1(b)(4) in connection with a sale, exchange, or other disposition by a taxpayer (transferor) of all or a portion of its qualifying interest in a nuclear power plant to another taxpayer (transferee). This section also explains how a schedule of ruling amounts will be determined for the transferor and transferee. For purposes of this section, a nuclear power plant includes a plant that previously qualified as a nuclear power plant and that has permanently ceased to produce electricity.

(b) *Requirements.* This section applies if—

(1) Immediately before the disposition, the transferor maintained a Fund with respect to the interest disposed of;

(2) Immediately after the disposition—

(i) The transferee maintains a Fund with respect to the interest acquired;

(ii) The interest acquired is a qualifying interest of the transferee in the nuclear power plant;

(3) In connection with the disposition, either—

(i) The transferee acquires part or all of the transferor's qualifying interest in the plant and a proportionate amount of the assets of the transferor's Fund (all such assets if the transferee acquires the transferor's entire qualifying interest in the plant) is transferred to a Fund of the transferee; or

(ii) The transferee acquires the transferor's entire qualifying interest in the plant and the transferor's entire Fund is transferred to the transferee; and

(4) The transferee continues to satisfy the requirements of § 1.468A–5(a)(1)(iii), which permits an electing taxpayer to maintain only one Fund for each plant.

(c) *Tax consequences.* A disposition that satisfies the requirements of paragraph (b) of this section will have the following tax consequences at the time it occurs:

(1) *The transferor and its Fund.* (i) Except as provided in paragraph (c)(1)(ii) of this section, neither the transferor nor the transferor's Fund will recognize gain or loss or otherwise take any income or deduction into account by reason of the transfer of a proportionate amount of the assets of the transferor's Fund to the transferee's Fund (or by reason of the transfer of the transferor's entire Fund to the transferee). For purposes of §§ 1.468A–1 through 1.468A–9, this transfer (or the transfer of the transferor's Fund) will not be considered a distribution of assets by the transferor's Fund.

(ii) Notwithstanding paragraph (c)(1)(i) of this section, if the transferor has made a special transfer under § 1.468A–8 prior to the transfer of the Fund or Fund assets, any deduction with respect to that special transfer allowable under section 468A(f)(2) for a taxable year ending after the date of the transfer of the Fund or Fund assets (the unamortized special transfer deduction) is allowed under section 468A(f)(2)(C) for the taxable year that includes the date of the transfer of the Fund or Fund assets. If the taxpayer transfers only a portion of its interest in a nuclear power plant, only the corresponding portion of the unamortized special transfer deduction qualifies for the acceleration under section 468A(f)(2)(C).

(2) *The transferee and its Fund.* Neither the transferee nor the transferee's Fund will recognize gain or loss or otherwise take any income or deduction into account by reason of the transfer of a proportionate amount of the assets of the transferor's Fund to the transferee's Fund (or by reason of the transfer of the transferor's Fund to the transferee). For purposes of §§ 1.468A–1 through 1.468A–9, this transfer (or the transfer of the transferor's Fund) will not constitute a payment or a contribution of assets by the transferee to its Fund.

(3) *Basis.* Transfers of assets of a Fund to which this section applies do not affect basis. Thus, the transferee's Fund will have a basis in the assets received from the transferor's Fund that is the same as the basis of those assets in the transferor's Fund immediately before the disposition.

(d) *Determination of proportionate amount.* For purposes of this section, a transferor of a qualifying interest in a nuclear power plant is considered to transfer a proportionate amount of the assets of its Fund to a Fund of a transferee of the interest if, on the date of the transfer of the interest, the percentage of the fair market value of the Fund's assets attributable to the assets transferred equals the percentage of the transferor's qualifying interest that is transferred.

(e) *Calculation of schedule of ruling amounts and schedule of deduction amounts for dispositions described in this section*—(1) *Transferor.* If a transferor disposes of all or a portion of its qualifying interest in a nuclear power plant in a transaction to which this section applies, the transferor's schedule of ruling amounts with respect to the interests disposed of and retained (if any) and, if applicable, the amount allowable as a deduction for a special transfer under § 1.468A–8 will be determined under the following rules:

(i) *Taxable year of disposition; ruling amount.* If the transferor does not file a request for a revised schedule of ruling amounts on or before the deemed payment deadline for the taxable year of the transferor in which the disposition of its interest in the nuclear power plant occurs (that is, the date that is two and one-half months after the close of that year), the transferor's ruling amount with respect to that plant for that year will equal the sum of—

(A) The ruling amount contained in the transferor's current schedule of ruling amounts with respect to that plant for that taxable year multiplied by the portion of the qualifying interest that is retained (if any); and

(B) The ruling amount contained in the transferor's current schedule of ruling amounts with respect to that plant for that taxable year multiplied by the product of—

(*1*) The portion of the transferor's qualifying interest that is disposed of; and

(*2*) A fraction, the numerator of which is the number of days in that taxable year that precede the date of disposition, and the denominator of which is the number of days in that taxable year.

(ii) *Taxable year of disposition; deduction under § 1.468A–8.* If the transferor has elected to make a special transfer under section 468A(f), the amount allowable as a deduction under § 1.468A–8 for the taxable year in which it transfers a portion of its interest in the nuclear plant is equal to the deduction amount for that taxable year from its existing schedule of deduction amounts multiplied by the percentage of its interest that it retains. This deduction is in addition to the deduction described in paragraph (c)(1)(ii) of this section.

(iii) *Taxable years after the year of disposition.* A transferor that retains a qualifying interest in a nuclear power plant must file a request for a revised schedule of ruling amounts (and, if applicable, a revised schedule of deduction amounts) with respect to that interest on or before the deemed payment deadline for the first taxable year of the transferor beginning after the disposition. *See* §§ 1.468A–3(f)(1)(ii)(B) and 1.468A–8(c)(3). If the transferor does not timely file such a request, the transferor's ruling amount and the transferor's deduction amount under § 1.468A–8 with respect to that interest for the affected year or years will be zero, unless the Internal Revenue Service (IRS) waives the application of this paragraph (e)(1)(iii) upon a showing of good cause for the delay.

(2) *Transferee.* If a transferee acquires all or a portion of a transferor's qualifying interest in a nuclear power plant in a transaction to which this section applies, the transferee's schedule of ruling amounts with respect to the interest acquired will be determined under the following rules:

(i) *Taxable year of disposition.* If the transferee does not file a request for a schedule of ruling amounts on or before the deemed payment deadline for the taxable year of the transferee in which the disposition occurs (that is, the date that is two and one-half months after the close of that year), the transferee's ruling amount with respect to the interest acquired in the nuclear power plant for that year is equal to the amount contained in the transferor's current schedule of ruling amounts for that plant for the taxable year of the transferor in which the disposition occurred, multiplied by the product of—

(A) The portion of the transferor's qualifying interest that is transferred; and

(B) A fraction, the numerator of which is the number of days in the taxable year of the transferor including and following the date of disposition, and the denominator of which is the number of days in that taxable year.

(ii) *Taxable years after the year of disposition.* A transferee of a qualifying interest in a nuclear power plant must file a request for a revised schedule of ruling amounts with respect to that interest on or before the deemed payment deadline for the first taxable year of the transferee beginning after the disposition. *See* § 1.468A–3(f)(1)(ii)(B). If the transferee does not timely file such a request, the transferee's ruling amount with respect to that interest for the affected year or years will be zero, unless the IRS waives the application of this paragraph (e)(2)(ii) upon a showing of good cause for the delay.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (e):

Example 1. (i) X Corporation is a calendar year taxpayer engaged in the sale of electric energy generated by a nuclear power plant. The plant is owned entirely by X. On May 27, 2010, X transfers a 60-percent qualifying interest in the plant to Y Corporation, a calendar year taxpayer. Before the transfer, X had received a schedule of ruling amounts containing an annual ruling amount of $10 million for the taxable years 2005 through 2025. For 2010, neither X nor Y files a request for a revised schedule of ruling amounts.

(ii) Under paragraph (e)(1)(i) of this section, X's ruling amount for 2010 is calculated as follows: ($10,000,000 × .40) + ($10,000,000 × .60 × 146/365) = $6,400,000. Under paragraph (e)(2)(i) of this section, Y's ruling amount for 2010 is calculated as follows: $10,000,000 × .60 × 219/365 = $3,600,000. Under paragraphs (e)(1)(iii) and (e)(2)(ii) of this section, X and Y must file requests for revised schedules of ruling amounts by March 15, 2012.

Example 2. Y Corporation, the sole owner of a nuclear power plant, is a calendar year taxpayer. In year 1, Y elects to make a special transfer under section 468A(f)(1) to the nuclear decommissioning fund Y maintains with respect to the plant. The amount of the special transfer is $100 ×, and the remaining useful life of the plant is 20 years. Y obtains a schedule of deduction amounts under § 1.468A–8T(c) permitting a $5 × deduction each year over the 20-year remaining useful life, and deducts $5 × of the special transfer amount in year 1, year 2, year 3, and year 4. On the first day of year 5, Y transfers a 25% interest in the plant to an unrelated party. Under paragraph (c)(1)(ii) of this section, Y may deduct in Year 5 the unamortized special transfer deduction corresponding to the portion of the plant transferred (25 percent of $80 × or $20 ×). In addition, under paragraph (e)(1)(ii) of this section, Y may deduct the portion of the deduction amount for year 5 from the schedule of deduction amounts corresponding to its retained interest in the plant (75 percent of $5 × or $3.75 ×). Pursuant to paragraph (e)(1)(iii) of this section, Y must file a request for a revised schedule of ruling amounts by March 15 of year 7.

(f) *Anti-abuse provision.* The IRS may treat a disposition as satisfying the requirements of this section if the IRS determines that this treatment is necessary or appropriate to carry out the purposes of section 468A and §§ 1.468A–1 through 1.468A–9.

[T.D. 9512, 75 FR 80701, Dec. 23, 2010, as amended by 76 FR 3837, Jan. 21, 2011]

§ 1.468A–7 Manner of and time for making election.

(a) *In general.* An eligible taxpayer is allowed a deduction for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment) to a nuclear decommissioning fund or for a special transfer under §1.468A–8 only if the taxpayer elects the application of section 468A. A separate election is required for each nuclear decommissioning fund and for each taxable year with respect to which payments are to be deducted under section 468A or a special transfer is made under §1.468A–8. In the case of an affiliated group of corporations that join in the filing of a consolidated return for a taxable year, the common parent must make a separate election on behalf of each member whose payments to a nuclear decommissioning fund during such taxable year are to be deducted under section 468A and each member that makes a special transfer under §1.468A–8 with respect to such year. The election under section 468A for any taxable year is irrevocable and must be made by attaching a statement (Election Statement) and a copy of the schedule of ruling amounts provided pursuant to the rules of §1.468A–3 to the taxpayer's Federal income tax return (or, in the case of an affiliated group of corporations that join in the filing of a consolidated return, the consolidated return) for such taxable year. The return to which the Election Statement and a copy of the schedule of ruling amounts is attached must be filed on or before the time prescribed by law (including extensions) for filing the return for the taxable year with respect to which payments are to be deducted under section 468A.

(b) *Required information.* The Election Statement must include the following information:

(1) The legend ''Election Under Section 468A'' typed or legibly printed at the top of the first page.

(2) The electing taxpayer's name, address and taxpayer identification number (or, in the case of an affiliated group of corporations that join in the filing of a consolidated return, the name, address and taxpayer identification number of each electing taxpayer).

(3) The taxable year for which the election is made.

(4) For each nuclear decommissioning fund for which an election is made—

(i) The name and location of the nuclear power plant to which the fund relates;

(ii) The name and employer identification number of the nuclear decommissioning fund;

(iii) The total amount of actual cash payments made to the nuclear decommissioning fund during the taxable year that were not treated as deemed cash payments under §1.468A–2(c)(1) for a prior taxable year;

(iv) The total amount of cash payments deemed made to the nuclear decommissioning fund under §1.468A–2(c)(1) for the taxable year;

(v) The total amount of any special transfers (whether in cash or property) made to the nuclear decommissioning fund under §1.468A–8 during the taxable year that were not treated as deemed transfers under §1.468A–8(a)(4) for a prior taxable year;

(vi) The total amount of any special transfers (whether in cash or property) deemed made to the nuclear decommissioning fund under §1.468A–8(a)(4) for the taxable year; and

(vii) For each item of property included in the amounts described in paragraph (b)(4)((v) or (vi) of this section, the amount of the item of property and whether the basis of the item of property is determined under §1.468A–8(b)(5)(iii)(A) or §1.468A–8(b)(5)(iii)(B).

[T.D. 9512, 75 FR 80701, Dec. 23, 2010]

§ 1.468A–8 Special transfers to qualified funds pursuant to section 468A(f).

(a) *General rule*—(1) *In general.* Under section 468A(f), a taxpayer maintaining a qualified nuclear decommissioning fund with respect to a nuclear power plant may transfer cash or property into the fund (a special transfer). The special transfer is not subject to the ruling amount limitation in section 468A(b) and is not treated as a cash payment for purposes of that limitation. Thus, a taxpayer may, in the same taxable year, pay the ruling amount and make a special transfer into the fund. A special transfer may be made in cash, property, or both cash and property. The amount of a special transfer (that is, the amount of cash and the fair market value of property transferred) may not exceed the present value of the pre-2005 nonqualifying amount of nuclear decommissioning costs with respect to the nuclear power plant. The taxpayer is entitled to a deduction against income for a special transfer, as described in paragraph (b) of this section. A special transfer may not be made to a nuclear decommissioning fund before the first taxable year in which a deduction amount is applicable to the nuclear decommissioning fund (*see* paragraph (c) of this section).

(2) *Pre-2005 nonqualifying amount*—(i) *In general.* The present value of the pre-2005 nonqualifying amount of nuclear decommissioning costs with respect to a nuclear power plant is the amount equal to the pre-2005 nonqualifying percentage of the present value of the estimated future decommissioning costs (as defined in §1.468A–1(b)(6)) with respect to the nuclear power plant as of the first day of the taxable year of the taxpayer in which the special transfer is made or deemed made (or a later date that is on or before the date on which the special transfer is expected to be made if the taxpayer establishes to the satisfaction of the IRS that the determination of present value as of such date is reasonable and consistent with the principles and provisions of this section). For this purpose, the pre-2005 nonqualifying percentage for the plant is 100 percent reduced by the sum of—

(A) The qualifying percentage (within the meaning of §1.468A–3(d)(4) as in effect on December 31, 2005) used in determining the taxpayer's last schedule of ruling amounts for the nuclear decommissioning fund under the law in effect before the enactment of the Energy Policy Act of 2005 (that is, the percentage of the plant's total nuclear decommissioning costs that were permitted to be funded through the fund under the law in effect before the enactment of the Energy Policy Act of 2005); and

(B) The percentage of decommissioning costs transferred in any previous special transfer (that is, the amount transferred as a percentage of the present value of the estimated future costs of decommissioning as of the first day of the taxable year in which such previous transfer was made).

(ii) *Pre-2005 nonqualifying amount of transferee.* If there is a transfer of a nuclear decommissioning fund or part or all of its assets and §1.468A–6 applies to the transfer, the pre-2005 nonqualifying amount determined with respect to the transferee is equal to the pre-2005 nonqualifying amount (or a proportionate part of the pre-2005 nonqualifying amount) that would have been determined with respect to the transferor but for such transfer.

(3) *Transfers in multiple years.* A taxpayer making a special transfer is not required to transfer the entire eligible amount in a single year. The requirements of paragraph (c) of this section apply separately to each year in which a special transfer is made. In calculating the amount of any subsequent transfer, the taxpayer must reduce the pre-2005 nonqualifying percentage under paragraph (a)(2) of this section to take into account all previous transfers. For example, if a taxpayer has a pre-2005 nonqualifying percentage of 40 percent, and transfers half of the eligible amount in a special transfer, any subsequent transfer must be calculated on the basis of a pre-2005 nonqualifying percentage of 20 percent.

(4) *Deemed payment rules*—(i) *In general.* The amount of any special transfer (whether in cash or property) described in §1.468A–8 and made by an electing taxpayer to a nuclear decommissioning fund on or before the 15th day of the third calendar month after the close of any taxable year (the deemed payment deadline date) shall be deemed made during such taxable year if the electing taxpayer irrevocably designates the amount as relating to such taxable year on its timely filed Federal income tax return for such taxable year or, in the case of special transfers described in paragraph (a)(4)(ii) of this section, on an amended return for such taxable year (*see* §1.468A–7(b)(4)(v) and (vi) for rules relating to such designation).

(ii) *Special rule for certain special transfers.* Special transfers that the electing taxpayer designates as relating to a taxable year beginning after December 31, 2005, and ending before January 1, 2010, which are actually made within 90 days after the electing taxpayer receives a ruling from the Secretary relating to the special transfer are deemed made during the taxable year designated as the year to which the special transfer relates.

(b) *Deduction for amounts transferred*—(1) *In general*. (i) Except as provided in this paragraph (b), the deduction for any special transfer is allowed ratably over the remaining useful life of the nuclear power plant. The amount of the deduction for any taxable year is the deduction amount for such year specified in the schedule of deduction amounts required under paragraph (c) of this section.

(ii) For purposes of this paragraph (b), the remaining useful life of the nuclear power plant is the period beginning on the first day of the taxable year during which the transfer is made and ending on the last day of the taxable year that includes the last day of the estimated useful life of the nuclear power plant. The last day of the estimated useful life of the nuclear power plant is determined for this purpose under the rules of §1.468A–3(c)(2).

(2) *Amount of deduction*—(i) *General rule*. Except as provided in this paragraph (b)(2), the deduction for property contributed in a special transfer is limited to the lesser of the fair market value of the property contributed or the taxpayer's basis in that property.

(ii) *Election*—(*A*) *In general*. If the fair market value of the property contributed is less than the taxpayer's adjusted basis in such property as of the date the property is contributed and the fund elects to treat the fair market value of the property as its adjusted basis in the property, the taxpayer may deduct an amount equal to the adjusted basis of the contributed property.

(B) *Manner of making election*. The election described in paragraph (b)(2)(ii)(A) of this section is made for property contributed in a special transfer by attaching a description of the property and a statement that the fund is making an election under §1.468A–8(b)(2)(ii) with respect to the property to the return of the fund for the taxable year in which the property is contributed to the fund.

(*C*) *Election allowed for property transferred prior to December 23, 2010*. The election described in paragraph (b)(2)(ii)(A) of this section may be made and a deduction equal to adjusted basis will be allowed for property contributed in a special transfer prior to December 23, 2010. The election in such a case may be made on an amended return of the fund for the taxable year in which the property is contributed to the fund and the transferor may amend previously filed returns to claim a deduction calculated by reference to the adjusted basis of the property.

(3) *Denial of deduction for previously deducted amounts*. If a deduction (other than a deduction under section 468A) has been allowed to the taxpayer (or a predecessor) on account of expected decommissioning costs for a nuclear power plant (a nonconforming deduction) or an amount otherwise includible in income has been excluded from the gross income of the taxpayer (or a predecessor) on account of such expected decommissioning costs (a nonconforming exclusion), the deduction allowed for a special transfer to the nuclear decommissioning fund maintained with respect to the plant is reduced. In the case of a single special transfer of the full eligible amount, the reduction is equal to the aggregate amount of all nonconforming deductions and nonconforming exclusions. In the case of a transfer of less than the full eligible amount, the reduction is a ratable portion of such aggregate amount.

(4) *Transfers of qualified nuclear decommissioning funds*. (i) If a special transfer is made to any qualified nuclear decommissioning fund, there is a subsequent transfer of the fund or the assets of the fund (a fund transfer), and §1.468–6 applies to the fund transfer, any amount of the deduction under paragraph (b) of this section allocable to taxable years ending after the date of the fund transfer will be allowed as a current deduction to the transferor for the taxable year that includes the date of the fund transfer. *See* §468A–6(c) for additional rules concerning transfers of decommissioning funds, including the transfer of a portion of the taxpayer's interest in a nuclear power plant. If a taxpayer transfers only part

of the fund or the fund's assets, the rules in this paragraph (b)(4) apply only to the corresponding portion of the deduction under paragraph (b) of this section.

(ii) If a deduction is allowed to the transferor under paragraph (b)(4)(i) of this section and the transferee is related to the transferor, the Internal Revenue Service (IRS) will not approve the transferee's schedule of ruling amounts for taxable years beginning after the date of the transfer unless the ruling amounts are deferred in a manner that results in recapture of the acceleration amount. For this purpose—

(A) The acceleration amount is the difference between the deduction allowed under this paragraph (b)(4) and the present value as of the beginning of the acceleration period of the deductions that, but for the transfer, would have been allowed under this paragraph (b) for taxable years during the acceleration period;

(B) The acceleration amount is recaptured if the aggregate present value of the ruling amounts at the beginning of the acceleration period is equal to the amount by which the aggregate present value of the ruling amounts that would have been approved but for this paragraph (b)(4)(ii) exceeds the acceleration amount;

(C) The acceleration period is the period from the first day of the transferor's first taxable year beginning after the date of the transfer until the end of the plant's remaining useful life;

(D) Present values will be determined using the assumptions that are used in determining the transferee's first schedule of ruling amounts; and

(E) A transferor and a transferee are related if their relationship is specified in section 267(b) or section 707(b)(1) or they are treated as a single taxpayer under section 41(f)(1)(A) or (B).

(5) *Special rules*—(i) *Gain or loss not recognized on transfers to fund.* No gain or loss will be recognized on any special transfer.

(ii) *Taxpayer basis in fund.* Notwithstanding any other provision of the Internal Revenue Code (Code) and regulations, the taxpayer's basis in the fund is not increased by reason of the special transfer.

(iii) *Fund basis in transferred property*—(*A*) *In general.* Except as provided in paragraph (b)(5)(iii)(B) of this section, the fund's basis in any property transferred in a special transfer is the same as the transferor's basis in the property immediately before the transfer.

(*B*) *Basis in case of election.* If a fund makes the election described in paragraph (b)(2)(ii) of this section, the fund's basis in the property transferred is the fair market value of the property on the date of transfer.

(c) *Schedule of deductions required*—(1) *In general.* A taxpayer may not make a special transfer to a qualified nuclear decommissioning fund unless the taxpayer requests from the IRS a schedule of deduction amounts in connection with such transfer. A schedule of deduction amounts for a nuclear decommissioning fund (schedule of deduction amounts) is a ruling (within the meaning of §601.201(a)(2) of this chapter) specifying the annual deductions (deduction amounts) that, over the taxable years in the remaining useful life of the nuclear power plant, will result in the deduction of the entire amount of the special transfer. Such a request may be combined with a request for a schedule of ruling amounts under §1.468A–3(a). In the case of a combined request, the schedule of deduction amounts requested under this paragraph (c)(1) must be stated separately from the schedule of ruling amounts requested under §1.468A–3(a) and approval of the schedule of deduction amounts under this section will constitute a separate ruling. A request for a schedule of deduction amounts must comply with all provisions of paragraph (d) of this section.

(2) *Transfers in multiple taxable years.* A taxpayer making a special transfer in more than one taxable year pursuant to paragraph (a)(3) of this section must request a separate schedule of deduction amounts in connection with each special transfer. More than one schedule of deduction amounts can be requested in a single ruling request to the Secretary and the Secretary will provide, in a single ruling, separate schedules of deduction amounts for each of a series of special transfers provided that each request for a separate

schedule of deduction amounts complies with all requirements of this paragraph.

(3) *Transfer of partial interest in fund.* If a taxpayer transfers part of a fund or a fund's assets and is allowed a deduction under paragraph (b)(3) of this section, the taxpayer must request a new schedule of deduction amounts in connection with the transfer.

(4) *Special transfer permitted before receipt of schedule.* If an electing taxpayer has filed a timely request for a schedule of deduction amounts in connection with a special transfer for a taxable year and does not receive the schedule of deduction amounts before the deemed payment deadline for such taxable year, the taxpayer may make a special transfer to the nuclear decommissioning fund on the basis of the special transfer amount proposed in the taxpayer's request. If the schedule of deduction amounts provided by the Secretary is based on a special transfer amount that differs from the special transfer amount proposed in the taxpayer's request, rules similar to the rules of §1.468A–3(g)(2) and (3) shall apply.

(d) *Manner of requesting schedule of deduction amounts*—(1) *In general.* (i) In order to receive a deduction amount for any taxable year, a taxpayer must file a request for a schedule of deduction amounts that complies with the requirements of this paragraph (d), the applicable procedural rules set forth in §601.201(e) of this chapter (Statement of Procedural Rules) and the requirements of any applicable revenue procedure that is in effect on the date the request is filed.

(ii) A separate request for a schedule of deduction amounts is required for each nuclear decommissioning fund established by a taxpayer (*see* §1.468A–5(a) for rules relating to the number of nuclear decommissioning funds that a taxpayer can establish).

(iii) Except as provided by §1.468A–5(a)(1)(iv) (relating to certain unincorporated organizations that may be taxable as corporations) and §1.468A–3 (relating to a request for a schedule of ruling amounts), a request for a schedule of deduction amounts must not contain a request for a ruling on any other issue, whether the issue involves section 468A or another section of the Code.

(iv) In the case of an affiliated group of corporations that join in the filing of a consolidated return, the common parent of the group may request a schedule of deduction amounts for each member of the group that possesses a qualifying interest in the same nuclear power plant by filing a single submission with the IRS.

(v) Except as provided in paragraph (d)(1)(vi) of this section, the IRS will not provide or revise a deduction amount applicable to a taxable year in response to a request for a schedule of deduction amounts that is filed after the deemed payment deadline date (as defined in paragraph (a)(4) of this section) for such taxable year.

(vi) For special transfers relating to taxable years beginning after December 31, 2005, and before January 1, 2010, the IRS will not provide a deduction amount in response to a request for a schedule of deduction amounts that is filed after February 22, 2011.

(vii) Except as provided in paragraph (d)(1)(viii) of this section, a request for a schedule of deduction amounts shall be considered filed only if such request complies substantially with the requirements of this paragraph (d). In determining the date when a request is filed, the principles of sections 7502 and 7503 shall apply.

(viii) If a request does not comply substantially with the requirements of this paragraph (d), the IRS will notify the taxpayer of that fact. If the information or materials necessary to comply substantially with the requirements of this paragraph (d) are provided to the IRS within 30 days after this notification, the request will be considered filed on the date of the original submission. In addition, the request will be considered filed on the date of the original submission in a case in which the information and materials are provided more than 30 days after the notification if the IRS determines that the electing taxpayer made a good faith effort to provide the applicable information or materials within 30 days after notification and also determines that treating the request as filed on the date of the original submission is consistent with the purposes of section 468A. In any other case in which the information or materials necessary to comply substantially with the requirements of this paragraph (d) are not provided within 30 days after the notification, the request will be considered filed on the date that all information or materials necessary to comply with the requirements of this paragraph (d) are provided.

(2) *Information required.* A request for a schedule of deduction amounts must contain the following information:

(i) The taxpayer's name, address and taxpayer identification number.

(ii) Whether the request is for an initial schedule of deduction amounts or a schedule of deduction amounts for a subsequent special transfer.

(iii) The name and location of the nuclear power plant with respect to which a schedule of deduction amounts is requested.

(iv) A description of the taxpayer's qualifying interest in the nuclear power plant and the percentage of such nuclear power plant that the qualifying interest of the taxpayer represents.

(v) The present value of the estimated future decommissioning costs (as defined in §1.468A–1(b)(6)) with respect to the taxpayer's qualifying interest in the nuclear power plant as of the first day of the taxable year of the taxpayer in which a transfer is made under this section.

(vi) A description of the assumptions, estimates and other factors that were used by the taxpayer to determine the amount of decommissioning costs, including each of the following if applicable:

(A) A description of the proposed method of decommissioning the nuclear power plant (for example, prompt removal/dismantlement, safe storage entombment with delayed dismantlement, or safe storage mothballing with delayed dismantlement).

(B) The estimated year in which substantial decommissioning costs will first be incurred.

(C) The estimated year in which the decommissioning of the nuclear power plant will be substantially complete (*see* §1.468A–5(d)(3) for a definition of substantial completion of decommissioning).

(D) The total estimated cost of decommissioning expressed in current dollars (that is, based on price levels in effect at the time of the current determination).

(E) The total estimated cost of decommissioning expressed in future dollars (that is, based on anticipated price levels when expenses are expected to be paid).

(F) For each taxable year in the period that begins with the year specified in paragraph (d)(2)(vi)(B) of this section (the estimated year in which substantial decommissioning costs will first be incurred) and ends with the year specified in paragraph (d)(2)(vi)(C) of this section (the estimated year in which the decommissioning of the nuclear power plant will be substantially complete), the estimated cost of decommissioning expressed in future dollars.

(G) A description of the methodology used in converting the estimated cost of decommissioning expressed in current dollars to the estimated cost of decommissioning expressed in future dollars.

(H) The assumed after-tax rate of return to be earned by the amounts collected for decommissioning.

(I) A copy of each engineering or cost study that was relied on or used by the taxpayer in determining the amount of decommissioning costs.

(vii) The taxpayer's pre-2005 nonqualifying percentage (as defined in paragraph (a)(2) of this section).

(viii) The estimated useful life of the nuclear power plant (as such term is defined in paragraph (b)(1)(ii) or (iii) of this section).

(ix) If the request is for a subsequent schedule of deduction amounts, the amount of the previous special transfer and the present value of the estimated future decommissioning costs (as defined in §1.468A–1(b)(6)) with respect to the taxpayer's qualifying interest in the nuclear power plant as of the first day of the taxable year of the taxpayer in which the previous special transfer was made.

(x) If the request is for a subsequent schedule of deduction amounts, a copy of all schedules of deduction amounts that relate to the nuclear power plant to which the request relates and that were previously issued to the taxpayer making the request.

(xi) If the request for a schedule of deduction amounts contains a request, pursuant to § 1.468A–5(a)(1)(iv), that the IRS rule whether an unincorporated organization through which the assets of the fund are invested is an association taxable as a corporation for Federal tax purposes, a copy of the legal documents establishing or otherwise governing the organization.

(xii) Any other information required by the IRS that may be necessary or useful in determining the schedule of deduction amounts.

(3) *Statement required.* A taxpayer requesting a schedule of deduction amounts under this paragraph (d) must submit a statement that any nonconforming deductions and nonconforming exclusions have reduced the deduction allowed for the special transfer in accordance with paragraph (b)(2) of this section.

(4) *Administrative procedures.* The IRS may prescribe administrative procedures that supplement the provisions of paragraphs (d)(1) and (2) of this section. In addition, the IRS may, in its discretion, waive the requirements of paragraphs (d)(1) and (2) of this section under appropriate circumstances.

[T.D. 9512, 75 FR 80701, Dec. 23, 2010]

§ 1.468A–9 Effective/applicability date.

Sections 1.468A–1 through 1.468A–8 are effective on December 23, 2010 and apply with respect to taxable years ending after such date. Special rules that are provided for taxable years ending on or before such date, such as the special rule for certain special transfers contained in § 1.468A–8(a)(4)(ii), apply with respect to such taxable years. In addition, a taxpayer may apply the provisions of §§ 1.468A–1 through 1.468A–8 with respect to a taxable year ending on or before December 23, 2010 if all such provisions are consistently applied.

[T.D. 9512, 75 FR 80701, Dec. 23, 2010]

§ 1.468B Designated settlement funds.

A designated settlement fund, as defined in section 468B(d)(2), is taxed in the manner described in § 1.468B–2. The rules for transferors to a qualified settlement fund described in § 1.468B–3 apply to transferors to a designated settlement fund. Similarly, the rules for claimants of a qualified settlement fund described in § 1.468B–4 apply to claimants of a designated settlement fund. A fund, account, or trust that does not qualify as a designated settlement fund is, however, a qualified settlement fund if it meets the requirements of a qualified settlement fund described in § 1.468B–1.

[T.D. 8459, 57 FR 60988, Dec. 23, 1992]

§ 1.468B–0 Table of contents.

This section lists the table of contents for §§ 1.468B–1 through 1.468B–9.

§ 1.468B–8 Contingent-at-closing escrows. [Reserved]

§ 1.468B–9 Disputed ownership funds.

(a) Scope.
(b) Definitions.
(c) Taxation of a disputed ownership fund.
(1) In general.
(2) Exceptions.
(3) Property received by the disputed ownership fund.
(i) Generally excluded from income.
(ii) Basis and holding period.
(4) Property distributed by the disputed ownership fund.
(i) Computing gain or loss.
(ii) Denial of deduction.
(5) Taxable year and accounting method.
(6) Unused carryovers.
(d) Rules applicable to transferors that are not transferor-claimants.
(1) Transfer of property.
(2) Economic performance.
(i) In general.
(ii) Obligations of the transferor.
(3) Distributions to transferors.
(i) In general.
(ii) Exception.
(iii) Deemed distributions.
(e) Rules applicable to transferor-claimants.
(1) Transfer of property.
(2) Economic performance.
(i) In general.
(ii) Obligations of the transferor-claimant.
(3) Distributions to transferor-claimants.
(i) In general.
(ii) Deemed distributions.
(f) Distributions to claimants other than transferor-claimants.
(g) Statement to the disputed ownership fund and the Internal Revenue Service with respect to transfers of property other than cash.
(1) In general.
(2) Combined statements.
(3) Information required on the statement.
(h) Examples.
(i) [Reserved]
(j) Effective dates.
(1) In general.
(2) Transition rule.

[T.D. 8459, 57 FR 60988, Dec. 23, 1992, as amended by T.D. 8495, 58 FR 58787, Nov. 4, 1993; T.D. 9249, 71 FR 6200, Feb. 7, 2006; T.D. 9413, 73 FR 39619, July 10, 2008]

§ 1.468B–1 Qualified settlement funds.

(a) *In general.* A qualified settlement fund is a fund, account, or trust that satisfies the requirements of paragraph (c) of this section.

(b) *Coordination with other entity classifications.* If a fund, account, or trust that is a qualified settlement fund could be classified as a trust within the meaning of § 301.7701–4 of this chapter, it is classified as a qualified settlement fund for all purposes of the Internal Revenue Code (Code). If a fund, account, or trust, organized as a trust under applicable state law, is a qualified settlement fund, and could be classified as either an association (within the meaning of § 301.7701–2 of this chapter) or a partnership (within the meaning of § 301.7701–3 of this chapter), it is classified as a qualified settlement fund for all purposes of the Code. If a fund, account, or trust, established for contested liabilities pursuant to § 1.461–2(c)(1) is a qualified settlement fund, it is classified as a qualified settlement fund for all purposes of the Code.

(c) *Requirements.* A fund, account, or trust satisfies the requirements of this paragraph (c) if—

(1) It is established pursuant to an order of, or is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continuing jurisdiction of that governmental authority;

(2) It is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability—

(i) Under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (hereinafter referred to as CERCLA), as amended, 42 U.S.C. 9601 *et seq.*; or

(ii) Arising out of a tort, breach of contract, or violation of law; or

(iii) Designated by the Commissioner in a revenue ruling or revenue procedure; and

(3) The fund, account, or trust is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related persons).

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

(1) *Transferor.* A ''transferor'' is a person that transfers (or on behalf of

whom an insurer or other person transfers) money or property to a qualified settlement fund to resolve or satisfy claims described in paragraph (c)(2) of this section against that person.

(2) *Related person.* A ''related person'' is any person who is related to the transferor within the meaning of sections 267(b) or 707(b)(1).

(e) *Governmental order or approval requirement*—(1) *In general.* A fund, account, or trust is ''ordered by'' or ''approved by'' a governmental authority described in paragraph (c)(1) of this section when the authority issues its initial or preliminary order to establish, or grants its initial or preliminary approval of, the fund, account, or trust, even if that order or approval may be subject to review or revision. Except as otherwise provided in paragraph (j)(2) of this section, the governmental authority's order or approval has no retroactive effect and does not permit a fund, account, or trust to be a qualified settlement fund prior to the date the order is issued or the approval is granted.

(2) *Arbitration panels.* An arbitration award that orders the establishment of, or approves, a fund, account, or trust is an order or approval of a governmental authority described in paragraph (c)(1) of this section if—

(i) The arbitration award is judicially enforceable;

(ii) The arbitration award is issued pursuant to a bona fide arbitration proceeding in accordance with rules that are approved by a governmental authority described in paragraph (c)(1) of this section (such as self-regulatory organization-administered arbitration proceedings in the securities industry); and

(iii) The fund, account, or trust is subject to the continuing jurisdiction of the arbitration panel, the court of law that has jurisdiction to enforce the arbitration award, or the governmental authority that approved the rules of the arbitration proceeding.

(f) *Resolve or satisfy requirement*—(1) *Liabilities to provide services or property.* Except as otherwise provided in paragraph (f)(2) of this section, a liability is not described in paragraph (c)(2) of this section if it is a liability for the provision of services or property, unless the transferor's obligation to provide services or property is extinguished by a transfer or transfers to the fund, account, or trust.

(2) *CERCLA liabilities.* A transferor's liability under CERCLA to provide services or property is described in paragraph (c)(2) of this section if following its transfer to a fund, account, or trust the transferor's only remaining liability to the Environmental Protection Agency (if any) is a remote, future obligation to provide services or property.

(g) *Excluded liabilities.* A liability is not described in paragraph (c)(2) of this section if it—

(1) Arises under a workers compensation act or a self-insured health plan;

(2) Is an obligation to refund the purchase price of, or to repair or replace, products regularly sold in the ordinary course of the transferor's trade or business;

(3) Is an obligation of the transferor to make payments to its general trade creditors or debtholders that relates to a title 11 or similar case (as defined in section 368(a)(3)(A)), or a workout; or

(4) Is designated by the Commissioner in a revenue ruling or a revenue procedure (see §601.601(d)(2)(ii)(*b*) of this chapter).

(h) *Segregation requirement*—(1) *In general.* If it is not a trust under applicable state law, a fund, account, or trust satisfies the requirements of paragraph (c)(3) of this section if its assets are physically segregated from other assets of the transferor (and related persons). For example, cash held by a transferor in a separate bank account satisfies the segregation requirement of paragraph (c)(3) of this section.

(2) *Classification of fund established to resolve or satisfy allowable and non-allowable claims.* If a fund, account, or trust is established to resolve or satisfy claims described in paragraph (c)(2) of this section as well as other types of claims (*i.e.,* non-allowable claims) arising from the same event or related series of events, the fund is a qualified settlement fund. However, under §1.468B–3(c), economic performance does not occur with respect to transfers to the qualified settlement fund for non-allowable claims.

(i) [Reserved]

(j) *Classification of fund prior to satisfaction of requirements in paragraph (c) of this section*—(1) *In general.* If a fund, account, or trust is established to resolve or satisfy claims described in paragraph (c)(2) of this section, the assets of the fund, account, or trust are treated as owned by the transferor of those assets until the fund, account, or trust also meets the requirements of paragraphs (c) (1) and (3) of this section. On the date the fund, account, or trust satisfies all the requirements of paragraph (c) of this section, the transferor is treated as transferring the assets to a qualified settlement fund.

(2) *Relation-back rule*—(i) *In general.* If a fund, account, or trust meets the requirements of paragraphs (c)(2) and (c)(3) of this section prior to the time it meets the requirements of paragraph (c)(1) of this section, the transferor and administrator (as defined in §1.468B–2(k)(3)) may jointly elect (a relation-back election) to treat the fund, account, or trust as coming into existence as a qualified settlement fund on the later of the date the fund, account, or trust meets the requirements of paragraphs (c)(2) and (c)(3) of this section or January 1 of the calendar year in which all the requirements of paragraph (c) of this section are met. If a relation-back election is made, the assets held by the fund, account, or trust on the date the qualified settlement fund is treated as coming into existence are treated as transferred to the qualified settlement fund on that date.

(ii) *Relation-back election.* A relation-back election is made by attaching a copy of the election statement, signed by each transferor and the administrator, to (and as part of) the timely filed income tax return (including extensions) of the qualified settlement fund for the taxable year in which the fund is treated as coming into existence. A copy of the election statement must also be attached to (and as part of) the timely filed income tax return (including extensions), or an amended return that is consistent with the requirements of §§1.468B–1 through 1.468B–4, of each transferor for the taxable year of the transferor that includes the date on which the qualified settlement fund is treated as coming into existence. The election statement must contain—

(A) A legend, "§1.468B–1 Relation-Back Election", at the top of the first page;

(B) Each transferor's name, address, and taxpayer identification number;

(C) The qualified settlement fund's name, address, and employer identification number;

(D) The date as of which the qualified settlement fund is treated as coming into existence; and

(E) A schedule describing each asset treated as transferred to the qualified settlement fund on the date the fund is treated as coming into existence. The schedule of assets does not have to identify the amount of cash or the property treated as transferred by a particular transferor. If the schedule does not identify the transferor of each asset, however, each transferor must include with the copy of the election statement that is attached to its income tax return (or amended return) a schedule describing each asset the transferor is treated as transferring to the qualified settlement fund.

(k) *Election to treat a qualified settlement fund as a subpart E trust*—(1) *In general.* If a qualified settlement fund has only one transferor (as defined in paragraph (d)(1) of this section), the transferor may make an election (grantor trust election) to treat the qualified settlement fund as a trust all of which is owned by the transferor under section 671 and the regulations thereunder. A grantor trust election may be made whether or not the qualified settlement fund would be classified, in the absence of paragraph (b) of this section, as a trust all of which is treated as owned by the transferor under section 671 and the regulations thereunder. A grantor trust election may be revoked only for compelling circumstances upon consent of the Commissioner by private letter ruling.

(2) *Manner of making grantor trust election*—(i) *In general.* To make a grantor trust election, a transferor must attach an election statement satisfying the requirements of paragraph (k)(2)(ii) of this section to a timely filed (including extensions) Form 1041, "U.S. Income Tax Return for Estates and Trusts," that the administrator

files on behalf of the qualified settlement fund for the taxable year in which the qualified settlement fund is established. However, if a Form 1041 is not otherwise required to be filed (for example, because the provisions of §1.671–4(b) apply), then the transferor makes a grantor trust election by attaching an election statement satisfying the requirements of paragraph (k)(2)(ii) of this section to a timely filed (including extensions) income tax return of the transferor for the taxable year in which the qualified settlement fund is established. See §1.468B–5(c)(2) for transition rules.

(ii) *Requirements for election statement.* The election statement must include a statement by the transferor that the transferor will treat the qualified settlement fund as a grantor trust. The election statement must include the transferor's name, address, taxpayer identification number, and the legend, "§1.468B–1(k) Election." The election statement and the statement described in §1.671–4(a) may be combined into a single statement.

(3) *Effect of making the election.* If a grantor trust election is made—

(i) Paragraph (b) of this section, and §§1.468B–2, 1.468B–3, and 1.468B–5(a) and (b) do not apply to the qualified settlement fund. However, this section (except for paragraph (b) of this section) and §1.468B–4 apply to the qualified settlement fund;

(ii) The qualified settlement fund is treated, for Federal income tax purposes, as a trust all of which is treated as owned by the transferor under section 671 and the regulations thereunder;

(iii) The transferor must take into account in computing the transferor's income tax liability all items of income, deduction, and credit (including capital gains and losses) of the qualified settlement fund in accordance with §1.671–3(a)(1); and

(iv) The reporting obligations imposed by §1.671–4 on the trustee of a trust apply to the administrator.

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

Example 1. In a class action brought in a United States federal district court, the court holds that the defendant, Corporation X, violated certain securities laws and must pay damages in the amount of $150 million. Pursuant to an order of the court, Corporation X transfers $50 million in cash and transfers property with a fair market value of $75 million to a state law trust. The trust will liquidate the property and distribute the cash proceeds to the plaintiffs in the class action. The trust is a qualified settlement fund because it was established pursuant to the order of a federal district court to resolve or satisfy claims against Corporation X for securities law violations that have occurred.

Example 2. (i) Assume the same facts as in *Example 1*, except that Corporation X and the class of plaintiffs reach an out-of-court settlement that requires Corporation X to establish and fund a state law trust before the settlement agreement is submitted to the court for approval.

(ii) The trust is not a qualified settlement fund because it neither is established pursuant to an order of, nor has it been approved by, a governmental authority described in paragraph (c)(1) of this section.

Example 3. On June 1, 1994, Corporation Y establishes a fund to resolve or satisfy claims against it arising from the violation of certain securities laws. On that date, Corporation Y transfers $10 million to a segregated account. On December 1, 1994, a federal district court approves the fund. Assuming Corporation Y and the administrator of the qualified settlement fund do not make a relation-back election, Corporation Y is treated as the owner of the $10 million, and is taxable on any income earned on that money, from June 1 through November 30, 1994. The fund is a qualified settlement fund beginning on December 1, 1994.

Example 4. (i) On September 1, 1993, Corporation X, which has a taxable year ending on October 31, enters into a settlement agreement with a plaintiff class for asserted tort liabilities. Under the settlement agreement, Corporation X makes two $50 million payments into a segregated fund, one on September 1, 1993, and one on October 1, 1993, to resolve or satisfy the tort liabilities. A federal district court approves the settlement agreement on November 1, 1993.

(ii) The administrator of the fund and Corporation X elect to treat the fund as a qualified settlement fund prior to governmental approval under the relation-back rule of paragraph (j)(2) of this section. The administrator must attach the relation-back election statement to the fund's income tax return for calendar year 1993, and Corporation X must attach the election to its original or amended income tax return for its taxable year ending October 31, 1993.

(iii) Pursuant to the relation-back election, the fund begins its existence as a qualified settlement fund on September 1, 1993, and Corporation X is treated as transferring $50 million to the qualified settlement fund on September 1, 1993, and $50 million on October 1, 1993.

(iv) With respect to these transfers, Corporation X must provide the statement described in § 1.468B–3(e) to the administrator of the qualified settlement fund by February 15, 1994, and must attach a copy of this statement to its original or amended income tax return for its taxable year ending October 31, 1993.

Example 5. Assume the same facts as in *Example 4,* except that the court approves the settlement on May 1, 1994. The administrator must attach the relation-back election statement to the fund's income tax return for calendar year 1994, and Corporation X must attach the election statement to its original or amended income tax return for its taxable year ending October 31, 1994. Pursuant to this election, the fund begins its existence as a qualified settlement fund on January 1, 1994. In addition, Corporation X is treated as transferring to the qualified settlement fund all amounts held in the fund on January 1, 1994. With respect to the transfer, Corporation X must provide the statement described in § 1.468B–3(e) to the administrator of the qualified settlement fund by February 15, 1995, and must attach a copy of this statement to its income tax return for its taxable year ending October 31, 1994.

Example 6. Corporation Z establishes a fund that meets all the requirements of section 468B(d)(2) for a designated settlement fund, except that Corporation Z does not make the election under section 468B(d)(2)(F). Although the fund does not qualify as a designated settlement fund, it is a qualified settlement fund because the fund meets the requirements of paragraph (c) of this section.

Example 7. Corporation X owns and operates a landfill in State A. State A requires Corporation X to transfer money to a trust annually based on the total tonnage of material placed in the landfill during the year. Under the laws of State A, Corporation X will be required to perform (either itself or through contractors) specified closure activities when the landfill is full, and the trust assets will be used to reimburse Corporation X for those closure costs. The trust is not a qualified settlement fund because it is established to secure the liability of Corporation X to perform the closure activities.

[T.D. 8459, 57 FR 60989, Dec. 23, 1992; 58 FR 7865, Feb. 10, 1993, as amended by T.D. 9249, 71 FR 6201, Feb. 7, 2006]

§ 1.468B–2 Taxation of qualified settlement funds and related administrative requirements.

(a) *In general.* A qualified settlement fund is a United States person and is subject to tax on its modified gross income for any taxable year at a rate equal to the maximum rate in effect for that taxable year under section 1(e).

(b) *Modified gross income.* The ''modified gross income'' of a qualified settlement fund is its gross income, as defined in section 61, computed with the following modifications—

(1) In general, amounts transferred to the qualified settlement fund by, or on behalf of, a transferor to resolve or satisfy a liability for which the fund is established are excluded from gross income. However, dividends on stock of a transferor (or a related person), interest on debt of a transferor (or a related person), and payments in compensation for late or delayed transfers, are not excluded from gross income.

(2) A deduction is allowed for administrative costs and other incidental expenses incurred in connection with the operation of the qualified settlement fund that would be deductible under chapter 1 of the Internal Revenue Code in determining the taxable income of a corporation. Administrative costs and other incidental expenses include state and local taxes, legal, accounting, and actuarial fees relating to the operation of the qualified settlement fund, and expenses arising from the notification of claimants and the processing of their claims. Administrative costs and other incidental expenses do not include legal fees incurred by, or on behalf of, claimants.

(3) A deduction is allowed for losses sustained by the qualified settlement fund in connection with the sale, exchange, or worthlessness of property held by the fund to the extent the losses would be deductible in determining the taxable income of a corporation under section 165 (f) or (g), and sections 1211(a) and 1212(a).

(4) A deduction is allowed for the amount of a net operating loss of the qualified settlement fund to the extent the loss would be deductible in determining the taxable income of a corporation under section 172(a). For purposes of this paragraph (b)(4), the net operating loss of a qualified settlement fund for a taxable year is the amount by which the deductions allowed under paragraphs (b)(2) and (b)(3) of this section exceed the gross income of the fund computed with the modification

described in paragraph (b)(1) of this section.

(c) *Partnership interests held by a qualified settlement fund on February 14, 1992*—(1) *In general.* For taxable years ending prior to January 1, 2003, a qualified settlement fund that holds a partnership interest it acquired prior to February 15, 1992, is allowed a deduction for its distributive share of that partnership's items of loss, deduction, or credit described in section 702(a) that would be deductible in determining the taxable income (or in the case of a credit, the income tax liability) of a corporation to the extent of the fund's distributive share of that partnership's items of income and gain described in section 702(a) for the same taxable year. For purposes of this paragraph (c)(1), a distributive share of a partnership credit is treated as a deduction in an amount equal to the amount of the credit divided by the rate described in paragraph (a) of this section.

(2) *Limitation on changes in partnership agreements and capital contributions.* For purposes of paragraph (c)(1) of this section, changes in a qualified settlement fund's distributive share of items of income, gain, loss, deduction, or credit are disregarded if—

(i) They result from a change in the terms of the partnership agreement on or after December 18, 1992, or a capital contribution to the partnership on or after December 18, 1992, unless the partnership agreement as in effect prior to December 18, 1992, requires the contribution; and

(ii) A principal purpose of the change in the terms of the partnership agreement or the capital contribution is to circumvent the limitation described in paragraph (c)(1) of this section.

(d) *Distributions to transferors and claimants.* Amounts that are distributed by a qualified settlement fund to, or on behalf of, a transferor or a claimant are not deductible by the fund.

(e) *Basis of property transferred to a qualified settlement fund.* A qualified settlement fund's initial basis in property it receives from a transferor (or from an insurer or other person on behalf of a transferor) is the fair market value of that property on the date of transfer to the fund.

(f) *Distribution of property.* A qualified settlement fund must treat a distribution of property as a sale or exchange of that property for purposes of section 1001(a). In computing gain or loss, the amount realized by the qualified settlement fund is the fair market value of the property on the date of distribution.

(g) *Other taxes.* The tax imposed under paragraph (a) of this section is in lieu of any other taxation of the income of a qualified settlement fund under subtitle A of the Internal Revenue Code. Thus, a qualified settlement fund is not subject to the alternative minimum tax of section 55, the accumulated earnings tax of section 531, the personal holding company tax of section 541, or the maximum capital gains rate of section 1(h). A qualified settlement fund is, however, subject to taxes that are not imposed on the income of a taxpayer, such as the tax on transfers of property to foreign entities under section 1491.

(h) *Denial of credits against tax.* The tax imposed on the modified gross income of a qualified settlement fund under paragraph (a) of this section may not be reduced or offset by any credits against tax provided by part IV of subchapter A of chapter 1 of the Internal Revenue Code.

(i) [Reserved]

(j) *Taxable year and accounting method.* The taxable year of a qualified settlement fund is the calendar year. A qualified settlement fund must use an accrual method of accounting within the meaning of section 446(c).

(k) *Treatment as corporation for purposes of subtitle F.* Except as otherwise provided in §1.468B–5(b), for purposes of subtitle F of the Internal Revenue Code, a qualified settlement fund is treated as a corporation and any tax imposed under paragraph (a) of this section is treated as a tax imposed by section 11. Subtitle F rules that apply to qualified settlement funds include, but are not limited to—

(1) A qualified settlement fund must file an income tax return with respect to the tax imposed under paragraph (a) of this section for each taxable year that the fund is in existence, whether or not the fund has gross income for that taxable year.

(2) A qualified settlement fund is in existence for the period that—

(i) Begins on the first date on which the fund is treated as a qualified settlement fund under § 1.468B–1; and

(ii) Ends on the earlier of the date the fund—

(A) No longer satisfies the requirements of § 1.468B–1; or

(B) No longer has any assets and will not receive any more transfers. (See paragraph (m) of this section for procedures for the prompt assessment of tax.)

(3) The income tax return of the qualified settlement fund must be filed on or before March 15 of the year following the close of the taxable year of the qualified settlement fund unless the fund is granted an extension of time for filing under section 6081. The return must be made by the administrator of the qualified settlement fund. The ''administrator'' (which may include a trustee if the qualified settlement fund is a trust) of a qualified settlement fund is, in order of priority—

(i) The person designated, or approved, by the governmental authority that ordered or approved the fund for purposes of § 1.468B–1(c)(1);

(ii) The person designated in the escrow agreement, settlement agreement, or other similar agreement governing the fund;

(iii) The escrow agent, custodian, or other person in possession or control of the fund's assets; or

(iv) The transferor or, if there are multiple transferors, all the transferors, unless an agreement signed by all the transferors designates a single transferor as the administrator.

(4) The administrator of a qualified settlement fund must obtain an employer identification number for the fund.

(5) A qualified settlement fund must deposit all payments of tax imposed under paragraph (a) of this section (including any payments of estimated tax) with an authorized government depositary in accordance with § 1.6302–1.

(6) A qualified settlement fund is subject to the addition to tax imposed by section 6655 in the case of an underpayment of estimated tax computed with respect to the tax imposed under paragraph (a) of this section. For purposes of section 6655(g)(2), a qualified settlement fund's taxable income is its modified gross income and a transferor is not considered a predecessor of a qualified settlement fund.

(l) *Information reporting and withholding requirements*—(1) *Payments to a qualified settlement fund.* Payments to a qualified settlement fund are treated as payments to a corporation for purposes of the information reporting requirements of part III of subchapter A of chapter 61 of the Internal Revenue Code.

(2) *Payments and distributions by a qualified settlement fund*—(i) *In general.* Payments and distributions by a qualified settlement fund are subject to the information reporting requirements of part III of subchapter A of chapter 61 of the Internal Revenue Code (Code), and the withholding requirements of subchapter A of chapter 3 of subtitle A and subtitle C of the Code.

(ii) *Special rules.* The following rules apply with respect to payments and distributions by a qualified settlement fund—

(A) A qualified settlement fund must make a return for, or must withhold tax on, a distribution to a claimant if one or more transferors would have been required to make a return or withhold tax had that transferor made the distribution directly to the claimant;

(B) For purposes of sections 6041(a) and 6041A, if a qualified settlement fund makes a payment or distribution to a transferor, the fund is deemed to make the payment or distribution to the transferor in the course of a trade or business;

(C) For purposes of sections 6041(a) and 6041A, if a qualified settlement fund makes a payment or distribution on behalf of a transferor or a claimant, the fund is deemed to make the payment or distribution to the recipient of that payment or distribution in the course of a trade or business;

(D) With respect to a distribution or payment described in paragraph (l)(2)(ii)(C) of this section and the information reporting requirements of part III of subchapter A of chapter 61 of the Internal Revenue Code, the qualified settlement fund is also deemed to have made the distribution or payment to the transferor or claimant.

(m) *Request for prompt assessment.* A qualified settlement fund is eligible to request the prompt assessment of tax under section 6501(d). For purposes of section 6501(d), a qualified settlement fund is treated as dissolving on the date the fund no longer has any assets (other than a reasonable reserve for potential tax liabilities and related professional fees) and will not receive any more transfers.

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

Example 1. On June 30, 1993, a United States federal district court approves the settlement of a lawsuit under which Corporation X must transfer $10,833,000 to a qualified settlement fund on August 1, 1993. The $10,833,000 includes $10 million of damages incurred by plaintiffs on October 1, 1992, and $833,000 of interest calculated at 10 percent annually from October 1, 1992, to August 1, 1993. The $833,000 of interest is not a payment to the qualified settlement fund in compensation for a late or delayed transfer to the fund within the meaning of paragraph (b)(1) of this section because the payment of $10,833,000 to the fund is not due until August 1, 1993.

Example 2. Assume the same facts as in *Example 1* except that the settlement agreement also provides for interest to accrue at a rate of 12 percent annually on any amount not transferred to the qualified settlement fund on August 1, 1993, and the only transfer Corporation X makes to the fund is $11,374,650 on January 1, 1994. The additional payment of $541,650 ($11,374,650 paid on January 1, 1994, less $10,833,000 due on August 1, 1993) is a payment to the qualified settlement fund in compensation for a late or delayed transfer to the fund within the meaning of paragraph (b)(1) of this section.

[T.D. 8459, 57 FR 60991, Dec. 23, 1992; 58 FR 7865, Feb. 10, 1993]

§ 1.468B–3 Rules applicable to the transferor.

(a) *Transfer of property*—(1) *In general.* A transferor must treat a transfer of property to a qualified settlement fund as a sale or exchange of that property for purposes of section 1001(a). In computing the gain or loss, the amount realized by the transferor is the fair market value of the property on the date the transfer is made (or is treated as made under § 1.468B–1(g)) to the qualified settlement fund. Because the issuance of a transferor's debt, obligation to provide services or property in the future, or obligation to make a payment described in § 1.461–4(g), is generally not a transfer of property by the transferor, it generally does not result in gain or loss to the transferor under this paragraph (a)(1). If a person other than the transferor transfers property to a qualified settlement fund, there may be other tax consequences as determined under general federal income tax principles.

(2) *Anti-abuse rule.* The Commissioner may disallow a loss resulting from the transfer of property to a qualified settlement fund if the Commissioner determines that a principal purpose for the transfer was to claim the loss and—

(i) The transferor places significant restrictions on the fund's ability to use or dispose of the property; or

(ii) The property (or substantially similar property) is distributed to the transferor (or a related person).

(b) *Qualified appraisal requirement for transfers of certain property*—(1) *In general.* A transferor must obtain a qualified appraisal to support a loss or deduction it claims with respect to a transfer to a qualified settlement fund of the following types of property—

(i) Nonpublicly traded securities (as defined in § 1.170A–13(c)(7)(ix)) issued by the transferor (or a related person); and

(ii) Interests in the transferor (if the transferor is a partnership) and in a partnership in which the transferor (or a related person) is a direct or indirect partner.

(2) *Provision of copies.* The transferor must provide a copy of the qualified appraisal to the administrator of the qualified settlement fund no later than February 15 of the year following the calendar year in which the property is transferred. The transferor also must attach a copy of the qualified appraisal to (and as part of) its timely filed income tax return (including extensions) for the taxable year of the transferor in which the transfer is made.

(3) *Qualified appraisal.* A ''qualified appraisal'' is a written appraisal that—

(i) Is made within 60 days before or after the date the property is transferred to the qualified settlement fund;

(ii) Is prepared, signed, and dated by an individual who is a qualified appraiser within the meaning of §1.170A–13(c)(5);

(iii) Includes the information required by paragraph (b)(4) of this section; and

(iv) Does not involve an appraisal fee of the type prohibited by §1.170A–13(c)(6).

(4) *Information included in a qualified appraisal.* A qualified appraisal must include the following information—

(i) A description of the appraised property;

(ii) The date (or expected date) of the property's transfer to the qualified settlement fund;

(iii) The appraised fair market value of the property on the date (or expected date) of transfer;

(iv) The method of valuing the property, such as the comparable sales approach;

(v) The specific basis for the valuation, such as specific comparable sales or statistical sampling, including a justification for using comparable sales or statistical sampling and an explanation of the procedure employed;

(vi) The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the transferor (or a related person) or the qualified settlement fund that relates to the use, sale, or other disposition of the transferred property, including, for example, the terms of any agreement or understanding that temporarily or permanently—

(A) Restricts the qualified settlement fund's right to use or dispose of the property; or

(B) Reserves to, or confers upon, any person other than the qualified settlement fund any right (including designating another person as having the right) to income from the property, to possess the property (including the right to purchase or otherwise acquire the property), or to exercise any voting rights with respect to the property;

(vii) The name, address, and taxpayer identification number of the qualified appraiser; and if the qualified appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person, or an independent contractor engaged by a person other than the transferor, the name, address, and taxpayer identification number of the partnership or the person who employs or engages the qualified appraiser;

(viii) The qualifications of the qualified appraiser, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations; and

(ix) A statement that the appraisal was prepared for income tax purposes.

(5) *Effect of signature of the qualified appraiser.* Any appraiser who falsely or fraudulently overstates the value of the transferred property referred to in a qualified appraisal may be subject to a civil penalty under section 6701 for aiding and abetting an understatement of tax liability and may have appraisals disregarded pursuant to 31 U.S.C. 330(c).

(c) *Economic performance*—(1) *In general.* Except as otherwise provided in this paragraph (c), for purposes of section 461(h), economic performance occurs with respect to a liability described in §1.468B–1(c)(2) (determined with regard to §1.468B–1(f) and (g)) to the extent the transferor makes a transfer to a qualified settlement fund to resolve or satisfy the liability.

(2) *Right to a refund or reversion*—(i) *In general.* Economic performance does not occur to the extent—

(A) The transferor (or a related person) has a right to a refund or reversion of a transfer if that right is exercisable currently and without the agreement of an unrelated person that is independent or has an adverse interest (e.g., the court or agency that approved the fund, or the fund claimants); or

(B) Money or property is transferred under conditions that allow its refund or reversion by reason of the occurrence of an event that is certain to occur, such as the passage of time, or if restrictions on its refund or reversion are illusory.

(ii) *Right extinguished.* With respect to a transfer described in paragraph (c)(2)(i) of this section, economic performance is deemed to occur on the date, and to the extent, the transferor's right to a refund or reversion is extinguished.

(3) *Obligations of a transferor.* Economic performance does not occur

when a transferor transfers to a qualified settlement fund its debt (or the debt of a related person). Instead, economic performance occurs as the transferor (or related person) makes principal payments on the debt. Similarly, economic performance does not occur when a transferor transfers to a qualified settlement fund its obligation (or the obligation of a related person) to provide services or property in the future, or to make a payment described in §1.461–4(g). Instead, economic performance with respect to such an obligation occurs as services, property or payments are provided or made to the qualified settlement fund or a claimant.

(d) *Payment of insurance amounts.* No deduction is allowed to a transferor for a transfer to a qualified settlement fund to the extent the transferred amounts represent amounts received from the settlement of an insurance claim and are excludable from gross income. If the settlement of an insurance claim occurs after a transferor makes a transfer to a qualified settlement fund for which a deduction has been taken, the transferor must include in income the amounts received from the settlement of the insurance claim to the extent of the deduction.

(e) *Statement to the qualified settlement fund and the Internal Revenue Service*—(1) *In general.* A transferor must provide the statement described in paragraph (e)(2) of this section to the administrator of a qualified settlement fund no later than February 15 of the year following each calendar year in which the transferor (or an insurer or other person on behalf of the transferor) makes a transfer to the fund. The transferor must attach a copy of the statement to (and as part of) its timely filed income tax return (including extensions) for the taxable year of the transferor in which the transfer is made.

(2) *Required statement*—(i) *In general.* The statement required by this paragraph (e) must provide the following information—

(A) A legend, ''§1.468B–3 Statement'', at the top of the first page;

(B) The transferor's name, address, and taxpayer identification number;

(C) The qualified settlement fund's name, address, and employer identification number;

(D) The date of each transfer;

(E) The amount of cash transferred; and

(F) A description of property transferred and its fair market value on the date of transfer.

(ii) *Combined statements.* If a qualified settlement fund has more than one transferor, any two or more of the transferors may provide a combined statement to the administrator that does not identify the amount of cash or the property transferred by a particular transferor. If a combined statement is used, however, each transferor must include with its copy of the statement that is attached to its income tax return a schedule describing each asset that the transferor transferred to the qualified settlement fund.

(f) *Distributions to transferors*—(1) *In general.* A transferor must include in gross income any distribution (including a deemed distribution described in paragraph (f)(2) of this section) it receives from a qualified settlement fund. If property is distributed, the amount includible in gross income and the basis in that property, is the fair market value of the property on the date of the distribution.

(2) *Deemed distributions*—(i) *Other liabilities.* If a qualified settlement fund makes a distribution on behalf of a transferor to a person that is not a claimant, or to a claimant to resolve or satisfy a liability of the transferor (or a related person) other than a liability described in §1.468B–1(c)(2) for which the fund was established, the distribution is deemed made by the fund to the transferor. The transferor, in turn, is deemed to have made a payment to the actual recipient.

(ii) *Constructive receipt.* To the extent a transferor acquires a right to a refund or reversion described in paragraph (c)(2) of this section of all or a portion of the assets of a qualified settlement fund subsequent to the transfer of those assets to the fund, the fund is deemed to distribute those assets to the transferor on the date the right is acquired.

(3) *Tax benefit rule.* A distribution described in paragraph (f)(1) or (f)(2) of

this section is excluded from the gross income of a transferor to the extent provided by section 111(a).

(g) *Example.* The following example illustrates the rules of this section:

Example. On March 1, 1993, Individual A transfers $1 million to a qualified settlement fund to resolve or satisfy claims against him resulting from certain violations of securities laws. Individual A uses the cash receipts and disbursements method of accounting. Since Individual A does not use the accrual method of accounting, the economic performance rules of paragraph (c) of this section are not applicable. Therefore, whether, when, and to what extent Individual A can deduct the transfer is determined under applicable provisions of the Internal Revenue Code, such as sections 162 and 461.

[T.D. 8459, 57 FR 60992, Dec. 23, 1992]

§ 1.468B–4 Taxability of distributions to claimants.

Whether a distribution to a claimant is includible in the claimant's gross income is generally determined by reference to the claim in respect of which the distribution is made and as if the distribution were made directly by the transferor. For example, to the extent a distribution is in satisfaction of damages on account of personal injury or sickness, the distribution may be excludable from gross income under section 104(a)(2). Similarly, to the extent a distribution is in satisfaction of a claim for foregone taxable interest, the distribution is includible in the claimant's gross income under section 61(a)(4).

[T.D. 8459, 57 FR 60994, Dec. 23, 1992]

§ 1.468B–5 Effective dates and transition rules applicable to qualified settlement funds.

(a) *In general.* Section 468B, including section 468B(g), is effective as provided in the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. Except as otherwise provided in this section, §§ 1.468B–1 through 1.468–4 are effective on January 1, 1993. Thus, the regulations apply to income of a qualified settlement fund earned after December 31, 1992, transfers to a fund after December 31, 1992, and distributions from a fund after December 31, 1992. For purposes of § 1.468B–3(c) (relating to economic performance), previously transferred assets held by a qualified settlement fund on the date these regulations first apply to the fund (i.e., January 1, 1993, or the earlier date provided under paragraph (b)(2) of this section) are treated as transferred to the fund on that date, to the extent no taxpayer has previously claimed a deduction for the transfer.

(b) *Taxation of certain pre-1996 fund income*—(1) *Reasonable method*—(i) *In general.* With respect to a fund, account, or trust established after August 16, 1986, but prior to February 15, 1992, that satisfies (or, if it no longer exists, would have satisfied) the requirements of § 1.468B–1(c), the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation for transfers to the fund, income earned by the fund, and distributions made by the fund after August 16, 1986, but prior to January 1, 1996. A method is generally considered reasonable if, depending on the facts and circumstances, all transferors and the administrator of the fund have consistently treated transfers to the fund, income earned by the fund, and distributions made by the fund after August 16, 1986, as if the fund were—

(A) A grantor trust and the transferors are the grantors;

(B) A complex trust and the transferors are the grantors; or

(C) A designated settlement fund.

(ii) *Qualified settlement funds established after February 14, 1992, but before January 1, 1993.* With respect to a fund, account, or trust established after February 14, 1992, but prior to January 1, 1993, that satisfies the requirements of § 1.468B–1(c), the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation as described in paragraph (b)(1)(i) of this section for transfers to, income earned by, and distributions made by the fund prior to January 1, 1993. However, pursuant to paragraph (a) of this section, sections 1.468B–1 through 1.468B–4 apply to transfers to, income earned by, and distributions made by the qualified settlement fund after 1992.

(iii) *Use of cash method of accounting.* For purposes of paragraphs (b)(i) and (b)(ii) of this section, for taxable years beginning prior to January 1, 1996, the

Internal Revenue Service will not challenge the use of the cash receipts and disbursement method of accounting by a fund, account, or trust.

(iv) *Unreasonable position.* In no event is it a reasonable position to assert, pursuant to Rev. Rul. 71–119 (see § 601.601(d)(2)(ii)(*b*) of this chapter), that there is no current taxation of the income of a fund established after August 16, 1986.

(v) *Waiver of penalties.* For taxable years beginning prior to January 1, 1993, if a fund, account or trust is subject to section 468B(g) and the Internal Revenue Service does not challenge the method of taxation for transfers to, income earned by, and distributions made by, the fund pursuant to paragraph (b)(1)(i) or (b)(1)(ii) of this section, penalties will not be imposed in connection with the use of such method. For example, the penalties under section 6655 for failure to pay estimated tax, section 6651(a)(1) for failure to file a return, section 6651(a)(2) for failure to pay tax, section 6656 for failure to make deposit of taxes, and section 6662 for accuracy-related underpayments will generally not be imposed.

(2) *Election to apply qualified settlement fund rules*—(i) *In general.* The person that will be the administrator of a qualified settlement fund may elect to apply §§ 1.468B–1 through 1.468B–4 to transfers to, income earned by, and distributions made by, the fund in taxable years ending after August 16, 1986. The election is effective beginning on the first day of the earliest open taxable year of the qualified settlement fund. For purposes of this paragraph (b)(2), a taxable year is considered open if the period for assessment and collection of tax has not expired pursuant to the rules of section 6501. The election statement must provide the information described in paragraph (b)(2)(ii) of this section and must be signed by the person that will be the administrator. Such person must also provide each transferor of the qualified settlement fund with a copy of the election statement on or before March 15, 1993.

(ii) *Election statement.* The election statement must provide the following information—

(A) A legend, ''§ 1.468B–5(b)(2) Election'', at the top of the first page;

(B) Each transferor's name, address, and taxpayer identification number;

(C) The qualified settlement fund's name, address, and employer identification number; and

(D) The date the qualified settlement fund was established within the meaning of § 1.468B–1(j).

(iii) *Due date of returns and amended returns.* The election statement described in paragraph (b)(2)(ii) of this section must be filed with, and as part of, the qualified settlement fund's timely filed tax return for the taxable year ended December 31, 1992. In addition, the qualified settlement fund must file an amended return that is consistent with the requirements of §§ 1.468B–1 through 1.468B–4 for any taxable year to which the election applies in which the fund took a position inconsistent with those requirements. Any such amended return must be filed no later than March 15, 1993, and must include a copy of the election statement described in paragraph (b)(2)(ii) of this section.

(iv) *Computation of interest and waiver of penalties.* For purposes of section 6601 and section 6611, the income tax return for each taxable year of the qualified settlement fund to which the election applies is due on March 15 of the year following the taxable year of the fund. For taxable years of a qualified settlement fund ending prior to January 1, 1993, the income earned by the fund is deemed to have been earned on December 31 of each taxable year for purposes of section 6655. Thus, the addition to tax for failure to pay estimated tax under section 6655 will not be imposed. The penalty for failure to file a return under section 6651(a)(1), the penalty for failure to pay tax under section 6651(a)(2), the penalty for failure to make deposit of taxes under section 6656, and the accuracy-related penalty under section 6662 will not be imposed on a qualified settlement fund if the fund files its tax returns for taxable years ending prior to January 1, 1993, and pays any tax due for those taxable years, on or before March 15, 1993.

(c) *Grantor trust elections under §1.468B–1(k)*—(1) *In general.* A transferor may make a grantor trust election under §1.468B–1(k) if the qualified settlement fund is established after February 3, 2006.

(2) *Transition rules.* A transferor may make a grantor trust election under §1.468B–1(k) for a qualified settlement fund that was established on or before February 3, 2006, if the applicable period of limitation on filing an amended return has not expired for both the qualified settlement fund's first taxable year and all subsequent taxable years and the transferor's corresponding taxable year or years. A grantor trust election under this paragraph (c)(2) requires that the returns of the qualified settlement fund and the transferor for all affected taxable years are consistent with the grantor trust election. This requirement may be satisfied by timely filed original returns or amended returns filed before the applicable period of limitation expires.

(3) *Qualified settlement funds established by the U.S. government on or before* February 3, 2006. If the U.S. government, or any agency or instrumentality thereof, established a qualified settlement fund on or before February 3, 2006, and the fund would have been classified as a trust all of which is treated as owned by the U.S. government under section 671 and the regulations thereunder without regard to the regulations under section 468B, then the U.S. government is deemed to have made a grantor trust election under §1.468B–1(k), and the election is applicable for all taxable years of the fund.

[T.D. 8459, 57 FR 60994, Dec. 23, 1992, as amended by T.D. 9249, 71 FR 6201, Feb. 7, 2006]

§ 1.468B–6 Escrow accounts, trusts, and other funds used during deferred exchanges of like-kind property under section 1031(a)(3).

(a) *Scope.* This section provides rules under section 468B(g) relating to the current taxation of escrow accounts, trusts, and other funds used during deferred exchanges.

(b) *Definitions.* The definitions in this paragraph (b) apply for purposes of this section.

(1) *In general. Deferred exchange, escrow agreement, escrow holder, exchange agreement, qualified escrow account, qualified intermediary, qualified trust, relinquished property, replacement property, taxpayer, trust agreement,* and *trustee* have the same meanings as in §1.1031(k)–1; deferred exchange also includes any exchange intended to qualify as a deferred exchange, and qualified intermediary also includes any person or entity intended by a taxpayer to be a qualified intermediary within the meaning of §1.1031(k)–1(g)(4).

(2) *Exchange funds. Exchange funds* means relinquished property, cash, or cash equivalent that secures an obligation of a transferee to transfer replacement property, or proceeds from a transfer of relinquished property, held in a qualified escrow account, qualified trust, or other escrow account, trust, or fund in a deferred exchange.

(3) *Exchange facilitator. Exchange facilitator* means a qualified intermediary, transferee, escrow holder, trustee, or other party that holds exchange funds for a taxpayer in a deferred exchange pursuant to an escrow agreement, trust agreement, or exchange agreement.

(4) *Transactional expenses*—(i) *In general.* Except as provided in paragraph (b)(4)(ii) of this section, *transactional expenses* means transactional items within the meaning of §1.1031(k)–1(g)(7)(ii).

(ii) *Special rule for certain fees for exchange facilitator services.* The fee for the services of an exchange facilitator is not a transactional expense unless the escrow agreement, trust agreement, or exchange agreement, as applicable, provides that—

(A) The amount of the fee payable to the exchange facilitator is fixed on or before the date of the transfer of the relinquished property by the taxpayer (either by stating the fee as a fixed dollar amount in the agreement or determining the fee by a formula, the result of which is known on or before the transfer of the relinquished property by the taxpayer); and

(B) The amount of the fee is payable by the taxpayer regardless of whether the earnings attributable to the exchange funds are sufficient to pay the fee.

(c) *Taxation of exchange funds*—(1) *Exchange funds generally treated as loaned to an exchange facilitator*. Except as provided in paragraph (c)(2) of this section, exchange funds are treated as loaned from a taxpayer to an exchange facilitator (exchange facilitator loan). If a transaction is treated as an exchange facilitator loan under this paragraph (c)(1), the exchange facilitator must take into account all items of income, deduction, and credit (including capital gains and losses) attributable to the exchange funds. See §1.7872–16 to determine if an exchange facilitator loan is a below-market loan for purposes of section 7872 and §1.7872–5(b)(16) to determine if an exchange facilitator loan is exempt from section 7872.

(2) *Exchange funds not treated as loaned to an exchange facilitator*—(i) *Scope*. This paragraph (c)(2) applies if, in accordance with an escrow agreement, trust agreement, or exchange agreement, as applicable, all the earnings attributable to a taxpayer's exchange funds are paid to the taxpayer.

(ii) *Earnings attributable to the taxpayer's exchange funds*—(A) *Separately identified account*. If an exchange facilitator holds all of the taxpayer's exchange funds in a separately identified account, the earnings credited to that account are deemed to be all the earnings attributable to the taxpayer's exchange funds for purposes of paragraph (c)(2)(i) of this section. In general, a separately identified account is an account established under the taxpayer's name and taxpayer identification number with a depository institution. For purposes of paragraph (c)(2)(i) of this section, a sub-account will be treated as a separately identified account if the master account under which the sub-account is created is established with a depository institution, the depository institution identifies the sub-account by the taxpayer's name and taxpayer identification number, and the depository institution specifically credits earnings to the sub-account.

(B) *Allocation of earnings in commingled accounts*. If an exchange facilitator commingles (for investment or otherwise) the taxpayer's exchange funds with other funds or assets, all the earnings attributable to the taxpayer's exchange funds are paid to the taxpayer if all of the earnings attributable to the commingled funds or assets that are allocable on a pro-rata basis (using a reasonable method that takes into account the time that the exchange funds are in the commingled account, actual rate or rates of return, and the respective account balances) to the taxpayer's exchange funds either are paid to the taxpayer or are treated as paid to the taxpayer under paragraph (c)(2)(ii)(C) of this section.

(C) *Transactional expenses*. Any payment from the taxpayer's exchange funds, or from the earnings attributable to the taxpayer's exchange funds, for a transactional expense of the taxpayer (as defined in paragraph (b)(4) of this section) is treated as first paid to the taxpayer and then paid by the taxpayer to the recipient.

(iii) *Treatment of the taxpayer*. If this paragraph (c)(2) applies, exchange funds are not treated as loaned from a taxpayer to an exchange facilitator. The taxpayer must take into account all items of income, deduction, and credit (including capital gains and losses) attributable to the exchange funds.

(d) *Information reporting requirements*. A payor (as defined in §1.6041–1) must report the income attributable to exchange funds to the extent required by the information reporting provisions of subpart B, Part III, subchapter A, chapter 61, Subtitle F of the Internal Revenue Code, and the regulations under those provisions. See §1.6041–1(f) for rules relating to the amount to be reported when fees, expenses or commissions owed by a payee to a third party are deducted from a payment.

(e) *Examples*. The provisions of this section are illustrated by the following examples in which T is a taxpayer that uses a calendar taxable year and the cash receipts and disbursements method of accounting. The examples are as follows:

Example 1. All earnings attributable to exchange funds paid to taxpayer. (i) T enters into a deferred exchange with R. The sales agreement provides that T will transfer property (the relinquished property) to R and R will transfer replacement property to T. R's obligation to transfer replacement property to T is secured by cash equal to the fair market value of the relinquished property, which R will deposit into a qualified escrow account that T establishes with B, a depository institution. T enters into an escrow agreement with B that provides that all the earnings attributable to the exchange funds will be paid to T.

(ii) On November 1, 2008, T transfers property to R and R deposits $2,100,000 in T's qualified escrow account with B. Between November 1 and December 31, 2008, B credits T's account with $14,000 of interest. During January 2009, B credits T's account with $7000 of interest. On February 1, 2009, R transfers replacement property worth $2,100,000 to T and B pays $2,100,000 from the qualified escrow account to R. Additionally, on February 1, 2009, B pays the $21,000 of interest to T.

(iii) Under paragraph (b) of this section, the $2,100,000 deposited with B constitutes exchange funds and B is an exchange facilitator. Because all the earnings attributable to the exchange funds are paid to T in accordance with the escrow agreement, paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to B. T must take into account in computing T's income tax liability for 2008 the $14,000 of earnings credited to the qualified escrow account in 2008 and for 2009 the $7,000 of earnings credited to the qualified escrow account in 2009.

Example 2. Payment of transactional expenses from earnings. (i) The facts are the same as in *Example 1*, except that the escrow agreement provides that, prior to paying the earnings to T, B may deduct any amounts B has paid to third parties for T's transactional expenses. B pays a third party $350 on behalf of T for a survey of the replacement property. After deducting $350 from the earnings attributable to T's qualified escrow account, B pays T the remainder ($20,650) of the earnings.

(ii) Under paragraph (b)(4) of this section, the cost of the survey is a transactional expense. Under paragraph (c)(2)(ii)(C) of this section, the $350 that B pays for the survey is treated as first paid to T and then from T to the third party. Therefore, all the earnings attributable to T's exchange funds are paid or treated as paid to T in accordance with the escrow agreement, and paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to B, and T must take into account in computing T's income tax liability the $21,000 of earnings credited to the qualified escrow account.

Example 3. Earnings retained by exchange facilitator as compensation for services. (i) The facts are the same as in *Example 1*, except that the escrow agreement provides that B also may deduct any outstanding fees owed by T for B's services in facilitating the deferred exchange. In accordance with paragraph (b)(4)(ii) of this section, the escrow agreement provides for a fixed fee of $1,200 for B's services, which is payable by T regardless of the amount of earnings attributable to the exchange funds. Because the earnings on the exchange funds in this case exceed $1,200, B retains $1,200 as the unpaid portion of its fee and pays T the remainder ($19,800) of the earnings.

(ii) Under paragraph (b)(4) of this section, B's fee is treated as a transactional expense. Under paragraph (c)(2)(ii)(C) of this section, the $1200 that B retains for its fee is treated as first paid to T and then from T to B. Therefore, all the earnings attributable to T's exchange funds are paid or treated as paid to T in accordance with the escrow agreement, and paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to B, and T must take into account in computing T's income tax liability the $21,000 of earnings credited to the qualified escrow account.

Example 4. Exchange funds deposited by exchange facilitator with related depository institution in account in taxpayer's name. (i) The facts are the same as in *Example 1* except that, instead of entering into an escrow agreement, T enters into an exchange agreement with QI, a qualified intermediary. The exchange agreement provides that R will pay $2,100,000 to QI, QI will deposit $2,100,000 into an account with a depository institution under T's name and taxpayer identification number (TIN), and all the earnings attributable to the account will be paid to T.

(ii) On May 1, 2008, T transfers property to QI, QI transfers the property to R, R delivers $2,100,000 to QI, and QI deposits $2,100,000 into a money market account with depository institution B under T's name and TIN. B and QI are members of the same consolidated group of corporations within the meaning of section 1501. Between May 1 and September 1, 2008, the account earns $28,000 of interest at the stated rate established by B. During the period May 1 to September 1, 2008, B invests T's exchange funds and earns $40,000. On September 1, 2008, QI uses $2,100,000 of the funds in the account to purchase replacement property identified by T and transfers the replacement property to T. B pays to T the $28,000 of interest earned on the money market account at the stated rate.

(iii) Under paragraph (b) of this section, the $2,100,000 QI receives from R for the relinquished property is exchange funds and QI is an exchange facilitator. B is not an exchange facilitator. T has not entered into an escrow agreement, trust agreement, or exchange agreement with B, and QI, not B, holds the exchange funds on behalf of T. Under paragraph (c)(2)(ii)(A) of this section, the $40,000 B earns from investing T's exchange funds are not treated as earnings attributable to T's exchange funds. Because all the earnings attributable to T's exchange funds are paid to T in accordance with the exchange agreement, paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to QI, and T must take into account in computing T's income tax liability for 2008 the $28,000 of interest earned on the money market account.

Example 5. Earnings of related depository institution credited to exchange facilitator. (i) The facts are the same as in *Example 4*, except that at the end of each taxable year, B credits a portion of its earnings on deposits to QI. The amount credited is based on the total amount of exchange funds QI has deposited with B during the year. At the end of the 2008 taxable year, B credits $152,500 of B's earnings to QI.

(ii) Under paragraph (c)(2)(ii)(A) of this section, no part of the $152,500 credited by B to QI is earnings attributable to T's exchange funds. Therefore, all of the earnings attributable to the exchange funds are paid to T in accordance with the exchange agreement, and paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to QI, and T must take into account in computing T's income tax liability for 2008 the $28,000 of interest earned on T's account.

Example 6. Exchange funds deposited by exchange facilitator with unrelated depository institution in sub-account in taxpayer's name. (i) The facts are the same as in *Example 4*, except that QI and B are unrelated and the money market account in which QI deposits the $2,100,000 received from T is a sub-account within a master account QI maintains with B in QI's name and TIN. The master account includes other sub-accounts, each in the name and TIN of a taxpayer that has entered into an exchange agreement with QI, into which QI deposits each taxpayer's exchange funds. Each month, B transfers to QI's master account an additional amount of interest based upon the average daily balance of all exchange funds within the master account during the month. At the end of the 2008 taxable year, B has credited $152,500 of additional interest to QI.

(ii) Under paragraph (c)(2)(ii)(A) of this section, no part of the $152,500 credited by B to QI is earnings attributable to T's exchange funds. Therefore, all of the earnings attributable to the exchange funds are paid to T in accordance with the exchange agreement, and paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to QI, and T must take into account in computing T's income tax liability for 2008 the $28,000 of interest earned on T's account.

Example 7. Marketing fee paid to exchange facilitator. (i) The facts are the same as in *Example 4*, except that at the end of each taxable year, B pays a marketing fee to QI for using B as its depository institution for exchange funds. The amount of the fee is based on the total amount of exchange funds QI has deposited with B during the year.

(ii) Under paragraph (c)(2)(ii)(A) of this section, no part of the marketing fee that B pays to QI is earnings attributable to T's exchange funds. Therefore, all of the earnings attributable to the exchange funds are paid to T in accordance with the exchange agreement, and paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to QI, and T must take into account in computing T's income tax liability for 2008 the $28,000 of interest earned on T's account.

Example 8. Stated rate of interest on account less than earnings attributable to exchange funds. (i) The facts are the same as in *Example 4*, except that the exchange agreement provides only that QI will pay T a stated rate of interest. QI invests the exchange funds and earns $40,000. The exchange funds earn $28,000 at the stated rate of interest, and QI pays the $28,000 to T.

(ii) Paragraph (c)(1) of this section applies and the exchange funds are treated as loaned from T to QI. QI must take into account in computing QI's income tax liability all items of income, deduction, and credit (including capital gains and losses) attributable to the exchange funds. Paragraph (c)(2) of this section does not apply because QI does not pay all the earnings attributable to the exchange funds to T. See §§1.7872–5 and 1.7872–16 for rules relating to exchange facilitator loans.

Example 9. All earnings attributable to commingled exchange funds paid to taxpayer. (i) The facts are the same as in *Example 4*, except that the exchange agreement does not specify how the $2,100,000 QI receives from R must be invested.

(ii) On May 1, 2008, QI deposits the $2,100,000 with B in a pre-existing interest-bearing account under QI's name and TIN. The account has a total balance of $5,275,000 immediately thereafter. On the last day of each month between May and September, 2008, the account earns interest as follows: $17,583 in May, $17,642 in June, $18,756 in July, and $17,472 in August. On July 11, 2008, QI deposits $500,000 in the account. On August 15, 2008, QI withdraws $1,175,000 from the account.

(iii) QI calculates T's pro-rata share of the earnings allocable to the $2,100,000 based on the actual return, the average daily principal balances, and a 30-day month convention, as follows:

Month	Account's avg. daily bal.	T's avg. daily bal.	T's share* (percent)	Monthly interest	T's end. bal.**
May	$5,275,000	$2,100,000	39.8	$17,583	$2,106,998
June	5,292,583	2,106,998	39.8	17,642	2,114,020
July	5,643,558	2,114,020	37.5	18,756	2,121,054
August	5,035,647	2,121,054	42.1	17,472	2,128,410

* T's Average Daily Balance ÷ Account's Average Daily Balance.
** T's beginning balance + [(T's share) (Monthly Interest)].

(iv) On September 1, 2008, QI uses $2,100,000 of the funds to purchase replacement property identified by T and transfers the property to T. QI pays $28,410, the earnings of the account allocated to T's exchange funds, to T.

(v) Because QI uses a reasonable method to calculate the pro-rata share of account earnings allocable to T's exchange funds in accordance with paragraph (c)(2)(ii)(B) of this section, and pays all those earnings to T, paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to QI. T must take into account in computing T's income tax liability for 2008 the $28,410 of earnings attributable to T's exchange funds.

(f) *Effective/applicability dates*—(1) *In general*. This section applies to transfers of relinquished property made by taxpayers on or after October 8, 2008.

(2) *Transition rule*. With respect to transfers of relinquished property made by taxpayers after August 16, 1986, but before October 8, 2008, the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation for income attributable to exchange funds.

[T.D. 9413, 73 FR 39620, July 10, 2008]

§ 1.468B–7 Pre-closing escrows.

(a) *Scope*. This section provides rules under section 468B(g) for the current taxation of income of a pre-closing escrow.

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

(1) A *pre-closing escrow* is an escrow account, trust, or fund—

(i) Established in connection with the sale or exchange of real or personal property;

(ii) Funded with a down payment, earnest money, or similar payment that is deposited into the escrow prior to the sale or exchange of the property;

(iii) Used to secure the obligation of the purchaser to pay the purchase price for the property;

(iv) The assets of which, including any income earned thereon, will be paid to the purchaser or otherwise distributed for the purchaser's benefit when the property is sold or exchanged (for example, by being distributed to the seller as a credit against the purchase price); and

(v) Which is not an escrow account or trust established in connection with a deferred exchange under section 1031(a)(3).

(2) *Purchaser* means, in the case of an exchange, the intended transferee of the property whose obligation to pay the purchase price is secured by the pre-closing escrow;

(3) *Purchase price* means, in the case of an exchange, the required consideration for the property; and

(4) *Administrator* means the escrow agent, escrow holder, trustee, or other person responsible for administering the pre-closing escrow.

(c) *Taxation of pre-closing escrows*. The purchaser must take into account in computing the purchaser's income tax liability all items of income, deduction, and credit (including capital gains and losses) of the pre-closing escrow. In the case of an exchange with a single pre-closing escrow funded by two or more purchasers, each purchaser must take into account in computing the purchaser's income tax liability all items of income, deduction, and credit (including capital gains and losses) earned by the pre-closing escrow with respect to the money or property deposited in the pre-closing escrow by or on behalf of that purchaser.

(d) *Reporting obligations of the administrator*. For each calendar year (or portion thereof) that a pre-closing escrow is in existence, the administrator must report the income of the pre-closing escrow on Form 1099 to the extent required by the information reporting provisions of subpart B, Part III, subchapter A, chapter 61, Subtitle F of the

Internal Revenue Code and the regulations thereunder. See § 1.6041–1(f) for rules relating to the amount to be reported when fees, expenses, or commissions owed by a payee to a third party are deducted from a payment.

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

Example 1. P enters into a contract with S for the purchase of residential property owned by S for the price of $200,000. P is required to deposit $10,000 of earnest money into an escrow. At closing, the $10,000 and the interest earned thereon will be credited against the purchase price of the property. The escrow is a pre-closing escrow. P is taxable on the interest earned on the pre-closing escrow prior to closing.

Example 2. X and Y enter into a contract in which X agrees to exchange certain construction equipment for residential property owned by Y. The contract requires X and Y to each deposit $10,000 of earnest money into an escrow. At closing, $10,000 and the interest earned thereon will be paid to X and $10,000 and the interest earned thereon will be paid to Y. The escrow is a pre-closing escrow. X is taxable on the interest earned prior to closing on the $10,000 of funds X deposited in the pre-closing escrow. Similarly, Y is taxable on the interest earned prior to closing on the $10,000 of funds Y deposited in the pre-closing escrow.

(f) *Effective dates*—(1) *In general.* This section applies to pre-closing escrows established after February 3, 2006.

(2) *Transition rule.* With respect to a pre-closing escrow established after August 16, 1986, but on or before February 3, 2006, the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation for income earned by the escrow or a reasonable, consistently applied method for reporting the income.

[T.D. 9249, 71 FR 6202, Feb. 7, 2006]

§ 1.468B–8 Contingent-at-closing escrows. [Reserved]

§ 1.468B–9 Disputed ownership funds.

(a) *Scope.* This section provides rules under section 468B(g) relating to the current taxation of income of a disputed ownership fund.

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

(1) *Disputed ownership fund* means an escrow account, trust, or fund that—

(i) Is established to hold money or property subject to conflicting claims of ownership;

(ii) Is subject to the continuing jurisdiction of a court;

(iii) Requires the approval of the court to pay or distribute money or property to, or on behalf of, a claimant, transferor, or transferor-claimant; and

(iv) Is not a qualified settlement fund under § 1.468B–1, a bankruptcy estate (or part thereof) resulting from the commencement of a case under title 11 of the United States Code, or a liquidating trust under § 301.7701–4(d) of this chapter (except as provided in paragraph (c)(2)(ii) of this section);

(2) *Administrator* means a person designated as such by a court having jurisdiction over a disputed ownership fund, however, if no person is designated, the administrator is the escrow agent, escrow holder, trustee, receiver, or other person responsible for administering the fund;

(3) *Claimant* means a person who claims ownership of, in whole or in part, or a legal or equitable interest in, money or property immediately before and immediately after that property is transferred to a disputed ownership fund;

(4) *Court* means a court of law or equity of the United States or of any state (including the District of Columbia), territory, possession, or political subdivision thereof;

(5) *Disputed property* means money or property held in a disputed ownership fund subject to the claimants' conflicting claims of ownership;

(6) *Related person* means any person that is related to a transferor within the meaning of section 267(b) or 707(b)(1);

(7) *Transferor* means, in general, a person that transfers disputed property to a disputed ownership fund, except that—

(i) If disputed property is transferred by an agent, fiduciary, or other person acting in a similar capacity, the transferor is the person on whose behalf the agent, fiduciary, or other person acts; and

(ii) A payor of interest or other income earned by a disputed ownership fund is not a transferor within the meaning of this section (unless the payor is also a claimant);

(8) *Transferor-claimant* means a transferor that claims ownership of, in whole or in part, or a legal or equitable interest in, the disputed property immediately before and immediately after that property is transferred to the disputed ownership fund. Because a transferor-claimant is both a transferor and a claimant, generally the terms *transferor* and *claimant* also include a transferor-claimant. See paragraph (d) of this section for rules applicable only to transferors that are not transferor-claimants and paragraph (e) of this section for rules applicable only to transferors that are also transferor-claimants.

(c) *Taxation of a disputed ownership fund*—(1) *In general.* For Federal income tax purposes, a disputed ownership fund is treated as the owner of all assets that it holds. A disputed ownership fund is treated as a C corporation for purposes of subtitle F of the Internal Revenue Code, and the administrator of the fund must obtain an employer identification number for the fund, make all required income tax and information returns, and deposit all tax payments. Except as otherwise provided in this section, a disputed ownership fund is taxable as—

(i) A C corporation, unless all the assets transferred to the fund by or on behalf of transferors are passive investment assets. For purposes of this section, passive investment assets are assets of the type that generate portfolio income within the meaning of §1.469–2T(c)(3)(i); or

(ii) A qualified settlement fund, if all the assets transferred to the fund by or on behalf of transferors are passive investment assets. A disputed ownership fund taxable as a qualified settlement fund under this section is subject to all the provisions contained in §1.468B–2, except that the rules contained in paragraphs (c)(3), (4), and (c)(5)(i) of this section apply in lieu of the rules in §1.468B–2(b)(1), (d), (e), (f) and (j).

(2) *Exceptions.* (i) The claimants to a disputed ownership fund may submit a private letter ruling request proposing a method of taxation different than the method provided in paragraph (c)(1) of this section.

(ii) The trustee of a liquidating trust established pursuant to a plan confirmed by the court in a case under title 11 of the United States Code may, in the liquidating trust's first taxable year, elect to treat an escrow account, trust, or fund that holds assets of the liquidating trust that are subject to disputed claims as a disputed ownership fund. Pursuant to this election, creditors holding disputed claims are not treated as transferors of the money or property transferred to the disputed ownership fund. A trustee makes the election by attaching a statement to the timely filed Federal income tax return of the disputed ownership fund for the taxable year for which the election becomes effective. The election statement must include a statement that the trustee will treat the escrow account, trust, or fund as a disputed ownership fund and must include a legend, "§1.468B–9(c) Election," at the top of the page. The election may be revoked only upon consent of the Commissioner by private letter ruling.

(3) *Property received by the disputed ownership fund*—(i) *Generally excluded from income.* In general, a disputed ownership fund does not include an amount in income on account of a transfer of disputed property to the disputed ownership fund. However, the accrual or receipt of income from the disputed property in a disputed ownership fund is not a transfer of disputed property to the fund. Therefore, a disputed ownership fund must include in income all income received or accrued from the disputed property, including items such as—

(A) Payments to a disputed ownership fund made in compensation for late or delayed transfers of money or property;

(B) Dividends on stock of a transferor (or a related person) held by the fund; and

(C) Interest on debt of a transferor (or a related person) held by the fund.

(ii) *Basis and holding period.* In general, the initial basis of property transferred by, or on behalf of, a transferor to a disputed ownership fund is the fair market value of the property on the date of transfer to the fund, and the fund's holding period begins on the date of the transfer. However, if the transferor is a transferor-claimant, the fund's initial basis in the property is the same as the basis of the transferor-claimant immediately before the transfer to the fund, and the fund = s holding period for the property is determined under section 1223(2).

(4) *Property distributed by the disputed ownership fund*—(i) *Computing gain or loss.* Except in the case of a distribution or deemed distribution described in paragraph (e)(3) of this section, a disputed ownership fund must treat a distribution of disputed property as a sale or exchange of that property for purposes of section 1001(a). In computing gain or loss, the amount realized by the disputed ownership fund is the fair market value of that property on the date of distribution.

(ii) *Denial of deduction.* A disputed ownership fund is not allowed a deduction for a distribution of disputed property or of the net after-tax income earned by the disputed ownership fund made to or on behalf of a transferor or claimant.

(5) *Taxable year and accounting method.* (i) A disputed ownership fund taxable as a C corporation under paragraph (c)(1)(i) of this section may compute taxable income under any accounting method allowable under section 446 and is not subject to the limitations contained in section 448. A disputed ownership fund taxable as a C corporation may use any taxable year allowable under section 441.

(ii) A disputed ownership fund taxable as a qualified settlement fund under paragraph (c)(1)(ii) of this section may compute taxable income under any accounting method allowable under section 446 and may use any taxable year allowable under section 441.

(iii) Appropriate adjustments must be made by a disputed ownership fund or transferors to the fund to prevent the fund and the transferors from taking into account the same item of income, deduction, gain, loss, or credit (including capital gains and losses) more than once or from omitting such items. For example, if a transferor that is not a transferor-claimant uses the cash receipts and disbursements method of accounting and transfers an account receivable to a disputed ownership fund that uses an accrual method of accounting, at the time of the transfer of the account receivable to the disputed ownership fund, the transferor must include in its gross income the value of the account receivable because, under paragraph (c)(3)(ii) of this section, the disputed ownership fund will take a fair market value basis in the receivable and will not include the fair market value in its income when received from the transferor or when paid by the customer. If the account receivable were transferred to the disputed ownership fund by a transferor-claimant using the cash receipts and disbursements method, however, the disputed ownership fund would take a basis in the receivable equal to the transferor's basis, or $0, and would be required to report the income upon collection of the account.

(6) *Unused carryovers.* Upon the termination of a disputed ownership fund, if the fund has an unused net operating loss carryover under section 172, an unused capital loss carryover under section 1212, or an unused tax credit carryover, or if the fund has, for its last taxable year, deductions in excess of gross income, the claimant to which the fund's net assets are distributable will succeed to and take into account the fund's unused net operating loss carryover, unused capital loss carryover, unused tax credit carryover, or excess of deductions over gross income for the last taxable year of the fund. If the fund's net assets are distributable to more than one claimant, the unused net operating loss carryover, unused capital loss carryover, unused tax credit carryover, or excess of deductions over gross income for the last taxable year must be allocated among the claimants in proportion to the value of the assets distributable to each claimant from the fund. Unused carryovers described in this paragraph (c)(6) are not money or other property for purposes of paragraph (e)(3)(ii) of this section and thus are not deemed transferred to a transferor-claimant before being transferred to the claimants described in this paragraph (c)(6).

(d) *Rules applicable to transferors that are not transferor-claimants.* The rules in this paragraph (d) apply to transferors (as defined in paragraph (b)(7) of this section) that are not transferor-claimants (as defined in paragraph (b)(8) of this section).

(1) *Transfer of property.* A transferor must treat a transfer of property to a disputed ownership fund as a sale or other disposition of that property for purposes of section 1001(a). In computing the gain or loss on the disposition, the amount realized by the transferor is the fair market value of the property on the date the transfer is made to the disputed ownership fund.

(2) *Economic performance*—(i) *In general.* For purposes of section 461(h), if a transferor using an accrual method of accounting has a liability for which economic performance would otherwise occur under §1.461–4(g) when the transferor makes payment to the claimant or claimants, economic performance occurs with respect to the liability when and to the extent that the transferor makes a transfer to a disputed ownership fund to resolve or satisfy that liability.

(ii) *Obligations of the transferor.* Economic performance does not occur when a transferor using an accrual method of accounting issues to a disputed ownership fund its debt (or provides the debt of a related person). Instead, economic performance occurs as the transferor (or related person) makes principal payments on the debt. Economic performance does not occur when the transferor provides to a disputed ownership fund its obligation (or the obligation of a related person) to provide property or services in the future or to make a payment described in §1.461–4(g)(1)(ii)(A). Instead, economic performance occurs with respect to such an obligation as property or services are provided or payments are made to the disputed ownership fund or a claimant. With regard to interest on a debt issued or provided to a disputed ownership fund, economic performance occurs as determined under §1.461–4(e).

(3) *Distributions to transferors*—(i) *In general.* Except as provided in section 111(a) and paragraph (d)(3)(ii) of this section, the transferor must include in gross income any distribution to the transferor (including a deemed distribution described in paragraph (d)(3)(iii) of this section) from the disputed ownership fund. If property is distributed, the amount includible in gross income and the basis in that property are generally the fair market value of the property on the date of distribution.

(ii) *Exception.* A transferor is not required to include in gross income a distribution of money or property that it previously transferred to the disputed ownership fund if the transferor did not take into account, for example, by deduction or capitalization, an amount with respect to the transfer either at the time of the transfer to, or while the money or property was held by, the disputed ownership fund. The transferor's gross income does not include a distribution of money from the disputed ownership fund equal to the net after-tax income earned on money or property transferred to the disputed ownership fund by the transferor while that money or property was held by the fund. Money distributed to a transferor by a disputed ownership fund will be deemed to be distributed first from the money or property transferred to the disputed ownership fund by that transferor, then from the net after-tax income of any money or property transferred to the disputed ownership fund by that transferor, and then from other sources.

(iii) *Deemed distributions.* If a disputed ownership fund makes a distribution of money or property on behalf of a transferor to a person that is not a claimant, the distribution is deemed made by the fund to the transferor. The transferor, in turn, is deemed to make a payment to the actual recipient.

(e) *Rules applicable to transferor-claimants.* The rules in this paragraph (e) apply to transferor-claimants (as defined in paragraph (b)(8) of this section).

(1) *Transfer of property.* A transfer of property by a transferor-claimant to a disputed ownership fund is not a sale or other disposition of the property for purposes of section 1001(a).

(2) *Economic performance*—(i) *In general.* For purposes of section 461(h), if a transferor-claimant using an accrual method of accounting has a liability for which economic performance would otherwise occur under §1.461–4(g) when the transferor-claimant makes payment to another claimant, economic

performance occurs with respect to the liability when and to the extent that the disputed ownership fund transfers money or property to the other claimant to resolve or satisfy that liability.

(ii) *Obligations of the transferor-claimant.* Economic performance does not occur when a disputed ownership fund transfers the debt of a transferor-claimant (or of a person related to the transferor-claimant) to another claimant. Instead, economic performance occurs as principal payments on the debt are made to the other claimant. Economic performance does not occur when a disputed ownership fund transfers to another claimant the obligation of a transferor-claimant (or of a person related to the transferor-claimant) to provide property or services in the future or to make a payment described in §1.461–4(g)(1)(ii)(A). Instead, economic performance occurs with respect to such an obligation as property or services are provided or payments are made to the other claimant. With regard to interest on a debt issued or provided to a disputed ownership fund, economic performance occurs as determined under §1.461–4(e).

(3) *Distributions to transferor-claimants*—(i) *In general.* The gross income of a transferor-claimant does not include a distribution to the transferor-claimant (including a deemed distribution described in paragraph (e)(3)(ii) of this section) of money or property from a disputed ownership fund that the transferor-claimant previously transferred to the fund, or the net after-tax income earned on that money or property while it was held by the fund. If such property is distributed to the transferor-claimant by the disputed ownership fund, then the transferor-claimant's basis in the property is the same as the disputed ownership fund's basis in the property immediately before the distribution.

(ii) *Deemed distributions.* If a disputed ownership fund makes a distribution of money or property to a claimant or makes a distribution of money or property on behalf of a transferor-claimant to a person that is not a claimant, the distribution is deemed made by the fund to the transferor-claimant. The transferor-claimant, in turn, is deemed to make a payment to the actual recipient.

(f) *Distributions to claimants other than transferor-claimants.* Whether a claimant other than a transferor-claimant must include in gross income a distribution of money or property from a disputed ownership fund generally is determined by reference to the claim in respect of which the distribution is made.

(g) *Statement to the disputed ownership fund and the Internal Revenue Service with respect to transfers of property other than cash*—(1) *In general.* By February 15 of the year following each calendar year in which a transferor (or other person acting on behalf of a transferor) makes a transfer of property other than cash to a disputed ownership fund, the transferor must provide a statement to the administrator of the fund setting forth the information described in paragraph (g)(3) of this section. The transferor must attach a copy of this statement to its return for the taxable year of transfer.

(2) *Combined statements.* If a disputed ownership fund has more than one transferor, any two or more transferors may provide a combined statement to the administrator. If a combined statement is used, each transferor must attach a copy of the combined statement to its return and maintain with its books and records a schedule describing each asset that the transferor transferred to the disputed ownership fund.

(3) *Information required on the statement.* The statement required by paragraph (g)(1) of this section must include the following information—

(i) A legend, ''§1.468B–9 Statement,'' at the top of the first page;

(ii) The transferor's name, address, and taxpayer identification number;

(iii) The disputed ownership fund's name, address, and employer identification number;

(iv) A statement declaring whether the transferor is a transferor-claimant;

(v) The date of each transfer;

(vi) A description of the property (other than cash) transferred; and

(vii) The disputed ownership fund's basis in the property and holding period on the date of transfer as determined under paragraph (c)(3)(ii) of this section.

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

Example 1. (i) X Corporation petitions the United States Tax Court in 2006 for a redetermination of its tax liability for the 2003 taxable year. In 2006, the Tax Court determines that X Corporation is liable for an income tax deficiency for the 2003 taxable year. X Corporation files an appellate bond in accordance with section 7485(a) and files a notice of appeal with the appropriate United States Court of Appeals. In 2006, the Court of Appeals affirms the decision of the Tax Court and the United States Supreme Court denies X Corporation's petition for a writ of certiorari.

(ii) The appellate bond that X Corporation files with the court for the purpose of staying assessment and collection of deficiencies pending appeal is not an escrow account, trust or fund established to hold property subject to conflicting claims of ownership. Although X Corporation was found liable for an income tax deficiency, ownership of the appellate bond is not disputed. Rather, the bond serves as security for a disputed liability. Therefore, the bond is not a disputed ownership fund.

Example 2. (i) The facts are the same as *Example 1*, except that X Corporation deposits United States Treasury bonds with the Tax Court in accordance with section 7845(c)(2) and 31 U.S.C. 9303.

(ii) The deposit of United States Treasury bonds with the court for the purpose of staying assessment and collection of deficiencies while X Corporation prosecutes an appeal does not create a disputed ownership fund because ownership of the bonds is not disputed.

Example 3. (i) Prior to A's death, A was the insured under a life insurance policy issued by X, an insurance company. X uses an accrual method of accounting. Both A's current spouse and A's former spouse claim to be the beneficiary under the policy and entitled to the policy proceeds ($1 million). In 2005, X files an interpleader action and deposits $1 million into the registry of the court. On June 1, 2006, a final determination is made that A's current spouse is the beneficiary under the policy and entitled to the money held in the registry of the court. The interest earned on the registry account is $12,000. The money in the registry account is distributed to A's current spouse.

(ii) The money held in the registry of the court consisting of the policy proceeds and the earnings thereon are a disputed ownership fund taxable as if it were a qualified settlement fund. See paragraphs (b)(1) and (c)(1)(ii) of this section. The fund's gross income does not include the $1 million transferred to the fund by X, however, the $12,000 interest is included in the fund's gross income in accordance with its method of accounting. See paragraph (c)(3)(i) of this section. Under paragraph (c)(4)(ii) of this section, the fund is not allowed a deduction for a distribution to A's current spouse of the $1 million or the interest income earned by the fund.

(iii) X is a transferor that is not a transferor-claimant. See paragraphs (b)(7) and (b)(8) of this section.

(iv) Whether A's current spouse must include in income the $1 million insurance proceeds and the interest received from the fund is determined under other provisions of the Internal Revenue Code. See paragraph (f) of this section.

Example 4. (i) Corporation B and unrelated individual C claim ownership of certain rental property. B uses an accrual method of accounting. The rental property is property used in a trade or business. B claims to have purchased the property from C's father. However, C asserts that the purported sale to B was ineffective and that C acquired ownership of the property through intestate succession upon the death of C's father. For several years, B has maintained and received the rent from the property.

(ii) Pending the resolution of the title dispute between B and C, the title to the rental property is transferred to a court-supervised registry account on February 1, 2005. On that date the court appoints R as receiver for the property. R collects the rent earned on the property and hires employees necessary for the maintenance of the property. The rents paid to R cannot be distributed to B or C without the court's approval.

(iii) On June 1, 2006, the court makes a final determination that the rental property is owned by C. The court orders C to refund to B the purchase price paid by B to C's father plus interest on that amount from February 1, 2005. The court also orders that a distribution be made to C of all funds held in the court registry consisting of the rent collected by R and the income earned thereon. C takes title to the rental property.

(iv) The rental property and the funds held by the court registry are a disputed ownership fund under paragraph (b)(1) of this section. The fund is taxable as if it were a C corporation because the rental property is not a passive investment asset within the meaning of paragraph (c)(1)(i) of this section.

(v) The fund's gross income does not include the value of the rental property transferred to the fund by B. See paragraph (c)(3)(i) of this section. Under paragraph (c)(3)(ii) of this section, the fund's initial basis in the property is the same as B's adjusted basis immediately before the transfer to the fund and the fund's holding period is determined under section 1223(2). The fund's gross income includes the rents collected by R and any income earned thereon. For the period between February 1, 2005, and June 1, 2006, the fund may be allowed deductions for depreciation and for the costs of maintenance of the property because the fund is treated as owning the property during this period. See sections 162, 167, and 168. Under paragraph (c)(4)(ii) of this section, the fund may not deduct the distribution to C of the property, or the rents (or any income earned thereon) collected from the property while the fund holds the property. No gain or loss is recognized by the fund from this distribution or from the fund's transfer of the rental property to C pursuant to the court's determination that C owns the property. See paragraphs (c)(4)(i) and (e)(3) of this section.

(vi) B is the transferor to the fund. Under paragraphs (b)(8) and (e)(1) of this section, B is a transferor-claimant and does not recognize gain or loss under section 1001(a) on transfer of the property to the disputed ownership fund. The money and property distributed from the fund to C is deemed to be distributed first to B and then transferred from B to C. See paragraph (e)(3)(ii) of this section. Under paragraph (e)(2)(i) of this section, economic performance occurs when the disputed ownership fund transfers the property and any earnings thereon to C. The income tax consequences of the deemed transfer from B to C as well as the income tax consequences of C's refund to B of the purchase price paid to C's father and interest thereon are determined under other provisions of the Internal Revenue Code.

(i) [Reserved]

(j) *Effective dates*—(1) *In general.* This section applies to disputed ownership funds established after February 3, 2006.

(2) *Transition rule.* With respect to a disputed ownership fund established after August 16, 1986, but on or before February 3, 2006, the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation for income earned by the fund, transfers to the fund, and distributions made by the fund.

[T.D. 9249, 71 FR 6202, Feb. 7, 2006]

§ 1.469–0 Table of contents.

This section lists the captions that appear in the regulations under section 469.

§ 1.469–1 General rules.

§ 1.469–1T General rules (temporary).

(12) Future regulations.
(d) Effect of section 469 and the regulations thereunder for other purposes.
(1) Treatment of items of passive activity income and gain.
(2) Coordination with sections 613A(d) and 1211. [Reserved]
(3) Treatment of passive activity losses.
(e) Definition of "passive activity."
(1) In general.
(2) Trade or business activity. [Reserved]
(3) Rental Activity.
(i) In general.
(ii) Exceptions.
(iii) Average period of customer use. [Reserved]
(A) In general. [Reserved]
(B) Average use factor. [Reserved]
(C) Average period of customer use for class of property. [Reserved]
(D) Period of Customer use. [Reserved]
(E) Class of property. [Reserved]
(F) Gross rental income and daily rent. [Reserved]
(iv) Significant personal services.
(A) In general.
(B) Excluded services.
(v) Extraordinary personal services.
(vi) Rental of property incidental to a nonrental activity of the taxpayer.
(A) In general.
(B) Property held for investment.
(C) Property used in a trade or business.
(D) Lodging rented for convenience of employer. [Reserved]
(E) Unadjusted basis. [Reserved]
(vii) Property made available for use in a nonrental activity conducted by a partnership, S corporation or joint venture in which the taxpayer owns an interest.
(viii) Examples.
(4) Special rules for oil and gas working interests.
(i) In general.
(ii) Exception for deductions attributable to a period during which liability is limited.
(A) In general.
(B) Coordination with rules governing the identification of disallowed passive activity deductions.
(C) Meaning of certain terms.
(*1*) Allocable deductions.
(*2*) Disqualified deductions.
(*3*) Net loss.
(*4*) Ratable portion.
(iii) Examples.
(iv) Definition of "working interest." [Reserved]
(v) Entities that limit liability.
(A) General rule.
(B) Other limitations disregarded.
(C) Examples.
(vi) Cross reference to special rule for income from certain oil or gas properties.
(5) Rental of dwelling unit. [Reserved]
(6) Activity of trading personal property.
(i) In general.
(ii) Personal property.
(iii) Example.
(f) Treatment of disallowed passive activity losses and credits.
(1) Scope of this paragraph.
(2) Identification of disallowed passive activity deductions.
(i) Allocation of disallowed passive activity deductions.
(A) General rule.
(B) Loss from an activity.
(C) Significant participation passive activities.
(D) Examples.
(ii) Allocation with loss activities.
(A) In general.
(B) Excluded deductions.
(iii) Separately identified deductions.
(3) Identification of disallowed credits from passive activities.
(i) General rule.
(ii) Coordination rule.
(iii) Separately identified credits.
(4) Carryover of disallowed deductions and credits. [Reserved]
(i) In general.
(ii) Operations continued through C corporations or similar entities.
(iii) Examples.
(g) Application of these rules to C corporations.
(1) In general.
(2) Definitions.
(3) Participation of corporations.
(i) Material participation.
(ii) Significant participation.
(iii) Participation of individual.
(4) Modified computation of passive activity loss in the case of closely held corporations.
(i) In general.
(ii) Net active income.
(iii) Examples.
(5) Allowance of passive activity credit of closely held corporations to extent of net active income tax liability.
(i) In general.
(ii) Net active income tax liability.
(h) Special rules for affiliated group filing consolidated return.
(1)–(2) [Reserved]
(3) Disallowance of consolidated group's passive activity loss or credit.
(4) Status and participation of members. [Reserved]
(i) Determination by reference to status and participation of group. [Reserved]
(ii) Determination of status and participation of consolidated group. [Reserved]
(5) Modification of rules for identifying disallowed passive activity deductions and credits.
(i) Identification of disallowed deductions.
(ii) Ratable portion of disallowed passive activity losses.
(iii) Identification of disallowed credits.
(6) [Reserved]

(7) Disposition of stock of a member of an affiliated group.
(8) Dispositions of property used in multiple activities.
(i) [Reserved]
(j) Spouses filing joint returns.
(1) In general.
(2) Exceptions of treatment as one taxpayer.
(i) Identification of disallowed deductions and credits.
(ii) Treatment of deductions disallowed under sections 704(d), 1366(d) and 465.
(iii) Treatment of losses from working interests.
(3) Joint return no longer filed.
(4) Participation of spouses.
(k) Former passive activities and changes in status of corporations. [Reserved]

§ 1.469–2 Passive activity loss.

(a)–(c)(2)(ii) [Reserved]
(iii) Disposition of substantially appreciated property formerly used in a nonpassive activity.
(A) In general.
(B) Date of disposition.
(C) Substantially appreciated property.
(D) Investment property.
(E) Coordination with §1.469–2T(c)(2)(ii).
(F) Coordination with section 163(d).
(G) Examples.
(iv) Taxable acquisitions.
(v) Property held for sale to customers.
(A) Sale incidental to another activity.
(*1*) Applicability.
(*i*) In general.
(*ii*) Principal purpose.
(*2*) Dealing activity not taken into account.
(B) Use in a nondealing activity incidental to sale.
(C) Examples.
(c)(3)–(c)(5) [Reserved]
(6) Gross income from certain oil or gas properties.
(i) In general.
(ii) Gross and net passive income from the property.
(iii) Property.
(iv) Examples 1 and 2.
(c)(6)(iv) Example 3–(c)(7)(iii) [Reserved]
(c)(7)(iv) through (vi) (no paragraph headings)
(d)(1)–(d)(2)(viii) [Reserved]
(d)(2)(ix) through (d)(2)(xii) (no paragraph headings)
(d)(3)–(d)(5)(ii) [Reserved]
(d)(5)(iii)(A) Applicability of rules in §1.469–2T(c)(2).
(d)(5)(iii)(B)–(d)(6)(v)(D) [Reserved]
(d)(6)(v)(E) (no paragraph heading)
(d)(6)(v)(F)–(d)(7) [Reserved]
(8) Taxable year in which item arises.
(e)(1)–(e)(2)(i) [Reserved]
(ii) Section 707(c).
(iii) Payments in liquidation of a partner's interest in partnership property.
(A) In general.
(B) Payments in liquidation of a partner's interest in unrealized receivables and goodwill under section 736(a).
(e)(3)(i)–(iii)(A) [Reserved]
(e)(3)(iii)(B) (no paragraph heading)
(e)(3)(iii)(C)–(f)(4) [Reserved]
(5) Net income from certain property rented incidental to development activity.
(i) In general.
(ii) Commencement of use.
(iii) Services performed for the purpose of enhancing the value of property.
(iv) Examples.
(6) Property rented to a nonpassive activity.
(f)(7)–(f)(9)(ii) [Reserved]
(f)(9)(iii) through (f)(9)(iv) (no paragraph heading).
(10) Coordination with section 163(d).
(f)(11) [Reserved]

§ 1.469–2T Passive activity loss (temporary).

(a) Scope of this section.
(b) Definition of passive activity loss.
(1) In general.
(2) Cross reference.
(c) Passive activity group income.
(1) In general.
(2) Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity.
(i) In general.
(A) Treatment of gain.
(B) Dispositions of partnership interest and S corporation stock.
(C) Interest in property.
(D) Examples.
(ii) Disposition of property used in more than one activity in 12-month period preceding disposition.
(iii) Disposition of substantially appreciated property used in nonpassive activity. [Reserved]
(A) In general. [Reserved]
(B) Date of disposition. [Reserved]
(C) Substantially appreciated property. [Reserved]
(D) Investment property. [Reserved]
(E) Coordination with paragraph (c)(2)(ii) of this section. [Reserved]
(F) Coordination with section 163(d). [Reserved]
(G) Examples. [Reserved]
(iv) Taxable acquisitions. [Reserved]
(v) Property held for sale to customers. [Reserved]
(A) Sale incidental to another activity. [Reserved]
(*1*) Applicability. [Reserved]
(*i*) In general. [Reserved]
(*ii*) Principal purpose. [Reserved]
(*2*) Dealing activity not taken into account. [Reserved]

(B) Use in a nondealing activity incidental to sale. [Reserved]
(C) Examples. [Reserved]
(3) Items of portfolio income specifically excluded.
(i) In general.
(ii) Gross income derived in the ordinary course of a trade or business.
(iii) Special rules.
(A) Income from property held for investment by dealer.
(B) Royalties derived in the ordinary course of the trade or business of licensing intangible property.
(*1*) In general.
(*2*) Substantial services or costs.
(*i*) In general.
(*ii*) Exception.
(*iii*) Expenditures taken into account.
(*3*) Passthrough entities.
(*4*) Cross reference.
(C) Mineral production payments.
(iv) Examples.
(4) Items of personal service income specifically excluded.
(i) In general.
(ii) Example.
(5) Income from section 481 adjustments.
(i) In general.
(ii) Positive section 481 adjustments.
(iii) Ratable portion.
(6) Gross income from certain oil or gas properties. [Reserved]
(i) In general. [Reserved]
(ii) Gross and net passive income from the properties. [Reserved]
(iii) Property. [Reserved]
(iv) Examples.
(7) Other items specifically excluded.
(d) Passive activity deductions.
(1) In general.
(2) Exceptions.
(3) Interest expense.
(4) Clearly and directly allocable expenses.
(5) Treatment of loss from disposition.
(i) In general.
(ii) Disposition of property used in more than one activity in 12-month period preceding disposition.
(iii) Other applicable rules.
(A) Applicability or rules in paragraph (c)(2).
(B) Dispositions of partnership interest and S corporation stock.
(6) Coordination with other limitations on deductions that apply before section 469.
(i) In general.
(ii) Proration of deductions disallowed under basis limitations.
(A) Deductions disallowed under section 704(d).
(B) Deductions disallowed under section 1366(d).
(iii) Proration of deductions disallowed under at-risk limitations.
(iv) Coordination of basis and at-risk limitations.
(v) Separately identified items of deduction and loss.
(7) Deductions from section 481 adjustment.
(i) In general.
(ii) Negative section 481 adjustment.
(iii) Ratable portion.
(8) Taxable year in which item arises.
(e) Special rules for partners and S corporation shareholders.
(1) In general.
(2) Payments under sections 707(a), 707(c), and 736(b).
(i) Section 707(a).
(ii) Section 707(c).
(iii) Payments in liquidation of a partner's interest in partnership property.
(A) In general.
(B) Payments in liquidation of a partner's interest of a partnership property.
(3) Sale or exchange of interest in passthrough entity.
(i) Application of this paragraph (e)(3).
(ii) General rule.
(A) Allocation among activities.
(B) Ratable portions.
(1) Disposition on which gain is recognized.
(2) Disposition on which loss is recognized.
(C) Default rule.
(D) Special rules.
(*1*) Applicable valuation date.
(*i*) In general.
(*ii*) Exception.
(*2*) Basis adjustment.
(*3*) Tiered passthrough entities.
(E) Meaning of certain terms.
(iii) Treatment of gain allocated to certain passive activities as not from a passive activity.
(iv) Dispositions occurring in taxable years beginning before February 19, 1988.
(A) In general.
(B) Exceptions.
(v) Treatment of portfolio assets.
(vi) Definitions.
(vii) Examples.
(f) Recharacterization of passive income in certain situations.
(1) In general.
(2) Special rule for significant participation.
(i) In general.
(ii) Significant participation passive activity.
(iii) Example.
(3) Rental of nondepreciable property.
(4) Net interest income from passive equity-financed lending activity.
(i) In general.
(ii) Equity-financed lending activity.
(A) In general.
(B) Certain liabilities not taken into account.
(iii) Equity-financed interest income.
(iv) Net interest income.
(v) Interest-bearing assets.
(vi) Liabilities incurred in the activity.

(vii) Average outstanding balance.
(viii) Example.
(5) Net income from certain property rented incidental to development activity.
(i) In general. [Reserved]
(ii) Commencement of use. [Reserved]
(iii) Services performed for the purpose of enhancing the value of property. [Reserved]
(iv) Examples. [Reserved]
(6) Property rented to a nonpassive activity.
(7) Special rules applicable to the acquisition of an interest of a passthrough entity engaged in the trade or business of licensing intangible property.
(i) In general.
(ii) Royalty income from property.
(iii) Exceptions.
(iv) Capital expenditures.
(v) Example.
(8) Limitation on recharacterized income.
(9) Meaning of certain terms.
(10) Coordination with section 163(d).
(11) Effective date.

§ 1.469–3 Passive activity credit.

(a)–(d) [Reserved]
(e) Coordination with section 38(b).
(f) Coordination with section 50.
(g) [Reserved]

§ 1.469–3T Passive activity credit (temporary).

(a) Computation of passive activity credit.
(b) Credits subject to section 469.
(1) In general.
(2) Treatment of credits attributed to qualified progress expenditures.
(3) Special rule for partners and S corporations shareholders.
(4) Exception for pre-1987 credits.
(c) Taxable year to which credit is attributable.
(d) Regular tax liability allocable to passive activities.
(1) In general.
(2) Regular tax liability.
(e) Coordination with section 38(b). [Reserved]
(f) Coordination with section 47. [Reserved]
(g) Examples.

§ 1.469–4 Definition of activity.

(a) Scope and purpose.
(b) Definitions.
(1) Trade or business activities.
(2) Rental activities.
(c) General rules for grouping activities.
(1) Appropriate economic unit.
(2) Facts and circumstances test.
(3) Examples.
(d) Limitation on grouping certain activities.
(1) Grouping rental activities with other trade or business activities.
(i) Rule.
(ii) Examples.
(2) Grouping real property rentals and personal property rentals prohibited.
(3) Certain activities of limited partners and limited entrepreneurs.
(i) In general.
(ii) Example.
(4) Other activities identified by the Commissioner.
(5) Activities conducted through section 469 entities.
(i) In general.
(ii) Cross reference.
(e) Disclosure and consistency requirements.
(1) Original groupings.
(2) Regroupings.
(f) Grouping by Commissioner to prevent tax avoidance.
(1) Rule.
(2) Example.
(g) Treatment of partial dispositions.
(h) Rules for grouping rental real estate activities for taxpayers qualifying under section 469(c)(7).

§ 1.469–5 Material participation.

(a)–(e) [Reserved]
(f) Participation.
(1) In general.
(f)(2)–(h)(2) [Reserved]
(3) Coordination with rules governing the treatment of passthroughs entities.
(i) [Reserved]
(j) Material participation for preceding taxable years.
(1) In general.
(2) Material participation test for taxable years beginning before January 1, 1987
(k) Examples (1)–(4). [Reserved]
(k) Example 5.
(k) Examples (6)–(8). [Reserved]

§ 1.469–5T Material participation (temporary).

(a) In general.
(b) Facts and circumstances.
(1) In general. [Reserved]
(2) Certain participation insufficient to constitute material participation under this paragraph (b).
(i) Participation satisfying standards not contained in section 469.
(ii) Certain management activities.
(iii) Participation less than 100 hours.
(c) Significant participation activity.
(1) In general.
(2) Significant participation.
(d) Personal service activity.
(e) Treatment of limited partners.
(1) General rule.
(2) Exceptions.
(3) Limited partnership interest.
(i) In general.
(ii) Limited partner holding general partner interest.
(f) Participation. [Reserved]
(1) In general. [Reserved]

(2) Exceptions.
(i) Certain work not customarily done by owners.
(ii) participation as an investor.
(A) In general.
(B) Work done in individual's capacity as an investor.
(3) Participation of spouses.
(4) Methods of proof.
(g) Material participation of trust and estates. [Reserved]
(h) Miscellaneous rules.
(1) Participation of corporations.
(2) Treatment of certain retired farmers and surviving spouses of retired or disabled farmers.
(3) Coordination with rules governing the treatment of passthroughs entities. [Reserved]
(i) [Reserved]
(j) Material participation for preceding taxable years. [Reserved]
(1) In general. [Reserved]
(2) Material participation for taxable years beginning before January 1, 1987. [Reserved]
(k) Examples.

§ 1.469–6 Treatment of losses upon certain dispositions. [Reserved]

§ 1.469–7 Treatment of self-charged items of interest income and deduction.

(a) In general.
(1) Applicability and effect of rules.
(2) Priority of rules in this section.
(b) Definitions.
(1) Passthrough entity.
(2) Taxpayer's share.
(3) Taxpayer's indirect interest.
(4) Entity taxable year.
(5) Deductions for a taxable year.
(c) Taxpayer loans to passthrough entity.
(1) Applicability.
(2) General rule.
(3) Applicable percentage.
(d) Passthrough entity loans to taxpayer.
(1) Applicability.
(2) General rule.
(3) Applicable percentage.
(e) Identically-owned passthrough entities.
(1) Applicability.
(2) General rule.
(1) Example.
(f) Identification of properly allocable deductions.
(g) Election to avoid application of the rules of this section.
(1) In general.
(2) Form of election.
(3) Period for which election applies.
(4) Revocation.
(h) Examples.

§ 1.469–8 Application of section 469 to trust, estates, and their beneficiaries. [Reserved]

§ 1.469–9 Rules for certain rental real estate activities.

(a) Scope and purpose.
(b) Definitions.
(1) Trade or business.
(2) Real property trade or business.
(3) Rental real estate.
(4) Personal services.
(5) Material participation.
(6) Qualifying taxpayer.
(c) Requirements for qualifying taxpayers.
(1) In general.
(2) Closely held C corporations.
(3) Requirement of material participation in the real property trades or businesses.
(4) Treatment of spouses.
(5) Employees in real property trades or businesses.
(d) General rule for determining real property trades or businesses.
(1) Facts and circumstances.
(2) Consistency requirement.
(e) Treatment of rental real estate activities of a qualifying taxpayer.
(1) In general.
(2) Treatment as a former passive activity.
(3) Grouping rental real estate activities with other activities.
(i) In general.
(ii) Special rule for certain management activities.
(4) Example.
(f) Limited partnership interests in rental real estate activities.
(1) In general.
(2) De minimis exception.
(g) Election to treat all interests in rental real estate as a single rental real estate activity.
(1) In general.
(2) Certain changes not material.
(3) Filing a statement to make or revoke the election.
(h) Interests in rental real estate held by certain passthrough entities.
(1) General rule.
(2) Special rule if a qualifying taxpayer holds a fifty-percent or greater interest in a passthrough entity.
(3) Special rule for interests held in tiered passthrough entities.
(i) [Reserved]
(j) $25,000 offset for rental real estate activities of qualifying taxpayers.
(1) In general.
(2) Example.

§ 1.469–10 Application of section 469 to publicly traded partnerships. [Reserved]

§ 1.469–11 Effective date and transition rules.

(a) Generally applicable effective dates.
(b) Additional effective dates.

(1) Application of 1992 amendments for taxable years beginning before October 4, 1994.

(2) Additional transition rule for 1992 amendments.

(3) Fresh starts under consistency rules.

(i) Regrouping when tax liability is first determined under Project PS–1–89.

(ii) Regrouping when tax liability is first determined under § 1.469–4.

(iii) Regrouping when taxpayer is first subject to section 469(c)(7).

(iv) Regrouping for taxpayers subject to section 1411.

(A) In general.

(B) Eligibility criteria.

(C) Consequences of amended returns and examination adjustments.

(*1*) Taxpayers first subject to section 1411.

(*2*) Taxpayers ceasing to be subject to section 1411.

(*3*) Examples.

(D) Effective/applicability date.

(4) Certain investment credit property.

(c) Special rules.

(1) Application of certain income recharacterization rules and self-charged rules.

(i) Certain recharacterization rules inapplicable in 1987.

(ii) Property rented to a nonpassive activity.

(iii) Self-charged rules.

(2) Qualified low-income housing projects.

(3) Effect of events occurring in years prior to 1987.

(d) Examples.

[T.D. 8417, 57 FR 20748, May 15, 1992, as amended by T.D. 8477, 58 FR 11538, Feb. 26, 1993; T.D. 8495, 58 FR 58787, Nov. 4, 1993; T.D. 8565, 59 FR 50487, Oct. 4, 1994; T.D. 8597, 60 FR 36684, July 18, 1995; T.D. 8645, 60 FR 66498, Dec. 22, 1995; T.D. 9013, 67 FR 54089, Aug. 21, 2002; T.D. 9644, 78 FR 72421, Dec. 2, 2013]

§ 1.469–1 General rules.

(a)–(c)(7) [Reserved]

(c)(8) *Consolidated groups.* Rules relating to the application of section 469 to consolidated groups are contained in paragraph (h) of this section.

(c)(9)–(d)(1) [Reserved]

(d)(2) *Coordination with sections 613A (d) and 1211.* A passive activity deduction that is not disallowed for the taxable year under section 469 and the regulations thereunder may nonetheless be disallowed for the taxable year under section 613A(d) or 1211. The following example illustrates the application of this paragraph (d)(2):

Example. In 1993, an individual derives $10,000 of ordinary income from passive activity X, no gains from the sale or exchange of capital assets or assets used in a trade or business, $12,000 of capital loss from passive activity Y, and no income, gain, deductions, or losses from any other passive activity. The capital loss from activity Y is a passive activity deduction (within the meaning of § 1.469–2T(d)). Under section 469 and the regulations thereunder, the taxpayer is allowed $10,000 of the $12,000 passive activity deduction and has a $2,000 passive activity loss for the taxable year. Since the $10,000 passive activity deduction allowed under section 469 is a capital loss, such deduction is allowable for the taxable year only to the extent provided under section 1211. Therefore, the taxpayer is allowed $3,000 of the $10,000 capital loss under section 1211 and has a $7,000 capital loss carryover (within the meaning of section 1212(b)) to the succeeding taxable year.

(d)(3)–(e)(1) [Reserved]

(e)(2) *Trade or business activities. Trade or business activities* are activities that constitute trade or business activities within the meaning of § 1.469–4(b)(1).

(e)(3)(i)–(e)(3)(ii) [Reserved]

(e)(3)(iii) *Average period of customer use*—(A) *In general.* For purposes of this paragraph (e)(3), the average period of customer use for property held in connection with an activity (the *activity's average period of customer use*) is the sum of the average use factors for each class of property held in connection with the activity.

(B) *Average use factor.* The average use factor for a class of property held in connection with an activity is the average period of customer use for that class of property multiplied by the fraction obtained by dividing—

(*1*) The activity's gross rental income attributable to that class of property; by

(*2*) The activity's gross rental income.

(C) *Average period of customer use for class of property.* In determining an activity's average period of customer use for a taxable year, the average period of customer use for a class of property held in connection with an activity is determined by dividing—

(*1*) The aggregate number of days in all periods of customer use for property in the class (taking into account only periods that end during the taxable year or that include the last day of the taxable year); by

(*2*) The number of those periods of customer use.

(D) *Period of customer use.* Each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity (without regard to whether the customer uses the property for the entire period or whether the right to use the property is pursuant to a single agreement or to renewals thereof) is treated for purposes of this paragraph (e)(3)(iii) as a separate period of customer use. The duration of a period of customer use that includes the last day of a taxable year may be determined on the basis of reasonable estimates.

(E) *Class of property.* Taxpayers may organize property into classes for purposes of this paragraph (e)(3)(iii) using any method under which items of property for which the amount of the daily rent differs significantly are not included in the same class.

(F) *Gross rental income and daily rent.* In determining an activity's average period of customer use for a taxable year—

(*1*) The activity's gross rental income is the gross income from the activity for the taxable year taking into account only income that is attributable to amounts paid for the use of property;

(*2*) The activity's gross rental income attributable to a class of property is the gross income from the activity for the taxable year taking into account only income that is attributable to amounts paid for the use of property in that class; and

(*3*) The daily rent for items of property may be determined on any basis that reasonably reflects differences during the taxable year in the amounts ordinarily paid for one day's use of those items of property.

(e)(3)(iv)–(e)(3)(vi)(C) [Reserved]

(e)(3)(vi)(D) *Lodging rented for convenience of employer.* The provision of lodging to an employee or to an employee's spouse or dependents is treated as incidental to the activity (or activities) of the taxpayer in which the employee performs services if the lodging is furnished for the taxpayer's convenience (within the meaning of section 119).

(E) *Unadjusted basis.* For purposes of this paragraph (e)(3)(vi), the term *unadjusted basis* means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis.

(e)(3)(vii)–(e)(4)(iii) [Reserved]

(e)(4)(iv) *Definition of ''working interest.''* For purposes of section 469 and the regulations thereunder, the term *working interest* means a working or operating mineral interest in any tract or parcel of land (within the meaning of §1.612–4(a)).

(e)(4)(v)–(f)(3) [Reserved]

(f)(4) *Carryover of disallowed deductions and credits*—(i) *In general.* In the case of an activity of a taxpayer with respect to which any deductions or credits are disallowed for a taxable year under §1.469–1T (f)(2) or (f)(3) (the loss activity)—

(A) The disallowed deductions or credits is allocated among the taxpayer's activities for the succeeding taxable year in a manner that reasonably reflects the extent to which each activity continues the loss activity; and

(B) The disallowed deductions or credits allocated to an activity under paragraph (f)(4)(i)(A) of this section shall be treated as deductions or credits from the activity for the succeeding taxable year.

(ii) *Business continued through C corporations or similar entities.* If a taxpayer continues part or all of a loss activity through a C corporation or similar entity (C corporation entity), the taxpayer's interest in the C corporation entity shall be treated for purposes of this paragraph (f)(4) as an interest in a passive activity that continues that loss activity in whole or part. An entity is similar to a C corporation for this purpose if the owners of interests in the entity derive only portfolio income (within the meaning of §1.469–2T(c)(3)(i)) from the interests.

(iii) *Examples.* The following examples illustrate the application of this paragraph (f)(4). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example 1. (i) The taxpayer owns interests in a convenience store and an apartment building. In each taxable year, the taxpayer's interests in the convenience store and the apartment building are treated under §1.469–4 as interests in two separate passive activities of the taxpayer. A $5,000 loss from the convenience-store activity and a $3,000 loss from the apartment-building activity are disallowed under §1.469–1T(f)(2) for 1993. Under §1.469–1T(f)(2), the $5,000 loss from the convenience-store activity is allocated among the passive activity deductions from that activity for 1993, and the $3,000 loss from the apartment-building activity is treated similarly.

(ii) In 1994, the convenience store is continued in a single activity, and the section 469 activities that constituted the apartment building is similarly continued in a separate activity. Thus, the disallowed deductions from the convenience-store activity for 1993 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's convenience-store activity in 1994. Similarly, the disallowed deductions from the apartment-building activity for 1993 must be allocated to the taxpayer's apartment-building activity in 1994. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the convenience-store activity in 1994 are treated as deductions from that activity for 1994, and the disallowed deductions allocated to the apartment-building activity for 1994 are treated as deductions from the apartment-building activity for 1994.

Example 2. (i) In 1993, the taxpayer acquires a restaurant and a catering business. Assume that in 1993 and 1994 the restaurant and the catering business are treated under §1.469–4 as an interest in a single passive activity of the taxpayer (the restaurant and catering activity). A $10,000 loss from the activity is disallowed under §1.469–1T(f)(2) for 1994. Assume that in 1995, the taxpayer's interests in the restaurant and the catering business are treated under §1.469–4 as interests in two separate passive activities of the taxpayer.

(ii) Under §1.469–1T(f)(2), the $10,000 loss from the restaurant and catering activity is allocated among the passive activity deductions from that activity for 1994. In 1995, the businesses that constituted the restaurant and catering activity are continued, but are treated as two separate activities under §1.469–4. Thus, the disallowed deductions from the restaurant and catering activity for 1994 must be allocated under paragraph (f)(4)(i)(A) of this section between the restaurant activity and the catering activity in 1995 in a manner that reasonably reflects the extent to which each of the activities continues the single restaurant and catering activity. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the restaurant activity in 1995 are treated as deductions from the restaurant activity for 1995, and the disallowed deductions allocated to the catering activity in 1995 are treated as deductions from the catering activity for 1995.

Example 3. (i) In 1993, the taxpayer acquires a restaurant and a catering business. Assume that in 1993 and 1994 the restaurant and the catering business are treated under§1.469–4 as an interest in a single passive activity of the taxpayer (the restaurant and catering activity). A $10,000 loss from the activity is disallowed under §1.469–1T(f)(2) for 1994. Assume that in 1995, the taxpayer's interests in the restaurant and the catering business are treated under §1.469–4 as interestes in two separate passive activities of the taxpayer. In addition, a $20,000 loss from the activity was disallowed under §1.469–1T(f)(2) for 1993, and the gross income and deductions (including deductions that were disallowed for 1993 under §1.469–1T(f)(2)) from the restaurant and catering business for 1993 and 1994 are as follows:

	Restaurant	Catering business
1993:		
Gross income	$20,000	$60,000
Deductions	40,000	60,000
Net income (loss)	(20,000)	....
1994:		
Gross income	40,000	50,000
Deductions	[1] 30,000	[2] 70,000
Net income (loss)	10,000	(20,000)

[1] Includes $8,000 of deductions that were disallowed for 1993 ($20,000 × $40,000/$100,000).

[2] Includes $12,000 of deductions that were disallowed for 1993 ($20,000 × $60,000/$100,000).

(ii) Under paragraph (f)(4)(i)(A) of this section, the disallowed deductions from the restaurant and catering activity must be allocated among the taxpayer's activities for the succeeding year in a manner that reasonably reflects the extent to which those activities continue the restaurant and catering activity. The remainder of this example describes a number of allocation methods that will ordinarily satisfy the requirement of paragraph (f)(4)(i)(A) of this section. The description of specific allocation methods in this example does not preclude the use of other reasonable allocation methods for purposes of paragraph (f)(4)(i)(A) of this section.

(iii) Ordinarily, an allocation of disallowed deductions from the restaurant to the restaurant activity and disallowed deductions from the catering business to the catering activity would satisfy the requirement of paragraph (f)(4)(i)(A) of this section. Under §1.469–1T (f)(2)(ii), a ratable portion of each deduction from the restaurant and catering activity is disallowed for 1994. Thus, $3,000 of the 1994 deductions from the restaurant are disallowed ($10,000 × $30,000/$100,000), and $7,000 of the 1994 deductions from the catering business are disallowed ($10,000 × $70,000/ $100,000). Thus, the taxpayer can ordinarily treat $3,000 of the disallowed deductions as deductions from the restaurant activity for 1995, and $7,000 of the disallowed deductions as deductions from the catering activity for 1995.

(iv) Ordinarily, an allocation of disallowed deductions between the restaurant activity and catering activity in proportion to the losses from the restaurant and from the catering business for 1994 would also satisfy the requirement of paragraph (f)(4)(i)(A) of this section. If the restaurant and the catering business had been treated as separate activities in 1994, the restaurant activity would have had net income of $10,000 and the catering activity would have had a $20,000 loss. Thus, the taxpayer can ordinarily treat all $10,000 of disallowed deductions as deductions from the catering activity for 1995.

(v) Ordinarily, an allocation of disallowed deductions between the restaurant activity and catering activity in proportion to the losses from the restaurant and from the catering business for 1994 (determined as if the restaurant and the catering business had been separate activities for all taxable years) would also satisfy the requirement of paragraph (f)(4)(i)(A) of this section. If the restaurant and the catering business had been treated as separate activities for all taxable years, the entire $20,000 loss from the restaurant in 1993 would have been allocated to the restaurant activity in 1994, and the gross income and deductions from the separate activities for 1994 would be as follows:

	Restaurant	Catering business
Gross income	$40,000	$50,000
Deductions	42,000	58,000
Net income (loss)	(2,000)	(8,000)

Thus, the taxpayer can ordinarily treat $2,000 of the disallowed deductions as deductions from the restaurant activity for 1995, and $8,000 of the disallowed deductions as deductions from the catering activity for 1995.

Example 4. (i) The taxpayer is a partner in a law partnership that acquires a building in December 1993 for use in the partnership's law practice. In taxable year 1993, four floors that are not needed in the law practice are leased to tenants; in taxable year 1994, two floors are leased to tenants; in taxable years after 1994, only one floor is leased to tenants and the rental operations are insubstantial. Assume that under §1.469–4, the law practice and the rental property are treated as a trade or business activity and a separate rental activity for taxable years 1993 and 1994. Assume further that the law practice and the rental operations are a single trade or business activity for taxable years after 1994 under §1.469–4. The trade or business activity is not a passive activity of the taxpayer. The rental activity, however, is a passive activity. Under §1.469–T(f)(2), a $12,000 loss from the rental activity is disallowed for 1993 and a $9,000 loss from the rental activity is disallowed for 1994.

(ii) Under §1.469–1T(f)(2), the $12,000 loss from the rental activity for 1993 is allocated among the passive activity deductions from that activity for 1993. In 1994, the business of the rental activity is continued in two separate activities. Only two floors of the building remain in the rental activity, and the other two floors (*i.e.*, the floors that were leased to tenants in 1993, but not in 1994) are used in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1993 must be allocated under paragraph (f)(4)(i)(A) of this section between the rental activity and the law-practice activity in a manner that reasonably reflects the extent to which each of the activities continues business on the four floors that were leased to tenants in 1993. In these circumstances, the requirement of paragraph (f)(4)(i)(A) of this section would ordinarily be satisfied by any of the allocation methods illustrated in Example 3 or by an allocation of 50 percent of the disallowed deductions to each activity. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the rental activity in 1994 are treated as deductions from the rental activity for 1994, and the disallowed deductions ($6,000) allocated to the law-practice activity in 1994 are treated as deductions from the law-practice activity for 1994.

(iii) Under §1.469–1T(f)(2), the $9,000 loss from the rental activity for 1994 is allocated among the passive activity deductions from that activity for 1994. In 1995, the rental activity is continued in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1994 must be allocated under paragraph (f)(4)(ii) of this section to the taxpayer's law-practice activity in 1995. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the law-practice activity are treated as deductions from the law-practice activity for 1995.

(iv) Rules relating to former passive activities will be contained in paragraph (k) of this section. Under those rules, any disallowed deductions from the rental activity that are treated as deductions from the law-practice activity will be treated as unused deductions that are allocable to a former passive activity.

Example 5. (i) The taxpayer owns stock in a corporation that is an S corporation for the taxpayer's 1993 taxable year and a C coporation thereafter. The only activity of the corporation is a rental activity. For 1993, the taxpayer's pro rata share of the corporation's loss from the rental activity is $5,000, and the entire loss is disallowed under §1.469–1T(f)(2) of this section.

(ii) Under §1.469–1T(f)(2), the taxpayer's $5,000 loss from the rental activity is allocated among the taxpayer's deductions from that activity for 1993. In 1994, the rental activity is continued through a C corporation, and the taxpayer's interest in the C corporation is treated under paragraph (f)(4)(ii) of this section as a passive activity that continues the rental activity (the C corporation activity) for purposes of allocating the previously disallowed loss. Thus, the disallowed deductions from the rental activity for 1993 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1994, and are treated under paragraph (f)(4)(i)(B) of this section as deductions from the C corporation activity for 1994.

(iii) Treating the taxpayer's interest in the C corporation as an interest in a passive activity that continues the business of the rental activity does not change the character of the taxpayer's dividend income from the C corporation. Thus, the taxpayer's dividend income is portfolio income (within the meaning of §1.469–2T(c)(3)(i)) and is not included in passive activity gross income. Accordingly, the taxpayer's loss from the C corporation activity for 1994 is $5,000.

Example 6. (i) The taxpayer owns stock in a corporation that is an S corporation for the taxpayer's 1993 taxable year and a C corporation thereafter. The only activity of the corporation is a rental activity. For 1993, the taxpayer's pro rata share of the corporation's loss from the rental activity is $5,000, and the entire loss is disallowed under §1.469–1T(f)(2). The taxpayer has $2,000 in income from other passive activities for 1994, and as a result, only 60% of the taxpayer's loss from the C corporation activity ($3,000) is disallowed for 1994 under §1.469–1T(f)(2).

(ii) Under §1.469–1T(f)(2), the $3,000 disallowed loss from the C corporation activity is allocated among the passive activity deductions from that activity for 1994. In effect, therefore, 60 percent of each disallowed deduction from the rental activity for 1993 is again disallowed for 1994.

(iii) Under paragraph (f)(4) of this section, the taxpayer's interest in the C corporation is treated as a loss activity and as an interest in a passive activity that continues the business of that loss activity for 1995. Thus, the disallowed deductions from the C corporation activity for 1994 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1995, and are treated under paragraph (f)(4)(i)(B) of this section as deductions from that activity for 1995.

(g)(1)–(g)(4)(ii)(B) [Reserved]

(g)(4)(ii)(C) Portfolio income (within the meaning of §1.469–2T(c)(3)(i)), including any gross income that is treated as portfolio income under any other provision of the regulations (See, e.g., §1.469–2(c)(2)(iii)(F) (relating to gain from the disposition of substantially appreciated property formerly held for investment) and §1.469–2(f)(10) (relating to certain recharacterized passive activity gross income))

(5) [Reserved]

(h)(1) *In general.* This paragraph (h) provides rules for applying section 469 in computing a consolidated group's consolidated taxable income and consolidated tax liability (and the separate taxable income and tax liability of each member).

(2) *Definitions.* The definitions and nomenclature in the regulations under section 1502 apply for purposes of this paragraph (h). See, e.g., §§1.1502–1 (definitions of group, consolidated group, member, subsidiary, and consolidated return year), 1.1502–2 (consolidated tax liability), 1.1502–11 (consolidated taxable income), 1.1502–12 (separate taxable income), 1.1502–13 (intercompany transactions), 1.1502–21 (net operating losses, and 1.1502–22 (consolidated net capital gain and loss).

(3) [Reserved]

(4) *Status and participation of members*—(i) *Determination by reference to status and participation of group.* For purposes of section 469 and the regulations thereunder—

(A) Each member of a consolidated group shall be treated as a closely held corporation or personal service corporation, respectively, for the taxable year, if and only if the consolidated group is treated (under the rules of paragraph (h)(4)(ii) of this section) as a closely held corporation or personal service corporation for that year; and

(B) The determination of whether a trade or business activity (within the meaning of paragraph (e)(2) of this section) conducted by one or more members of a consolidated group is a passive activity of the members is made by reference to the consolidated group's participation in the activity.

(ii) *Determination of status and participation of consolidated group.* For purposes of determining under §1.469–1T(g)(2) whether a consolidated group is treated as a closely held corporation or a personal service corporation, and determining under §1.469–1T(g)(3) whether the consolidated group materially or significantly participates in any activity conducted by one or more members of the group—

(A) The members of the consolidated group shall be treated as one corporation;

(B) Only the outstanding stock of the common parent shall be treated as outstanding stock of the corporation;

(C) An employee of any member of the group shall be treated as an employee of the corporation; and

(D) An activity is treated as the principal activity of the corporation if and only if it is the principal activity (within the meaning of §1.441–3(e)) of the consolidated group.

(5) [Reserved]

(6) *Intercompany transactions*—(i) *In general*. Section 1.1502–13 applies to determine the treatment under section 469 of intercompany items and corresponding items from intercompany transactions between members of a consolidated group. For example, the matching rule of §1.1502–13(c) treats the selling member (S) and the buying member (B) as divisions of a single corporation for purposes of determining whether S's intercompany items and B's corresponding items are from a passive activity. Thus, for purposes of applying §1.469–2(c)(2)(iii) and §1.469–2T(d)(5)(ii) to property sold by S to B in an intercompany transaction—

(A) S and B are treated as divisions of a single corporation for determining the uses of the property during the 12-month period preceding its disposition to a nonmember, and generally have an aggregate holding period for the property; and

(B) §1.469–2(c)(2)(iv) does not apply.

(ii) *Example*. The following example illustrates the application of this paragraph (h)(6).

Example. (i) P, a closely held corporation, is the common parent of the P consolidated group. P owns all of the stock of S and B. X is a person unrelated to any member of the P group. S owns and operates equipment that is not used in a passive activity. On January 1 of Year 1, S sells the equipment to B at a gain. B uses the equipment in a passive activity and does not dispose of the equipment before it has been fully depreciated.

(ii) Under the matching rule of §1.1502–13(c), S's gain taken into account as a result of B's depreciation is treated as gain from a passive activity even though S used the equipment in a nonpassive activity.

(iii) The facts are the same as in paragraph (a) of this Example, except that B sells the equipment to X on December 1 of Year 3 at a further gain. Assume that if S and B were divisions of a single corporation, gain from the sale to X would be passive income attributable to a passive activity. To the extent of B's depreciation before the sale, the results are the same as in paragraph (ii) of this Example. B's gain and S's remaining gain taken into account as a result of B's sale are treated as attributable to a passive activity.

(iv) The facts are the same as in paragraph (iii) of this Example, except that B recognizes a loss on the sale to X. B's loss and S's gain taken into account as a result of B's sale are treated as attributable to a passive activity.

(iii) *Effective dates*. This paragraph (h)(6) applies with respect to transactions occurring in years beginning on or after July 12, 1995. For transactions occurring in years beginning before July 12, 1995, see §1.469–1T(h)(6) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(h)(7)–(k) [Reserved]

[T.D. 8417, 57 FR 20750, May 15, 1992; 57 FR 28612, June 26, 1992, as amended by T.D. 8417, 59 FR 45623, Sept. 2, 1994; T.D. 8597, 60 FR 36684, July 18, 1995; T.D. 8677, 61 FR 33322, June 27, 1996; T.D. 8823, 64 FR 36099, July 2, 1999; T.D. 8996, 67 FR 35012, May 17, 2002]

§ 1.469–1T General rules (temporary).

(a) *Passive activity loss and credit disallowed*—(1) *In general*. Except as otherwise provided in paragraph (a)(2) of this section—

(i) The passive activity loss for the taxable year shall not be allowed as a deduction; and

(ii) The passive activity credit for the taxable year shall not be allowed.

(2) *Exceptions*. Paragraph (a)(1) of this section shall not apply to the passive activity loss or the passive activity credit for the taxable year to the extent provided in—

(i) Section 469(i) and the rules to be contained in §1.469–9T (relating to losses and credits attributable to certain rental real estate activities); and

(ii) Section 1.469–11T (relating to losses and credits attributable to certain pre-enactment interests in activities).

(b) *Taxpayers to whom these rules apply*. The rules of section 469 and the regulations thereunder generally apply to—

(1) Individuals;

(2) Trusts (other than trusts (or portions of trusts) described in section 671);

(3) Estates;

(4) Personal service corporations (within the meaning of paragraph (g)(2)(i) of this section); and

(5) Closely held corporations (within the meaning of paragraph (g)(2)(ii) of this section).

(c) *Cross references*—(1) *Definition of ''passive activity.''* Rules relating to the definition of the term ''passive activity'' are contained in paragraph (e) of this section.

(2) *Passive activity loss.* Rules relating to the computation of the passive activity loss for the taxable year are contained in §1.469–2T.

(3) *Passive activity credit.* Rules relating to the computation of the passive activity credit for the taxable year are contained in §1.469–3T.

(4) *Effect of rules for other purposes.* Rules relating to the effect of section 469 and the regulations thereunder for other purposes under the Code are contained in paragraph (d) of this section.

(5) *Special rule for oil and gas working interests.* Rules relating to the treatment of losses and credits from certain interests in oil and gas wells are contained in paragraph (e)(4) of this section

(6) *Treatment of disallowed losses and credits.* Paragraph (f) of this section contains rules relating to—

(i) The treatment of deductions from passive activities in taxable years in which the passive activity loss is disallowed in whole or in part under paragraph (a)(1)(i) of this section; and

(ii) The treatment of credits from passive activities in taxable years in which the passive activity credit is disallowed in whole or in part under paragraph (a)(1)(ii) of this section.

(7) *Corporation subject to section 469.* Rules relating to the application of section 469 and regulations thereunder to C corporations are contained in paragraph (g) of this section.

(8) [Reserved]

(9) *Joint returns.* Rules relating to the application of section 469 and the regulations thereunder to spouses filing a joint return for the taxable year are contained in paragraph (j) of this section.

(10) *Material participation.* Rules defining the term ''material participation'' are contained in §1.469–5T.

(11) *Effective date and transition rules.* Rules relating to the effective date of section 469 and the regulations thereunder and transition rules applicable to pre-enactment interests in activities are contained in §1.469–11T.

(12) *Future regulations.* (i) Rules relating to former passive activities and changes in corporate status will be contained in paragraph (k) of this section.

(ii) Rules relating to the definition of ''activity'' will be contained in §1.469–4T.

(iii) Rules relating to the treatment of deductions from activities that are disposed of in certain transactions will be contained in §1.469–6T.

(iv) Rules relating to the treatment of self-charged items of income and expense will be contained in §1.469–7T.

(v) Rules relating to the application of section 469 and the regulations thereunder to trusts, estates, and their beneficiaries will be contained in §1.469–8T.

(vi) Rules relating to the treatment of income, deductions, and credits from certain rental real estate activities of individuals and certain estates will be contained in §1.469–9T.

(vii) Rules relating to the application of section 469 to publicly traded partnerships will be contained in §1.469–10T.

(d) *Effect of section 469 and the regulations thereunder for other purposes*—(1) *Treatment of items of passive activity income and gain.* Neither the provisions of section 469 (a)(1) and paragraph (a)(1) of this section nor the characterization of items of income or deduction as passive activity gross income (within the meaning of §1.469–2T (c)) or passive activity deductions (within the meaning of §1.469–2T (d)) affects the treatment of any item of income or gain under any provision of the Internal Revenue Code other than section 469. The following example illustrates the application of this paragraph (d)(1):

Example. (i) In 1991, an individual's only income and loss from passive activities are a $10,000 capital gain from passive activity X and a $12,000 ordinary loss from passive activity Y. The taxpayer also has a $10,000 capital loss that is not derived from a passive activity.

(ii) Under §1.469–2T (b), the taxpayer has a $2,000 passive activity loss for the taxable year. The only effect of section 469 and the regulations thereunder is to disallow a deduction for the taxpayer's $2,000 passive activity loss for the taxable year. Thus, the taxpayer's capital loss for the taxable year is allowed because the $10,000 capital gain from passive activity X is taken into account under section 1211 (b) in computing the taxpayer's allowable capital loss for the year.

(2) *Coordination with sections 613A(d) and 1211.* [Reserved]. See §1.469–1(d)(2) for rules relating to this paragraph.

(3) *Treatment of passive activity losses.* Except as otherwise provided by regulations, a deduction that is disallowed for a taxable year under section 469 and the regulations thereunder is not taken into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by subtitle A of the Internal Revenue Code. The following example illustrates the application of this paragraph (d)(3):

Example. An individual has a $5,000 passive activity loss for a taxable year, all of which is disallowed under paragraph (a)(1) of this section. All of the disallowed loss is allocated under paragraph (f) of this section to activities that are trades or businesses (within the meaning of section 1402(c)). Such loss is not taken into account for the taxable year in computing the taxpayer's taxable income subject to tax under section 1. In addition, under this paragraph (d)(3), such loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under section 1401.

(e) *Definition of "passive activity"*—(1) *In general.* Except as otherwise provided in this paragraph (e), an activity is a passive activity of the taxpayer for a taxable year if and only if the activity—

(i) Is a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer does not materially participate for such taxable year; or

(ii) Is a rental activity (within the meaning of paragraph (e)(3) of this section), without regard to whether or to what extent the taxpayer participates in such activity.

(2) *Trade or business activity.* [Reserved]. See §1.469–1(e)(2) for rules relating to this paragraph.

(3) *Rental activity*—(i) *In general.* Except as otherwise provided in this paragraph (e)(3), an activity is a rental activity for a taxable year if—

(A) During such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and

(B) The gross income attributable to the conduct of the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

(ii) *Exceptions.* For purposes of this paragraph (e)(3), an activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year—

(A) The average period of customer use for such property is seven days or less;

(B) The average period of customer use for such property is 30 days or less, and significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;

(C) Extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);

(D) The rental of such property is treated as incidental to a nonrental activity of the taxpayer under paragraph (e)(3)(vi) of this section;

(E) The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or

(F) The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under paragraph (e)(3)(vii) of this section.

(iii) *Average period of customer use.* [Reserved]. See §1.469–1(e)(3)(iii) for rules relating to this paragraph.

(iv) *Significant personal services*—(A) *In general.* For purposes of paragraph (e)(3)(ii)(B) of this section, personal services include only services performed by individuals, and do not include excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section). In determining whether personal services provided in connection with making property available for use by customers are significant, all of the relevant facts and circumstances shall be taken into account. Relevant facts and circumstances include the frequency with which such services are provided, the type and amount of labor required to perform such services, and the value of such services relative to the amount charged for the use of the property.

(B) *Excluded services.* For purposes of paragraph (e)(3)(iv)(A) of this section, the term ''excluded services'' means, with respect to any property made available for use by customers—

(*1*) Services necessary to permit the lawful use of the property;

(*2*) Services performed in connection with the construction of improvements to the property, or in connection with the performance of repairs that extend the property's useful life for a period substantially longer than the average period for which such property is used by customers; and

(*3*) Services, provided in connection with the use of any improved real property, that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential real property (e.g., cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security at entrances or perimeters).

(v) *Extraordinary personal services.* For purposes of paragraph (e)(3)(ii)(C) of this section, extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of such services. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided by the school's teaching staff.

(vi) *Rental of property incidental to a nonrental activity of the taxpayer*—(A) *In general.* For purposes of paragraph (e)(3)(ii)(D) of this section, the rental of property shall be treated as incidental to a nonrental activity of the taxpayer only to the extent provided in this paragraph (e)(3)(vi).

(B) *Property held for investment.* The rental of property during a taxable year shall be treated as incidental to an activity of holding such property for investment if and only if—

(*1*) The principal purpose for holding the property during such taxable year is to realize gain from the appreciation of the property (without regard to whether it is expected that such gain will be realized from the sale or exchange of the property in its current state of development); and

(*2*) The gross rental income from the property for such taxable year is less than two percent of the lesser of—

(*i*) The unadjusted basis of such property; and

(*ii*) The fair market value of such property.

(C) *Property used in a trade or business.* The rental of property during a taxable year shall be treated as incidental to a trade or business activity (within the meaning of paragraph (e)(2) of this section) if and only if—

(*1*) The taxpayer owns an interest in such trade or business activity during the taxable year;

(*2*) The property was predominantly used in such trade or business activity during the taxable year or during at least two of the five taxable years that immediately precede the taxable year; and

(*3*) The gross rental income from such property for the taxable year is less than two percent of the lesser of—

(*i*) The unadjusted basis of such property; and

(*ii*) The fair market value of such property.

(D) *Lodging for convenience of employer*. [Reserved]. See § 1.469–1(e)(3)(vi)(D) for rules relating to this paragraph.

(E) *Unadjusted basis*. [Reserved]. See § 1.469–1(e)(3)(vi)(E) for rules relating to this paragraph.

(vii) *Property made available for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.* If the taxpayer owns an interest in a partnership, S corporation, or joint venture conducting an activity other than a rental activity, and the taxpayer provides property for use in the activity in the taxpayer's capacity as an owner of an interest in such partnership, S corporation, or joint venture, the provision of such property is not a rental activity. Thus, if a partner contributes the use of property to a partnership, none of the partner's distributive share of partnership income is income from a rental activity unless the partnership is engaged in a rental activity. In addition, a partner's gross income attributable to a payment described in section 707(c) is not income from a rental activity under any circumstances (see § 1.469–2T (e)(2)). The determination of whether property used in an activity is provided by the taxpayer in the taxpayer's capacity as an owner of an interest in a partnership, S corporation, or joint venture shall be made on the basis of all of the facts and circumstances.

(viii) *Examples*. The following examples illustrate the application of this paragraph (e)(3):

Example 1. The taxpayer is engaged in an activity of leasing photocopying equipment. The average period of customer use for the equipment exceeds 30 days. Pursuant to the lease agreements, skilled technicians employed by the taxpayer maintain the equipment and service malfunctioning equipment for no additional charge. Service calls occur frequently (three times per week on average) and require substantial labor. The value of the maintenance and repair services (measured by the cost to the taxpayer of employees performing these services) exceeds 50 percent of the amount charged for the use of the equipment. Under these facts, services performed by individuals are provided in connection with the use of the photocopying equipment, but the customers' use of the photocopying equipment is not incidental to their receipt of the services. Therefore, extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are not provided in connection with making the photocopying equipment available for use by customers, and the activity is a rental activity.

Example 2. The facts are the same as in Example 1, except that the average period of customer use for the photocopying equipment exceeds seven days but does not exceed 30 days. Under these facts, significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided in connection with making the photocopying equipment available for use by customers and, under paragraph (e)(3)(ii)(B) of this section, the activity is not a rental activity.

Example 3. The taxpayer is engaged in an activity of transporting goods for customers. In conducting the activity, the taxpayer provides tractor-trailers to transport goods for customers pursuant to arrangements under which the tractor-trailers are selected by the taxpayer, may be replaced at the sole option of the taxpayer, and are operated and maintained by drivers and mechanics employed by the taxpayer. The average period of customer use for the tractor-trailers exceeds 30 days. Under these facts, the use of tractor-trailers by the taxpayer's customers is incidental to their receipt of personal services provided by the taxpayer. Accordingly, the services performed in the activity are extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) and, under paragraph (e)(3)(ii)(C) of this section, the activity is not a rental activity.

Example 4. The taxpayer is engaged in an activity of owning and operating a residential apartment hotel. For the taxable year, the average period of customer use for apartments exceeds seven days but does not exceed 30 days. In addition to cleaning public entrances, exists, stairways, and lobbies, and collecting and removing trash, the taxpayer provides a daily maid and linen service at no additional charge. All of the services other than maid and linen service are excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section), because such services are similar to those commonly provided in connection with long-term rentals of high-grade residential real property. The value of the maid and linen services (measured by the cost to the taxpayer of employees performing such services) is less than 10 percent of the amount charged to tenants for occupancy of apartments. Under these facts, neither significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) nor extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided in connection with making apartments available for use by customers. Accordingly, the activity is a rental activity.

Example 5. The taxpayer owns 1,000 acres of unimproved land with a fair market value of $350,000 and an unadjusted basis of $210,000. The taxpayer holds the land for the principal purpose of realizing gain from appreciation. In order to defray the cost of carrying the land, the taxpayer leases the land to a rancher, who uses the land to graze cattle and pays rent of $4,000 per year. Thus, the gross rental income from the land is less than two percent of the lesser of the fair market value and the unadjusted basis of the land (.02 × $210,000 = $4,200). Accordingly, under paragraph (e)(3)(ii)(D) of this section, the rental of the land is not a rental activity because the rental is treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding the property for investment.

Example 6. (i) A calendar year taxpayer owns an interest in a farming activity which is a trade or business activity (within the meaning of paragraph (e)(2) of this section) and owns farmland which was used in the farming activity in 1985 and 1986. The fair market value of the farmland is $350,000 and its unadjusted basis is $210,000. In 1987, 1988, and 1989, the taxpayer continues to own an interest in the farming activity but does not use the land in the activity. In 1987, the taxpayer leases the land for $4,000 to a rancher, who uses the land to graze cattle. In 1988, the taxpayer leases the land for $10,000 to a film production company, which uses the land to film scenes for a movie. In 1989, the taxpayer again leases the land for $4,000 to the rancher.

(ii) For 1987 and 1989, the taxpayer owns an interest in a trade or business activity, and the farmland which the taxpayer leases to the rancher was used in such activity for two out of the five immediately preceding taxable years. In addition, the gross rental income from the land ($4,000) is less than two percent of the lesser of the fair market value and the unadjusted basis of the land (.02 × $210,000 = $4,200). Accordingly, the taxpayer's rental of the land is treated under paragraph (e)(3)(vi)(C) of this section as incidental to the taxpayer's farming activity, and is not a rental activity.

(iii) Because the taxpayer's gross rental income from the land for 1988 ($10,000) is not less than two percent of the lesser of the fair market value and the unadjusted basis of the land, the requirement of paragraph (e)(3)(vi)(C)(*3*) of this section is not met. Therefore, the taxpayer's rental of the land in 1988 is not treated as incidental to the taxpayer's farming activity and is a rental activity.

Example 7. (i) In 1988, the taxpayer acquires vacant land for the purpose of constructing a shopping mall. Before commencing construction, the taxpayer leases the land under a one-year lease to an automobile dealer, who uses the land to park cars held in its inventory. The taxpayer commences construction of the shopping mall in 1989.

(ii) The taxpayer acquired the land for the principal purpose of constructing the shopping mall, not for the principal purpose of realizing gain from the appreciation of the property. Therefore, the rental of the property in 1988 is not treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding the property for investment.

(iii) The land has not been used in any taxable year in any trade or business of the taxpayer. Therefore, the rental of the property in 1988 is not treated under paragraph (e)(3)(vi)(C) of this section as incidental to a trade or business activity.

(iv) Since the rental of the land in 1988 is not treated under paragraph (e)(3)(vi) of this section as incidental to a nonrental activity of the taxpayer, the rental of the land in 1988 is a rental activity. See §1.469–2T(f)(3) for a special rule relating to the treatment of gross income from the rental of nondepreciable property.

Example 8. The taxpayer makes farmland available to a tenant farmer pursuant to an arrangement designated a ''crop-share lease.'' Under the arrangement, the tenant is required to use the tenant's best efforts to farm the land and produce marketable crops. The taxpayer is obligated to pay 50 percent of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50 percent of the crops produced (or 50 percent of the proceeds from marketing the crops). For purposes of paragraph (e)(3)(vii) of this section, the taxpayer is treated as providing the farmland for use in a farming activity conducted by a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture. Accordingly, under paragraph (e)(3)(ii)(F) of this section, the taxpayer is not engaged in a rental activity, without regard to whether the taxpayer performs any services in the farming activity.

Example 9. The taxpayer owns a taxicab which the taxpayer operates during the day and leases to another driver for use at night under a one-year lease. Under the terms of the lease, the other driver is charged a fixed rental for use of the taxicab. Assume that, under the rules to be contained in §1.469–4T, the taxpayer is engaged in two separate activities, an activity of operating the taxicab and an activity of making the taxicab available for use by the other driver. Under these facts, the period for which the other driver uses the taxicab exceeds 30 days, and the taxpayer does not provide extraordinary personal services in connection with making the taxicab available to the other driver. Accordingly, the lease of the taxicab is a rental activity.

Example 10. The taxpayer operates a golf course. Some customers of the golf course pay green fees upon each use of the golf course, while other customers purchase weekly, monthly, or annual passes. The golf course is open to all customers from sunrise to sunset every day of the year except certain holidays and days on which the taxpayer determines that the course is too wet for play. The taxpayer thus makes the golf course available during prescribed hours for nonexclusive use by various customers. Accordingly, under paragraph (e)(3)(ii)(E) of this section, the taxpayer is not engaged in a rental activity, without regard to the average period of customer use for the golf course.

(4) *Special rule for oil and gas working interests*—(i) *In general.* Except as otherwise provided in paragraph (e)(4)(ii) of this section, an interest in an oil or gas well drilled or operated pursuant to a working interest (within the meaning of paragraph (e)(4)(iv) of this section) of a taxpayer is not an interest in a passive activity for the taxpayer's taxable year (without regard to whether the taxpayer materially participates in such activity) if at any time during such taxable year the taxpayer holds such working interest either—

(A) Directly; or

(B) Through an entity that does not limit the liability of the taxpayer with respect to the drilling or operation of such well pursuant to such working interest.

(ii) *Exception for deductions attributable to a period during which liability is limited*—(A) *In general.* If paragraph (e)(4)(i) of this section applies for a taxable year to the taxpayer's interest in an oil or gas well that would, but for the application of paragraph (e)(4)(i) of this section, by an interest in a passive activity for the taxable year, and the taxpayer has a net loss (within the meaning of paragraph (e)(4)(ii)(C)(*3*) of this section) from the well for the taxable year—

(*1*) The taxpayer's disqualified deductions (within the meaning of paragraph (e)(4)(ii)(C)(*2*) of this section) from such oil or gas well for such year shall be treated as passive activity deductions for such year (within the meaning of §1.469–2T(d)); and

(*2*) A ratable portion (within the meaning of paragraph (e)(4)(ii)(C)(*4*) of this section) of the taxpayer's gross income from such oil or gas well for such year shall be treated as passive activity gross income for such year (within the meaning of §1.469–2T(c)).

(B) *Coordination with rules governing the identification of disallowed passive activity deductions.* If gross income and deductions from an activity for a taxable year are treated as passive activity gross income and passive activity deductions under paragraph (e)(4)(ii)(A) of this section, such activity shall be treated as a passive activity for such year for purposes of applying paragraph (f) (2) and (4) of this section.

(C) *Meaning of certain terms.* For purposes of this paragraph (e)(4)(ii), the following terms shall have the meanings set forth below:

(*1*) *Allocable deductions.* The deductions allocable to a taxable year are any deductions that arise in such year (within the meaning of §1.469–2T (d)(8)) and any deductions that are treated as deductions for such year under paragraph (f)(4) of this section.

(*2*) *Disqualified deductions.* The taxpayer's ''disqualified deductions'' from an oil or gas well for a taxable year are the taxpayer's deductions—

(*i*) That are attributable to such well and allocable to the taxable year; and

(*ii*) With respect to which economic performance (within the meaning of section 461(h), without regard to section 461 (h)(3) or (i)(2)) occurs at a time during which the taxpayer's only interest in the working interest is held through an entity that limits the taxpayer's liability with respect to the drilling or operation of such well.

(*3*) *Net loss.* The ''net loss'' of a taxpayer from an oil or gas well for a taxable year equals the amount by which the taxpayer's deductions that are attributable to such oil or gas well and allocable to such year exceeds the gross income of the taxpayer from such well for such year.

(*4*) *Ratable portion.* The ''ratable portion'' of the taxpayer's gross income from an oil or gas well for a taxable year equals the total amount of such gross income multiplied by the fraction obtained by dividing—

(*i*) The disqualified deductions from such oil or gas well for the taxable year; by

(*ii*) The total amount of the deductions that are attributable to such oil or gas well and allocable to the taxable year.

(iii) *Examples.* The following examples illustrate the application of paragraphs (e)(4) (i) and (ii) of this section:

Example 1. (i) A, a calendar year individual, acquires on January 1, 1987, a general partnership interest in P, a calendar year partnership that holds a working interest in an oil or gas property. Pursuant to the partnership agreement, A is entitled to convert the general partnership interest into a limited partnership interest at any time. On December 1, 1987, pursuant to a contract with D, an independent drilling contractor, P commences drilling a single well pursuant to the working interest. Under the drilling contract, P pays D for the drilling only as the work is performed. All drilling costs are deducted by P in the year in which they are paid. At the end of 1987, A converts the general partnership interest into a limited partnership interest, effective immediately. The drilling of the well is completed on February 28, 1988. A's interest in the well would but for this paragraph (e)(4) be an interest in a passive activity.

(ii) Throughout 1987, A holds the working interest through an entity that does not limit A's liability with respect to the drilling of the well pursuant to the working interest. In 1988, however, A holds the working interest through an entity that limits A's liability with respect to the drilling and operation of the well throughout such year. Accordingly, under paragraph (e)(4)(i) of this section, A's interest in P's well is not an interest in a passive activity for 1987 but is an interest in a passive activity for 1988. Moreover, since economic performance occurs in 1987 with respect to all items of deduction for drilling costs that are allocable to 1987, A has no disqualified deductions for 1987.

Example 2. The facts are the same as in Example 1, except that all costs of drilling under the contract with D (including costs of drilling performed after 1987) are paid before the end of 1987 and A has a net loss for 1987. In addition, A has $15,000 of total deductions that are attributable to the well and allocable to 1987, but economic performance (as that term is used in paragraph (e)(4)(ii)(C)(*2*)(*ii*) of this section) does not occur with respect to $5,000 of those deductions until 1988. Under paragraph (e)(4)(ii) of this section, the $5,000 of deductions with respect to which economic performance occurs in 1988 are disqualified deductions and are treated as passive activity deductions for 1987. In addition, one-third ($5,000/$15,000) of A's gross income from the well for 1987 is treated as passive activity gross income.

(iv) *Definition of ''working interest.''* [Reserved]. See §1.469–1(e)(4)(iv) for rules relating to this paragraph.

(v) *Entities that limit liability*—(A) *General rule.* For purposes of paragraph (e)(4)(i)(B) of this section, an entity limits the liability of the taxpayer with respect to the drilling or operation of a well pursuant to a working interest held through such entity if the taxpayer's interest in the entity is in the form of—

(*1*) A limited partnership interest in a partnership in which the taxpayer is not a general partner;

(*2*) Stock in a corporation; or

(*3*) An interest in any entity (other than a limited partnership or corporation) that, under applicable State law, limits the potential liability of a holder of such an interest for all obligations of the entity to a determinable fixed amount (for example, the sum of the taxpayer's capital contributions).

(B) *Other limitations disregarded.* For purposes of this paragraph (e)(4), protection against loss through any of the following is not taken into account in determining whether a taxpayer holds a working interest through an entity that limits the taxpayer's liability:

(*1*) An indemnification agreement;

(*2*) A stop loss arrangement;

(*3*) Insurance;

(*4*) Any similar arrangement; or

(*5*) Any combination of the foregoing.

(C) *Examples.* The following examples illustrate the application of this paragraph (e)(4)(v):

Example 1. A owns a 20 percent interest as a general partner in the capital and profits of P, a partnership which owns oil or gas working interests. The other partners of P agree to indemnify A against liability in excess of A's capital contribution for any of P's costs and expenses with respect to P's working interests. As a general partner, however, A is jointly and severally liable for all of P's liabilities and, under paragraph (e)(4)(v)(B)(*1*) of this section, the indemnification agreement is not taken into account in determining whether A holds the working interests through an entity that limits A's liability. Accordingly, the partnership does not limit A's liability with respect to the drilling or operation of wells pursuant to the working interests.

Example 2. B owns a 10 percent interest in X, an entity (other than a limited partnership or corporation) created under applicable State law to hold working interests in oil or gas properties. Under applicable State law, B is liable without limitation for 10 percent of X's costs and expenses with respect to X's working interests but is not liable for the remaining 90 percent of such costs and expenses. Since B's liability for the obligations of X is not limited to a determinable fixed amount (within the meaning of paragraph (e)(4)(v)(A)(*3*) of this section), the entity does not limit B's liability with respect to the drilling or operation of wells pursuant to the working interests.

Example 3. C is both a general partner and a limited partner in a partnership that owns a working interest in oil or gas property. Because C owns an interest as a general partner in each well drilled pursuant to the working interest, C's entire interest in each well drilled pursuant to the working interest is treated under paragraph (e)(4)(i) of this section as an interest in an activity that is not a passive activity (without regard to whether C materially participates in such activity).

(vi) *Cross reference to special rule for income from certain oil or gas properties.* A special rule relating to the treatment of income from certain interests in oil or gas properties is contained in §1.469–2T(c)(6).

(5) *Rental of dwelling unit.* [Reserved]. See §1.469–2(d)(2)(xii) for rules relating to this paragraph.

(6) *Activity of trading personal property*—(i) *In general.* An activity of trading personal property for the account of owners of interests in the activity is not a passive activity (without regard to whether such activity is a trade or business activity (within the meaning of paragraph (e)(2) of this section)).

(ii) *Personal property.* For purposes of this paragraph (e)(6), the term ''personal property'' means personal property (within the meaning of section 1092(d), without regard to paragraph (3) thereof).

(iii) *Example.* The following example illustrates the application of this paragraph (e)(6):

Example. A partnership is a trader of stocks, bonds, and other securities (within the meaning of section 1236(c)). The capital employed by the partnership in the trading activity consists of amounts contributed by the partners in exchange for their partnership interests, and funds borrowed by the partnership. The partnership derives gross income from the activity in the form of interest, dividends, and capital gains. Under these facts, the partnership is treated as conducting an activity of trading personal property for the account of its partners. Accordingly, under this paragraph (e)(6), the activity is not a passive activity.

(f) *Treatment of disallowed passive activity losses and credits*—(1) *Scope of this paragraph.* The rules in this paragraph (f)—

(i) Identify the passive activity deductions that are disallowed for any taxable year in which all or a portion of the taxpayer's passive activity loss is disallowed under paragraph (a)(1)(i) of this section;

(ii) Identify the credits from passive activities that are disallowed for any taxable year in which all or a portion of the taxpayer's passive activity credit is disallowed under paragraph (a)(1)(i) of this section; and

(iii) Provide for the carryover of disallowed deductions and credits.

(2) *Identification of disallowed passive activity deductions*—(i) *Allocation of disallowed passive activity loss among activities*—(A) *General rule.* If all or any portion of the taxpayer's passive activity loss is disallowed for the taxable year under paragraph (a)(1)(i) of this section, a ratable portion of the loss (if any) from each passive activity of the taxpayer is disallowed. For purposes of the preceding sentence, the ratable portion of a loss from an activity is computed by multiplying the passive activity loss that is disallowed for the taxable year by the fraction obtained by dividing—

(*1*) The loss from the activity for the taxable year; by

(*2*) The sum of the losses for the taxable year from all activities having losses for such year.

(B) *Loss from an activity.* For purposes of this paragraph (f)(2)(i), the term ''loss from an activity'' means—

(*1*) The amount by which the passive activity deductions from the activity for the taxable year (within the meaning of §1.469–2T(d)) exceed the passive activity gross income from the activity for the taxable year (within the meaning of §1.469–2T(c)); reduced by

(*2*) Any part of such amount that is allowed under section 469(i) and the rules to be contained in §1.469–9T (relating to the $25,000 allowance for certain rental real estate activities).

(C) *Significant participation passive activities.* If the taxpayer's passive activity gross income from significant participation passive activities (within the meaning of §1.469–2T(f)(2)(ii)) for the taxable year (determined without regard to §1.469–2T(f)(2) through (4)) exceeds the taxpayer's passive activity deductions from such activities for the taxable year, such activities shall be treated, solely for purposes of applying this paragraph (f)(2)(i) for the taxable year, as a single activity that does not have a loss for such taxable year.

(D) *Examples.* The following examples illustrate the application of this paragraph (f)(2)(i):

Example 1. An individual holds interests in three passive activities, A, B, and C. The gross income and deductions from these activities for the taxable year are as follows:

	A	B	C	Total
Gross income	$7,000	$4,000	$12,000	$23,000
Deductions	(16,000)	(20,000)	(8,000)	(44,000)
Net income (loss)	($9,000)	($16,000)	$4,000	($21,000)

The taxpayer's $21,000 passive activity loss for the taxable year is disallowed under paragraph (a)(1)(i) of this section. Therefore, a ratable portion of the losses from activities A and B is disallowed. The disallowed portion of each loss is determined as follows:

A: $21,000 × $9,000/$25,000	$7,560
B: $21,000 × $16,000/$25,000	$13,440
Total	$21,000

Example 2. An individual holds interests in four passive activities, A, B, C, and D. The results of operations of these activities for the taxable year are as follows:

	A	B	C	D	Total
Gross income	15,000	5,000	10,000	10,000	40,000
Deductions	(5,000)	(10,000)	(20,000)	(8,000)	(43,000)
Net income (loss)	10,000	(5,000)	(10,000)	2,000	(3,000)

Activities A and B are significant participation passive activities (within the meaning of §1.469–2T(f)(2)(ii)). The gross income from these activities for the taxable year ($20,000) exceeds the passive activity deductions from those activities for the taxable year ($15,000) by $5,000 and, under §1.469–2T(f)(2), $5,000 of gross income from those activities is treated as not from a passive activity. Therefore, solely for purposes of applying this paragraph (f)(2)(i) for the taxable year, activities A and B are treated as a single activity that does not have a loss for the taxable year. Under §1.469–2T(b), the taxpayer's passive activity loss for the taxable year is $8,000 ($43,000 of passive activity deductions minus $35,000 of passive activity gross income). The results of treating activities A and B as a single activity that does not have a loss for the taxable year is that none of the $8,000 passive activity loss is allocated under this paragraph (f)(2)(i) to activity B for the taxable year, even though the taxpayer incurred a loss in that activity for the taxable year.

(ii) *Allocation within loss activities*—(A) *In general.* If all or any portion of a taxpayer's loss from an activity is disallowed under paragraph (f)(2)(i) of this section for the taxable year, a ratable portion of each passive activity deduction (other than an excluded deduction (within the meaning of paragraph (f)(2)(ii)(B) of this section)) of the taxpayer from such activity is disallowed. For purposes of the preceding sentence, the ratable portion of a passive activity deduction of a taxpayer is the amount of the disallowed portion of the taxpayer's loss from the activity (within the meaning of paragraph (f)(2)(i)(B) of this section) for the taxable year multiplied by the fraction obtained by dividing—

(*1*) The amount of such deduction; by

(*2*) The sum of all passive activity deductions (other than excluded deductions (within the meaning of paragraph (f)(2)(ii)(B) of this section)) of the taxpayer from such activity from the taxable year.

(B) *Excluded deductions.* The term ''excluded deduction'' means any passive activity deduction of a taxpayer that is taken into account in computing the taxpayer's net income from an item of property for a taxable year in which an amount of the taxpayer's gross income from such item of property is treated as not from a passive activity under §1.469–2T(c)(6) or §1.469–2T(f) (5), (6), or (7).

(iii) *Separately identified deductions.* In identifying the deductions from an activity that are disallowed under this paragraph (f)(2), the taxpayer need not account separately for a deduction unless such deduction may, if separately taken into account, result in an income tax liability for any taxable year different from that which would result were such deduction not taken into account separately. For related rules applicable to partnerships and S corporations, see §1.702–1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Deductions that must be accounted for separately include (but are not limited to) deductions that—

(A) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in taxable years in which the taxpayer actively participates (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in such activity;

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in such activity; or

(C) Are taken into account under section 1211 (relating to the limitation on capital losses) or section 1231 (relating to property used in a trade or business and involuntary conversions).

(3) *Identification of disallowed credits from passive activities*—(i) *General rule.* If all or any portion of the taxpayer's passive activity credit is disallowed for the taxable year under paragraph (a)(1)(ii) of this section, a ratable portion of each credit from each passive activity of the taxpayer is disallowed. For purposes of the preceding sentence, the ratable portion of a credit of a taxpayer is computed by multiplying the portion of the taxpayer's passive activity credit that is disallowed for the taxable year by the fraction obtained by dividing—

(A) The amount of the credit; by

(B) The sum of all of the taxpayer's credits from passive activities for the taxable year.

(ii) *Coordination rule.* For purposes of paragraph (f)(3)(i) of this section, the credits from a passive activity do not include any credit or portion of a credit that—

(A) Is allowed for the taxable year under section 469(i) and the rules to be contained in §1.469–9T (relating to the $25,000 allowance for certain rental real estate activities); or

(B) Increases the basis of property during the taxable year under section 469(j)(9) and the rules to be contained in §1.469–6T (relating to the election to increase the basis of certain property by disallowed credits).

(iii) *Separately identified credits.* In identifying the credits from an activity that are disallowed under this paragraph (f)(3), the taxpayer need not account separately for any credit unless such credit may, if separately taken into account, result in an income tax liability for any taxable year different from that which would result were such credit not taken into account separately. For related rules applicable to partnerships and S corporations, see §1.702–1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Credits that must be accounted for separately include (but are not limited to)—

(A) Credits (other than the low-income housing and rehabilitation investment credits) from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) that arise in a taxable year in which the taxpayer actively participates (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in such activity;

(B) Credits (other than the low-income housing and rehabilitation investment credits) from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) that arise in a taxable year in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in such activity;

(C) Low-income housing and rehabilitation investment credits from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469–9T); and

(D) Any credit that is subject to the limitations of sections 26(a), 28(d)(2), 29(b)(5), or 38(c) in a manner that differs from the manner in which any other credit is subject to such limitations.

(4) *Carryover of disallowed deductions and credits.* [Reserved]. See §1.469–1(f)(4) for rules relating to this paragraph.

(g) *Application of these rules to C corporations*—(1) *In general.* Except as otherwise provided in the rules to be contained in paragraph (k) of this section, section 469 and the regulations thereunder do not apply to any corporation that is not a personal service corporation or a closely held corporation for the taxable year. See paragraphs (g) (4) and (5) of this section for special rules for computing the passive activity loss and passive activity credit, respectively, of a closely held corporation.

(2) *Definitions.* For purposes of section 469 and the regulations thereunder—

(i) The term *personal service corporation* means a C corporation that is a personal service corporation for the taxable year (within the meaning of §1.441–3(c)); and

(ii) The term *closely held corporation* means a C corporation that meets the stock ownership requirements of section 542(a)(2) (taking into account the modifications in section 465(a)(3)) for the taxable year and is not a personal service corporation for such year.

(3) *Participation of corporations*—(i) *Material participation.* For purposes of section 469 and the regulations thereunder, a corporation described in paragraph (g)(2) of this section shall be treated as materially participating in an activity for a taxable year if and only if—

(A) One or more individuals, each of whom is treated under paragraph (g)(3)(iii) of this section as materially participating in such activity for the taxable year, directly or indirectly hold (in the aggregate) more than 50 percent (by value) of the outstanding stock of such corporation; or

(B) In the case of a closely held corporation (within the meaning of paragraph (g)(2)(ii) of this section), the requirements of section 465(c)(7)(C) (without regard to clause (iv) thereof and taking into account section 465(c)(7)(D)) are met with respect to such activity.

(ii) *Significant participation.* For purposes of §1.469–2T(f)(2), an activity of a corporation described in paragraph (g)(2) of this section shall be treated as a significant participation passive activity for a taxable year if and only if—

(A) The corporation is not treated as materially participating in such activity for the taxable year; and

(B) One or more individuals, each of whom is treated under paragraph (g)(3)(iii) of this section as significantly participating in such activity, directly or indirectly hold (in the aggregate) more than 50 percent (by value) of the outstanding stock of such corporation.

(iii) *Participation of individual.* Whether an individual is treated for purposes of this paragraph (g)(3) as materially participating or significantly participating in an activity of a corporation shall be determined under the rules of §1.469–5T, except that in applying such rules—

(A) All activities of the corporation shall be treated as activities in which the individual holds an interest in determining whether the individual participates (within the meaning of §1.469–5T(f)) in an activity of the corporation; and

(B) The individual's participation in all activities other than activities of the corporation shall be disregarded in determining whether the individual's participation in an activity of the corporation is treated as material participation under §1.469–5T(a)(4) (relating to material participation in significant participation activities).

(4) *Modified computation of passive activity loss in the case of closely held corporations*—(i) *In general.* A closely held corporation's passive activity loss for the taxable year is the amount, if any, by which the corporation's passive activity deductions for the taxable year (within the meaning of §1.469–2T(d)) exceed the sum of—

(A) The corporation's passive activity gross income for the taxable year (within the meaning of §1.469–2T(c)); and

(B) The corporation's net active income for the taxable year.

(ii) *Net active income*. For purposes of this paragraph (g)(4), a corporation's net active income for the taxable year is such corporation's taxable income for the taxable year, determined without regard to the following items for the year:

(A) Passive activity gross income;

(B) Passive activity deductions;

(C) [Reserved]. See §1.469–1(g)(4)(ii)(C) for rules relating to this paragraph.

(D) Gross income that is treated under §1.469–2T(c)(6) (relating to gross income from certain oil or gas properties) as not from a passive activity;

(E) Gross income and deductions from any trade or business activity (within the meaning of paragraph (e)(2) of this section) that is described in paragraph (e)(6) of this section (relating to certain activities of trading personal property) but only if the corporation did not materially participate in such activity for the taxable year;

(F) Deductions described in §1.469–2T(d)(2)(i), (ii), and (iv) (relating to certain deductions attributable to portfolio income); and

(G) Interest expense allocated under §1.163–8T to a portfolio expenditure (within the meaning of §1.163–8T(b)(6)).

(iii) *Examples*. The following examples illustrate the application of this paragraph (g)(4):

Example 1. (i) For 1987, X, a closely held corporation, is engaged in two activities, a trade or business activity in which X materially participates for 1987 and a rental activity. X also holds portfolio investments. For 1987, X has the following gross income and deductions:

Gross income:	
Rents	$60,000
Gross income from business	100,000
Portfolio income	35,000
Total	$195,000
Deductions:	
Rental deductions	($100,000)
Business deductions (80,000).	
Interest expense allocable to portfolio expenditures under §1.163–8T	(10,000)
Deductions (other than interest expense) clearly and directly allocable to portfolio income	(5,000)
Total	($195,000)

(ii) The corporation's net active income for 1987 is $20,000, computed as follows:

Gross income		$195,000	
Amounts not taken into account in computing net active income:			
Rents (see paragraph (g)(4)(ii)(A) of this section)	$60,000		
Portfolio income (see paragraph (g)(4)(ii)(C) of this section)	$35,000		
	$95,000	($95,000)	
Gross income taken into account in computing net active income		$100,000	$100,000
Deductions		($195,000)	
Amounts not taken into account in computing net active income:			
Rental deductions (see paragraph (g)(4)(ii)(B) of this section)	($100,000)		
Interest expense allocated to portfolio expenditures (see paragraph (g)(4)(ii)(G) of this section)	($10,000)		
Other deductions clearly and directly allocable to portfolio income (see paragraph (g)(4)(ii)(F) of this section)	($5,000)		
	($115,000)	$115,000	
Deductions taken into account in computing net active income		($80,000)	($80,000)
Net active income			$20,000

(iii) Under paragraph (g)(4)(i) of this section, X's passive activity loss for 1987 is $20,000, the amount by which the passive activity deductions for the taxable year ($100,000) exceed the sum of (a) the passive activity gross income for the taxable year ($60,000) and (b) the net active income for the taxable year ($20,000). Under paragraph (f)(4) of this section, the $20,000 of deductions from X's rental activity that are disallowed for 1987 are treated as deductions from the rental activity for 1988. If computed without regard to the net active income for the taxable year, X's passive activity loss would be $40,000 ($100,000 of rental deductions minus $60,000 of rental income). Thus, the effect of the rule in paragraph (g)(4)(i) of this section is to reduce the corporation's passive activity loss for the taxable year by the amount of the corporation's net active income for such year.

(iv) Under these facts, X's taxable income for 1987 is $20,000, computed as follows:

Gross income		$195,000
Deductions:		
Total deductions	($195,000)	
Passive activity loss	$20,000	
Allowable deductions	($175,000)	($175,000)
Taxable income		$20,000

Example 2. (i) The facts are the same as in Example 1, except that, in 1988, X has a loss from the trade or business activity, and a net operating loss (''NOL'') of $15,000 that is carried back under section 172(b) to 1987. Since NOL carrybacks are taken into account in computing net active income, X's net active income for 1987 must be recomputed as follows:

Net active income before NOL carryback	$20,000
NOL carryback	($15,000)
Net active income	$5,000

(ii) Under these facts, X's disallowed passive activity loss for 1987 is $35,000, the amount by which the passive activity deductions for the taxable year ($100,000) exceed the sum of (a) the passive activity gross income for the taxable year ($60,000) and (b) the net active income for the taxable year ($5,000).

(iii) Under paragraph (f)(4) of this section, the $35,000 of deductions from X's rental activity that are disallowed for 1987 are treated as deductions from the rental activity for 1988. X's taxable income for 1987 is $20,000, computed as follows:

Gross income		$195,000
Deductions:		
Total deductions	($210,000)	
Passive activity loss	$35,000	
Allowable deductions	($175,000)	($175,000)
Taxable income		$20,000

Thus, taking the NOL carryback into account in computing net active income for 1987 does not affect X's taxable income for 1987, but increases the deductions treated under paragraph (f)(4) as deductions from X's rental activity for 1988 and decreases X's NOL carryover to years other than 1987.

(5) *Allowance of passive activity credit of closely held corporations to extent of net active income tax liability*—(i) *In general*. Solely for purposes of determining the amount disallowed under paragraph (a)(1)(ii) of this section, a closely held corporation's passive activity credit for the taxable year shall be reduced by such corporation's net active income tax liability for such year.

(ii) *Net active income tax liability*. For purposes of paragraph (g)(5)(i) of this section, a corporation's net active income tax liability for a taxable year is the amount (if any) by which—

(A) The corporation's regular tax liability (within the meaning of section 26(b)) for the taxable year, determined by reducing the corporation's taxable income for such year by an amount equal to the excess (if any) of the corporation's passive activity gross income for such year over the corporation's passive activity deductions for such year; exceeds

(B) The sum of—

(*1*) The corporation's regular tax liability for the taxable year, determined by reducing the corporation's taxable income for such year by an amount equal to the excess (if any) of the sum of the corporation's net active income (within the meaning of paragraph (g)(4)(ii) of this section) and passive activity gross income for such year over the corporation's passive activity deductions for such year; and

(*2*) The corporation's credits (other than credits from passive activities) that are allowable for the taxable year (without regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469).

(h) *Special rules for affiliated group filing consolidated return*. (1)–(2) [Reserved]

(3) *Disallowance of consolidated group's passive activity loss or credit*. A consolidated group's passive activity loss or passive activity credit for the taxable year shall be disallowed to the extent provided in paragraph (a) of this section. For purposes of the preceding sentence, a consolidated group's passive activity loss and passive activity credit shall be determined by taking into account the following items of each member of such group:

(i) Passive activity gross income;

(ii) Passive activity deductions;

(iii) Net active income (in the case of a consolidated group treated as a closely held corporation under paragraph (h)(4)(ii) of this section); and

(iv) Credits from passive activities.

(4) [Reserved]. See §1.469–1(h)(4) for rules relating to this paragraph.

(5) *Modification of rules for identifying disallowed passive activity deductions and credits*—(i) *Identification of disallowed deductions*. In applying paragraphs (f)(2) and (4) of this section to a consolidated group for purposes of identifying the passive activity deductions of such consolidated group and of each member of such consolidated group that are disallowed for the taxable year and treated as deductions from activities for the succeeding taxable year, the following rules shall apply:

(A) A ratable portion (within the meaning of paragraph (h)(5)(ii) of this section) of the passive activity loss of the consolidated group that is disallowed for the taxable year shall be allocated to each member of the group;

(B) Pararaph (f)(2) of this section shall then be applied to each member of the group as if—

(*1*) Such member were a separate taxpayer; and

(*2*) The amount allocated to such member under paragraph (h)(5)(i)(A) of this section were the amount of such member's passive activity loss that is disallowed for the taxable year; and

(C) Paragraph (f)(4) of this section shall be applied to each member of the group as if it were a separate taxpayer.

(ii) *Ratable portion of disallowed passive activity loss*. For purposes of paragraph (h)(5)(i)(A) of this section, a member's ratable portion of the disallowed passive activity loss of the consolidated group is the amount of such disallowed loss multiplied by the fraction obtained by dividing—

(A) The amount of the passive activity loss of such member of the consolidated group that would be disallowed for the taxable year if the items of gross income and deduction of such member were the only items of the group for such year; by

(B) The sum of the amounts described in paragraph (h)(5)(ii)(A) of this section for all members of the group.

(iii) *Identification of disallowed credits*. In applying paragraph (f)(3) of this section to a consolidated group for purposes of identifying the credits from passive activities of members of such consolidated group that are disallowed for the taxable year, the consolidated group shall be treated as one taxpayer. Thus, a ratable portion of each of the group's credits from passive activities is disallowed.

(6) [Reserved]

(7) *Disposition of stock of a member of an affiliated group*. Any gain recognized by a member on the disposition of stock of a subsidiary (including income resulting from the recognition of an excess loss account under §1.1502–19) shall be treated as portfolio income (within the meaning of §1.469–2T (c)(3)(i)).

(8) *Dispositions of property used in multiple activities*. The determination of whether §1.469–2T(c)(2)(ii) or (iii) or (d)(5)(ii) applies to a disposition (including a deemed disposition described in paragraph (h)(6)(iii)(C)(*1*) of this section) of property by a member of a consolidated group shall be made by treating such member as having held the property for the entire period that the group has owned such property and as having used the property in all of the activities in which the group has used such property

(i) [Reserved]

(j) *Spouses filing joint return*—(1) *In general*. Except as otherwise provided in the regulations under section 469, spouses filing a joint return for a taxable year shall be treated for such year as one taxpayer for purposes of section 469 and the regulations thereunder Thus, for example, spouses filing a joint return are treated as one taxpayer for purposes of—

(i) Section 1.469–2T (relating generally to the computation of such taxpayer's passive activity loss); and

(ii) Paragraph (f) of this section (relating to the allocation of such taxpayer's disallowed passive activity loss and passive activity credit among activities and the identification of disallowed passive activity deductions and credits from passive activities).

(2) *Exceptions to treatment as one taxpayer*—(i) *Identification of disallowed deductions and credits*. For purposes of paragraphs (f)(2)(iii) and (3)(iii) of this section, spouses filing a joint return for the taxable year must account separately for the deductions and credits attributable to the interests of each spouse in any activity.

(ii) *Treatment of deductions disallowed under sections 704(d), 1366(d), and 465.*

Notwithstanding any other provision of this section or §1.469–2T, this paragraph (j) shall not affect the application of section 704(d), section 1366(d), or section 465 to taxpayers filing a joint return for the taxable year.

(iii) *Treatment of losses from working interests.* Paragraph (e)(4) of this section (relating to losses and credits from certain interests in oil and gas wells) shall be applied by treating a husband and wife (whether or not filing a joint return) as separate taxpayers.

(3) *Joint return no longer filed.* If an individual—

(A) Does not file a joint return for the taxable years; and

(B) Filed a joint return for the immediately preceding taxable year;

then the passive activity deductions and credits allocable to such individual's activities for the taxable year under paragraph (f)(4) of this section shall be determined by taking into account the items of deduction and credit attributable to such individual's interests in passive activities for the immediately preceding taxable year. See paragraph (j)(2)(i) of this section.

(4) *Participation of spouses.* Rules treating an individual's participation in an activity as participation of such individual's spouse in such activity (without regard to whether the spouses file a joint return) are contained in §1.469–5T(f)(3).

(k) *Former passive activities and changes in status of corporations.* [Reserved]

[T.D. 8175, 53 FR 5700, Feb. 25, 1988, as amended by T.D. 8253, 54 FR 20535, May 12, 1989; T.D. 8319, 55 FR 49038, Nov. 26, 1990; T.D. 8417, 57 FR 20753, May 15, 1992; 58 FR 29536, May 21, 1993; 58 FR 45059, Aug. 26, 1993; 59 FR 17478, Apr. 13, 1994; T.D. 8560, 59 FR 41674, Aug. 15, 1994; T.D. 8597, 60 FR 36685, July 18, 1995; T.D. 8996, 67 FR 35012, May 17, 2002]

§ 1.469–2 Passive activity loss.

(a)–(c)(2)(ii) [Reserved]

(c)(2)(iii) *Disposition of substantially appreciated property formerly used in nonpassive activity*—(A) *In general.* If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity unless the interest in property was used in a passive activity for either—

(*1*) 20 percent of the period during which the taxpayer held the interest in property; or

(*2*) The entire 24-month period ending on the date of the disposition.

(B) *Date of disposition.* For purposes of this paragraph (c)(2)(iii), a disposition of an interest in property is deemed to occur on the date that the interest in property becomes subject to an oral or written agreement that either requires the owner or gives the owner an option to transfer the interest in property for consideration that is fixed or otherwise determinable on that date.

(C) *Substantially appreciated property.* For purposes of this paragraph (c)(2)(iii), an interest in property is substantially appreciated if the fair market value of the interest in property exceeds 120 percent of the adjusted basis of the interest.

(D) *Investment property.* For purposes of this paragraph (c)(2)(iii), an interest in property is treated as an interest in property used in an activity other than a passive activity and as an interest in property held for investment for any period during which the interest is held through a C corporation or similar entity. An entity is similar to a C corporation for this purpose if the owners of interests in the entity derive only portfolio income (within the meaning of §1.469–2T) from the interests.

(E) *Coordination with §1.469–2T(c)(2)(ii).* If §1.469–2T(c)(2)(ii) applies to the disposition of an interest in property, this paragraph (c)(2)(iii) applies only to that portion of the gain from the disposition of the interest in property that is characterized as gain from a passive activity after the application of §1.469–2T(c)(2)(ii).

(F) *Coordination with section 163(d).* Gain that is treated as not from a passive activity under this paragraph (c)(2)(iii) is treated as income described in section 469(e)(1)(A) and §1.469–2T(c)(3)(i) if and only if the gain is from the disposition of an interest in property that was held for investment for more than 50 percent of the period during which the taxpayer held that interest in property in activities other than passive activities.

(G) *Examples.* The following examples illustrate the application of this paragraph (c)(2)(iii):

Example 1. A acquires a building on January 1, 1993, and uses the building in a trade or business activity in which A materially participates until March 31, 2004. On April 1, 2004, A leases the building to B. On December 31, 2005, A sells the building. At the time of the sale, A's interest in the building is substantially appreciated (within the meaning of paragraph (c)(2)(iii)(C) of this section). Assuming A's lease of the building to B constitutes a rental activity (within the meaning of §1.469–1T(e)(3)), the building is used in a passive activity for 21 months (April 1, 2004, through December 31, 2005). Thus, the building was not used in a passive activity for the entire 24-month period ending on the date of the sale. In addition, the 21-month period during which the building was used in a passive activity is less than 20 percent of A's holding period for the building (13 years). Therefore, the gain from the sale is treated under this paragraph (c)(2)(iii) as not from a passive activity.

Example 2. (i) A, an individual, is a stockholder of corporation X. X is a C corporation until December 31, 1993, and is an S corporation thereafter. X acquires a building on January 1, 1993, and sells the building on March 1, 1994. At the time of the sale, A's interest in the building held through X is substantially appreciated (within the meaning of paragraph (c)(2)(iii)(C) of this section). The building is leased to various tenants at all times during the period in which it is held by X. Assume that the lease of the building would constitute a rental activity (within the meaning of §1.469–1T(e)(3)) with respect to a person that holds the building directly or through an S corporation.

(ii) Paragraph (c)(2)(iii)(D) of this section provides that an interest in property is treated for purposes of this paragraph (c)(2)(iii) as used in an activity other than a passive activity and as held for investment for any period during which the interest is held through a C corporation. Thus, for purposes of determining the character of A's gain from the sale of the building, A's interest in the building is treated as an interest in property held for investment for the period from January 1, 1993, to December 31, 1993, and as an interest in property used in a passive activity for the period from January 1, 1994, to February 28, 1994.

(iii) A's interest in the building was not used in a passive activity for the entire 24-month period ending on the date of the sale. In addition, the 2-month period during which A's interest in the building was used in a passive activity is less than 20 percent of the period during which A held an interest in the building (14 months). Therefore, the gain from the sale is treated under this paragraph (c)(2)(iii) as not from a passive activity.

(iv) Under paragraph (c)(2)(iii)(F) of this section, gain that is treated as nonpassive under this paragraph (c)(2)(iii) is treated as portfolio income (within the meaning of §1.469–2T(c)(3)(i)) if the gain is from the disposition of an interest in property that was held for investment for more than 50 percent of the period during which the taxpayer held the interest in activities other than passive activities. In this case, A's interest in the building was treated as held for investment for the entire period during which it was used in activities other than passive activities (*i.e.*, the 12-month period from January 1, 1993, to December 31, 1993). Accordingly, A's gain from the sale is treated under this paragraph (c)(2)(iii) as portfolio income.

(iv) *Taxable acquisitions.* If a taxpayer acquires an interest in property in a transaction other than a nonrecognition transaction (within the meaning of section 7701(a)(45)), the ownership and use of the interest in property before the transaction is not taken into account for purposes of applying this paragraph (c)(2) to any subsequent disposition of the interest in property by the taxpayer.

(v) *Property held for sale to customers*—(A) *Sale incidental to another activity*—(*1*) *Applicability*—(*i*) *In general.* This paragraph (c)(2)(v)(A) applies to the disposition of a taxpayer's interest in property if and only if—

(*A*) At the time of the disposition, the taxpayer holds the interest in property in an activity that, for purposes of section 1221(1), involves holding the property or similar property primarily for sale to customers in the ordinary course of a trade or business (a dealing activity);

(*B*) One or more other activities of the taxpayer do not involve holding similar property for sale to customers in the ordinary course of a trade or business (nondealing activities) and the interest in property was used in the nondealing activity or activities for more than 80 percent of the period during which the taxpayer held the interest in property; and

(*C*) The interest in property was not acquired and held by the taxpayer for the principal purpose of selling the interest to customers in the ordinary course of a trade or business.

(*ii*) *Principal purpose.* For purposes of this paragraph (c)(2)(v)(A), a taxpayer is rebuttably presumed to have acquired and held an interest in property for the principal purpose of selling the interest to customers in the ordinary course of a trade or business if—

(*A*) The period during which the interest in property was used in nondealing activities of the taxpayer does not exceed the lesser of 24 months or 20 percent of the recovery period (within the meaning of section 168) applicable to the property; or

(*B*) The interest in property was simultaneously offered for sale to customers and used in a nondealing activity of the taxpayer for more than 25 percent of the period during which the interest in property was used in nondealing activities of the taxpayer.

For purposes of the preceding sentence, an interest in property is not considered to be offered for sale to customers solely because a lessee of the property has been granted an option to purchase the property.

(*2*) *Dealing activity not taken into account.* If paragraph (c)(2)(v)(A) applies to the disposition of a taxpayer's interest in property, holding the interest in the dealing activity is treated, for purposes of §1.469–2T(c)(2), as the use of the interest in the last nondealing activity of the taxpayer in which the interest in property was used prior to its disposition.

(B) *Use in a nondealing activity incidental to sale.* If paragraph (c)(2)(v)(A) of this section does not apply to the disposition of a taxpayer's interest in property that is held in a dealing activity of the taxpayer at the time of disposition, the use of the interest in property in a nondealing activity of the taxpayer for any period during which the interest in property is also offered for sale to customers is treated, for purposes of §1.469–2T(c)(2), as the use of the interest in property in the dealing activity of the taxpayer.

(C) *Examples.* The following examples illustrate the application of this paragraph (c)(2)(v):

Example 1. (i) The taxpayer acquires a residential apartment building on January 1, 1993, and uses the building in a rental activity. In January 1996, the taxpayer converts the apartments into condominium units. After the conversion, the taxpayer holds the condominium units for sale to customers in the ordinary course of a trade or business of dealing in condominium units. (Assume that these are dealing operations treated as separate activities under §1.469–4, and that the taxpayer materially participates in the activity.) In addition, the taxpayer continues to use the units in the rental activity until they are sold. The units are first held for sale on January 1, 1996, and the last unit is sold on December 31, 1996.

(ii) This paragraph (c)(2)(v) provides that holding an interest in property in a dealing activity (the marketing of the property) is treated for purposes of §1.469–2T(c)(2) as the use of the interest in a nondealing activity if the marketing of the property is incidental to the nondealing use. Under paragraph (c)(2)(v)(A)(*2*) of this section, the interests in property are treated as used in the last nondealing activity in which they were used prior to their disposition. In addition, paragraph (c)(2)(v)(A)(*1*) of this section provides rules for determining whether the marketing of the property is incidental to the use of an interest in property in a nondealing activity. Under these rules, the marketing of the property is treated as incidental to the use in a nondealing activity if the interest in property was used in nondealing activities for more than 80 percent of the taxpayer's holding period in the property (the holding period requirement) and the taxpayer did not acquire and hold the interest in property for the principal purpose of selling it to customers in the ordinary course of a trade or business (a dealing purpose).

(iii) In this case, the apartments were used in a rental activity for the entire period during which they were held by the taxpayer. Thus, the apartments were used in a nondealing activity for more than 80 percent of the taxpayer's holding period in the property, and the marketing of the property satisfies the holding period requirement.

(iv) Paragraph (c)(2)(v)(A)(*1*)(*ii*) of this section provides that a taxpayer is rebuttably presumed to have a dealing purpose unless the interest in property was used in nondealing activities for more than 24 months or 20 percent of the property's recovery period (whichever is less). The same presumption applies if the interest in property was offered for sale to customers during more than 25 percent of the period in which the interest was held in nondealing activities. In this case, the taxpayer used each apartment in a nondealing activity (the rental activity) for a period of 36 to 48 months (*i.e.,* from January 1, 1993, to the date of sale in the period from January through December 1996). Thus, the apartments were used in nondealing activities for more than 24 months, and the first of the rebuttable presumptions described above does not apply. In addition, the apartments were offered for sale to customers for up to 12 months (depending on the month in which the apartment was sold) during the period in which the apartments were used in a nondealing activity. The percentage obtained by dividing the period during which an apartment was held for sale to customers by the period during which the apartment was used in nondealing activities ranges from zero in the case of apartments sold on January 1, 1996, to 25 percent (*i.e.*, 12 months/48 months) in the case of apartments sold on December 31, 1996. Thus, no apartment was offered for sale to customers during more than 25 percent of the period in which it was used in nondealing activities, and the second rebuttable presumption does not apply.

(v) Because neither of the rebuttable presumptions in paragraph (c)(2)(v)(A)(*1*)(*ii*) of this section applies in this case, the taxpayer will not be treated as having a dealing purpose unless other facts and circumstances establish that the taxpayer acquired and held the apartments for the principal purpose of selling the apartments to customers in the ordinary course of a trade or business. Assume that none of the facts and circumstances suggest that the taxpayer had such a purpose. If that is the case, the taxpayer does not have a dealing purpose.

(vi) The marketing of the property satisfies the holding period requirement, and the taxpayer does not have a dealing purpose. Thus, holding the apartments in the taxpayer's dealing activity is treated for purposes of this paragraph (c)(2) as the use of the apartments in a nondealing activity. In this case, the rental activity is the only nondealing activity in which the apartments were used prior to their disposition. Thus, the apartments are treated under paragraph (c)(2)(v)(A)(*2*) of this section as interests in property that were used only in the rental activity for the entire period during which the taxpayer held the interests. Accordingly, the rules in §1.469–2T(c)(2)(ii) and paragraph (c)(2)(iii) of this section do not apply, and all gain from the sale of the apartments is treated as passive activity gross income.

Example 2. (i) The taxpayer acquires a residential apartment building on January 1, 1993, and uses the building in a rental activity. The taxpayer converts the apartments into condominium units on July 1, 1993. After the conversion, the taxpayer holds the condominium units for sale to customers in the ordinary course of a trade or business of dealing in condominium units. (Assume that these are dealing operations treated as separate activities under §1.469–4, and that the taxpayer materially participates in the activities.) In addition, the taxpayer continues to use the units in the rental activity until they are sold. The first unit is sold on January 1, 1994, and the last unit is sold on December 31, 1996.

(ii) In this case, all of the apartments were simultaneously offered for sale to customers and used in a nondealing activity of the taxpayer for more than 25 percent of the period during which the apartments were used in nondealing activities. Thus, the taxpayer is rebuttably presumed to have acquired the apartments (including apartments that are used in the rental activity for at least 24 months) for the principal purpose of selling them to customers in the ordinary course of a trade or business. Assume that the facts and circumstances do not rebut this presumption. If that is the case, the taxpayer has a dealing purpose, and paragraph (c)(2)(v)(A) of this section does not apply to the disposition of the apartments.

(iii) Paragraph (c)(2)(v)(B) of this section provides that if paragraph (c)(2)(v)(A) of this section does not apply to the disposition of a taxpayer's interest in property that is held in a dealing activity of the taxpayer at the time of the disposition, the use of the interest in property in any nondealing activity of the taxpayer for any period during which the interest is also offered for sale to customers is treated as incidental to the use of the interest in the dealing activity. Accordingly, for purposes of applying the rules of §1.469–2T(c)(2) to the disposition of the apartments, the rental of the apartments after July 1, 1993, is treated as the use of the apartments in the taxpayer's dealing activity.

Example 3. (i) The taxpayer acquires a residential apartment building on January 1, 1993, and uses the building in a rental activity. In January 1996, the taxpayer converts the apartments into condominium units. After the conversion, the taxpayer holds the condominium units for sale to customers in the ordinary course of a trade or business of dealing in condominium units. (Assume that these are dealing operations treated as separate activities under §1.469–4, and that the taxpayer materially participates in the activities.) In addition, the taxpayer continues to use the units in the rental activity until they are sold. The units are first held for sale on January 1, 1996, and the last unit is sold in 1997.

(ii) The treatment of apartments sold in 1996 is the same as in Example 1. The apartments sold in 1997, however, were simultaneously offered for sale to customers and used in a nondealing activity for more than 25 percent of the period during which the apartments were used in nondealing activities. (For example, an apartment that is sold on January 31, 1997, has been offered for sale for 13 months or 26.1 percent of the 49-month period during which it was used in nondealing activities.) Thus, the taxpayer is rebuttably presumed to have acquired the apartments sold in 1997 for the principal purpose of selling them to customers in the ordinary course of a trade of business. Assume that the facts and circumstances do not rebut this presumption. In that case, the marketing of the apartments sold in 1997 does not satisfy the principal purpose requirement, and paragraph (c)(2)(v)(A) of this section does not apply to the disposition of those apartments. Accordingly, for purposes of applying the rules of §1.469–2T(c)(2) to the disposition of the apartments sold in 1997, the rental of the apartments after January 1, 1996, is treated, under paragraph (c)(2)(v)(B) of this section, as the use of the apartments in the taxpayer's dealing activity.

(c)(3)–(c)(5) [Reserved]

(c)(6) *Gross income from certain oil or gas properties*—(i) *In general.* Notwithstanding any other provision of the regulations under section 469, passive activity gross income for any taxable year does not include an amount of the taxpayer's gross passive income for the year from a property described in this paragraph (c)(6)(i) equal to the taxpayer's net passive income from the property for the year. Property is described in this paragraph (c)(6)(i) if the property is—

(A) An oil or gas property that includes an oil or gas well if, for any prior taxable year beginning after December 31, 1986, any of the taxpayer's loss from the well was treated, solely by reason of §1.469–1T(e)(4) (relating to a special rule for losses from oil and gas working interests), and not by reason of the taxpayer's material participation in the activity, as a loss that is not from a passive activity; or

(B) Any property the basis of which is determined in whole or in part by reference to the basis of property described in paragraph (c)(6)(i)(A) of this section.

(ii) *Gross and net passive income from the property.* For purposes of this paragraph (c)(6)—

(A) The taxpayer's gross passive income for any taxable year from any property described in paragraph (c)(6)(i) of this section is any passive activity gross income for the year (determined without regard to this paragraph (c)(6) and §1.469–2T(f)) from the property;

(B) The taxpayer's net passive income for any taxable year from any property described in paragraph (c)(6)(i) of this section is the excess, if any, of—

(*1*) The taxpayer's gross passive income for the taxable year from the property; over

(*2*) Any passive activity deductions for the taxable year (including any deduction treated as a deduction for the year under §1.469–1T(f)(4)) that are reasonably allocable to the income; and

(C) if any oil or gas well or other item of property (the item) is included in two or more properties described in paragraph (c)(6)(i) of this section (the properties), the taxpayer must allocate the passive activity gross income (determined without regard to this paragraph (c)(6) and §1.469–2T(f) from the item and the passive activity deductions reasonably allocable to the item among the properties.

(iii) *Property.* For purposes of paragraph (c)(6)(i)(A) of this section, the term ''property'' does not have the meaning given the term by section 614(a) or the regulations thereunder, and an oil or gas property that includes an oil or gas well is—

(A) The well; and

(B) Any other item of property (including any oil or gas well) the value of which is directly enhanced by any drilling, logging, seismic testing, or other activities the costs of which were taken into account in determining the amount of the taxpayer's income or loss from the well.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(6):

Example 1. A is a general partner in partnership P and a limited partner in partnership R. P and R own oil and gas working interests in two separate tracts of land acquired from two separate landowners. In 1993, P drills a well on its tract, and A's distributive share of P's losses from drilling the well are treated under §1.469–1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, P develops information indicating that the reservior in which the well was drilled underlies R's tract as well as P's. Under these facts, P's and R's tracts are treated as one property for purposes of this paragraph (c)(6), even if A's interests in the mineral deposits in the tracts are treated as separate properties under section 614(a). Accordingly, in 1994 and subsequent years, A's distributive share of both P's and R's income and expenses from their respective tracts is taken into account in computing A's net passive income from the property for purposes of this paragraph (c)(6).

Example 2. B is a general partner in partnership S. S owns an oil and gas working interest in a single tract of land. In 1993, S drills a well, and B's distributive share of S's losses from drilling the well is treated under §1.469–1T(e)(4) as not from a passive activity.

In the course of drilling the well, S discovers two oil-bearing formations, one underlying the other. On December 1, 1993, S completes the well in the underlying formation. On January 1, 1994, B converts B's entire general partnership interest in S into a limited partnership interest. In 1994, S completes in, and commences production from, the shallow formation. Under these facts, the two mineral deposits in S's tract are treated as one property for purposes of this paragraph (c)(6), even if they are treated as separate properties under section 614(a). Accordingly, B's distributive share of S's income and expenses from both the underlying formation and from recompletion in and production from the shallow formation is taken into account in computing B's net passive income from the property for purposes of this paragraph (c)(6).

(c)(6)(iv) *Example 3*—(c)(7)(iii) [Reserved]

(c)(7)(iv) Gross income of an individual from a covenant by such individual not to compete;

(v) Gross income that is treated as not from a passive activity under any provision of the regulations under section 469, including but not limited to §1.469–1T(h)(6) (relating to income from intercompany transactions of members of an affiliated group of corporations filing a consolidated return) and §1.469–2T(f) and paragraph (f) of this section (relating to recharacterized passive income);

(vi) Gross income attributable to the reimbursement of a loss from fire, storm, shipwreck, or other casualty, or from theft (as such terms are used in section 165(c)(3)) if—

(A) The reimbursement is included in gross income under §1.165–1(d)(2)(iii) (relating to reimbursements of losses that the taxpayer deducted in a prior taxable year); and

(B) The deduction for the loss was not a passive activity deduction; and

(c)(7)(vii) Gross income or gain allocable to business or rental use of a dwelling unit for any taxable year in which section 280A(c)(5) applies to such business or rental use.

(d)(1)–(d)(2)(viii) [Reserved]

(ix) An item of loss or deduction that is carried to the taxable year under section 172(a), section 613A(d), section 1212(a)(1) (in the case of corporations), or section 1212(b) (in the case of taxpayers other than corporations);

(x) An item of loss or deduction that would have been allowed for a taxable year beginning before January 1, 1987, but for section 704(d), 1366, or 465;

(xi) A deduction for a loss from fire, storm, shipwreck, or other casualty, or from theft (as such terms are used in section 165(c)(3)) if losses that are similar in cause and severity do not recur regularly in the conduct of the activity; and

(xii) A deduction or loss allocable to business or rental use of a dwelling unit for any taxable year in which section 280A(c)(5) applies to such business or rental use.

(d)(3)–(d)(5)(ii) [Reserved]

(d)(5)(iii) *Other applicable rules*—(A) *Applicability of rules in §1.469–2T(c)(2).* For purposes of this paragraph (d)(5), a taxpayer's interests in property used in an activity and the amounts allocated to the interests shall be determined under §1.469–2T(c)(2)(i)(C). In addition, the rules contained in paragraph (c)(2)(iv) and (v) of this section apply in determining for purposes of this paragraph (d)(5) the activity (or activities) in which an interest in property is used at the time of its disposition and during the 12-month period ending on the date of its disposition.

(d)(5)(iii)(B)–(d)(6)(v)(D) [Reserved]

(d)(6)(v)(E) Are taken into account under section 613A(d) (relating to limitations on certain depletion deductions), section 1211 (relating to the limitation on capital losses), or section 1231 (relating to property used in a trade or business and involuntary conversions); or

(d)(6)(v)(F)–(d)(7) [Reserved]

(d)(8) *Taxable year in which item arises.* For purposes of §1.469–2T(d), an item of deduction arises in the taxable year in which the item would be allowable as a deduction under the taxpayer's method of accounting if taxable income for all taxable years were determined without regard to sections 469, 613A(d) and 1211.

(e)(1)–(e)(2)(i) [Reserved]

(e)(2)(ii) *Section 707(c).* Except as provided in paragraph (e)(2)(iii)(B) of this section, any payment to a partner for services or the use of capital that is described in section 707(c), including any payment described in section 736(a)(2) (relating to guaranteed payments made in liquidation of the interest of a retiring or deceased partner), is characterized as a payment for services or as the payment of interest, respectively, and not as a distributive share of partnership income.

(iii) *Payments in liquidation of a partner's interest in partnership property*—(A) *In general.* If any gain or loss is taken into account by a retiring partner (or any other person that owns (directly or indirectly) an interest in the partner if the partner is a passthrough entity) or a deceased partner's successor in interest as a result of a payment to which section 736(b) (relating to payments made in exchange for a retired or deceased partner's interest in partnership property) applies, the gain or loss is treated as passive activity gross income or a passive activity deduction only to the extent that the gain or loss would have been passive activity gross income or a passive activity deduction of the retiring or deceased partner (or the other person) if it had been recognized at the time the liquidation of the partner's interest commenced.

(B) *Payments in liquidation of a partner's interest in unrealized receivables and goodwill under section 736(a).* (*1*) If a payment is made in liquidation of a retiring or deceased partner's interest, the payment is described in section 736(a), and any income—

(*i*) Is taken into account by the retiring partner (or any other person that owns (directly or indirectly) an interest in the partner if the partner is a passthrough entity) or the deceased partner's successor in interest as a result of the payment; and

(*ii*) Is attributable to the portion (if any) of the payment that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of the partnership;

the percentage of the income that is treated as passive activity gross income shall not exceed the percentage of passive activity gross income that would be included in the gross income that the retiring or deceased partner (or the other person) would have recognized if the unrealized receivables and goodwill had been sold at the time that the liquidation of the partner's interest commenced.

(*2*) For purposes of this paragarph (e)(2)(iii)(B), the portion (if any) of a payment under section 736(a) that is allocable to unrealized receivables and goodwill of a partnership shall be determined in accordance with the principles employed under §1.736–1(b) for determining the portion of a payment made under section 736 that is treated as a distribution under section 736(b).

(e)(3)(i)–(iii)(A) [Reserved]

(B) An amount of gain that would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) of this section (relating to substantially appreciated property formerly used in a nonpassive activity), paragraph (c)(6) of this section (relating to certain oil or gas properties), §1.469–2T(f)(5) (relating to certain property rented incidental to development), paragraph (f)(6) of this section (relating to property rented to a nonpassive activity), or §1.469–2T(f)(7) (relating to certain interests in a passthrough entity engaged in the trade or business of licensing intangible property) would have been allocated to the holder (or such other person) with respect to the interest if all of the property used in the passive activity had been sold immediately prior to the disposition for its fair market value on the applicable valuation date (within the meaning of §1.469–2T(e)(3)(ii)(D)(*1*)); and

(e)(3)(iii)(C)–(f)(4) [Reserved]

(f)(5) *Net income from certain property rented incidental to development activity*—(i) *In general.* An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from the item of property shall be treated as not from a passive activity if—

(A) Any gain from the sale, exchange, or other disposition of the item of property is included in the taxpayer's income for the taxable year;

(B) The taxpayer's use of the item of property in an activity involving the rental of the property commenced less than 12 months before the date of the disposition (within the meaning of paragraph (c)(2)(iii)(B) of this section) of such property; and

(C) The taxpayer materially participated (within the meaning of §1.469–5T) or significantly participated (within the meaning of §1.469–5T(c)(2)) for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the value of such item of property (or any other item of property if the basis of the item of property that is sold, exchanged, or otherwise disposed of is determined in whole or in part by reference to the basis of such other item of property).

(ii) *Commencement of use*—(A) *In general.* For purposes of paragraph (f)(5)(i)(B) of this section, a taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which—

(*1*) The taxpayer owns an interest in the property;

(*2*) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and

(*3*) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) *Value-enhancing services.* For purposes of this paragraph (f)(5)(ii), the term value-enhancing services means the services described in paragraphs (f)(5) (i)(C) and (iii) of this section, except that the term does not include lease-up. Thus, in cases in which this paragraph (f)(5) applies solely because substantial lease-up remains to be performed (see paragraph (f)(5)(iii)(C) of this section), the twelve month period described in paragraph (f)(5)(i)(B) of this section will begin when the taxpayer acquires an interest in the property if substantially all of the property is held out for rent and is in a state of readiness for rental on that date.

(iii) *Services performed for the purpose of enhancing the value of property.* For purposes of paragraph (f)(5)(i)(C) of this section, services that are treated as performed for the purpose of enhancing the value of an item of property include but are not limited to—

(A) Construction;

(B) Renovation; and

(C) Lease-up (unless more than 50 percent of the property is leased on the date that the taxpayer acquires an interest in the property).

(iv) *Examples.* The following examples illustrate the application of this paragraph (f)(5):

Example 1. (i) A, a calendar year individual, is a partner in P, a calendar year partnership, which develops real estate. In 1993, P acquires an interest in undeveloped land and arranges for the financing and construction of an office building on the land. Construction is completed in February 1995, and substantially all of the building is either rented or held out for rent and in a state of readiness for rental beginning on March 1, 1995. Twenty percent of the building is leased as of March 1, 1995.

(ii) P rents the building (or holds it out for rent) for the remainder of 1995 and all of 1996, and sells the building on February 1, 1997, pursuant to a contract entered into on January 15, 1996. P did not hold the building (or any other buildings) for sale to customers in the ordinary course of P's trade or business (see paragraph (c)(2)(v) of this section). A's distributive share of P's taxable losses from the rental of the building is $50,000 for 1995 and $30,000 for 1996. All of A's losses from the rental of the building are disallowed under 1.469–1(a)(1)(i) (relating to the disallowance of the passive activity loss for the taxable year). A's distributive share of P's gain from the sale of the building is $150,000. A has no other gross income or deductions from the activity of renting the building.

(iii) The real estate development activity that A holds through P in 1993, 1994, and 1995 involves the performance of services (e.g., construction) for the purpose of enhancing the value of the building. Accordingly, an amount equal to A's net rental activity income from the building may be treated as gross income that is not from a passive activity if A's use of the building in an activity involving the rental of the building commenced less that 12 months before the date of the disposition of the building. In this case, the date of the disposition of the building is January 15, 1996, the date of the binding contract for its sale.

(iv)(A) A taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which—

(*1*) The taxpayer owns an interest in the item of property;

(*2*) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and

(*3*) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) In this case, A's use of the building in an activity involving the rental of the building commenced on March 1, 1995, less than 12 months before January 15, 1996, the date of disposition. Accordingly, if A materially (or significantly) participated in the real estate development activity in 1993, 1994, or 1995 (without regard to whether A materially participated in the activity in more than one of those years), an amount of A's gross rental activity income from the building for 1997 equal to A's net rental activity income from the building for 1997 is treated under this paragraph (f)(5) as gross income that is not from a passive activity. Under paragraph (f)(9)(iv) of this section, A's net rental activity income from the building for 1997 is $70,000 ($150,000 distributive share of gain from the disposition of the building minus $80,000 of reasonably allocable passive activity deductions).

Example 2. (i) X, a calendar year taxpayer subject to section 469, acquires a building on February 1, 1994, when the building is 25 percent leased. During 1994, X rents the building (or holds it out for rent) and materially participates in an activity that involves the lease-up of the building. X's activities do not otherwise involve the performance of construction or other services for the purpose of enhancing the value of the building, and X does not hold the building (or any other building) for sale to customers in the ordinary course of X's trade or business. X sells the building on December 1, 1994.

(ii)(A) Under paragraph (f)(5)(iii)(C) of this section, lease-up is considered a service performed for the purpose of enhancing the value of property unless more than 50 percent of the property is leased on the date the taxpayer acquires an interest in the property. Under paragraph (f)(5)(ii)(B) of this section, however, lease-up is not considered a value-enhancing service for purposes of determining when the taxpayer commences using an item of property in an activity involving the rental of the property. Accordingly, X's acquisition of the building constitutes a commencement of X's use of the building in a rental activity, because February 1, 1994, is the first date on which—

(*1*) The taxpayer owns an interest in the item of property;

(*2*) Substantially all of the property is held out for rent; and

(*3*) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) In this case, X disposes of the property within 12 months of the date X commenced using the building in a rental activity. Accordingly, an amount of X's gross rental activity income for 1994 equal to X's net rental activity income from the building for 1994 is treated under this paragraph (f)(5) as gain that is not from a passive activity.

Example 3. The facts are the same as in Example 2, except that at the time X acquires the building it is 60 percent leased. Under paragraph (f)(5)(iii)(C) of this section, lease-up is not considered a service performed for the purpose of enhancing the value of property if more than 50 percent of the property is leased on the date the taxpayer acquires an interest in the property. Therefore, additional lease-up performed by X is not taken into account under this paragraph (f)(5). Since X's activities do not otherwise involve the performance of services for the purpose of enhancing the value of the building, none of X's gross rental activity income from the building will be treated as income that is not from a passive activity under this paragraph (f)(5).

(f)(6) *Property rented to a nonpassive activity.* An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property—

(i) Is rented for use in a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer materially participates (within the meaning of §1.469–5T) for the taxable year; and

(ii) Is not described in §1.469–2T(f)(5).

(f)(7)–(f)(9)(ii) [Reserved]

(f)(9)(iii) The gross rental activity income for a taxable year from an item of property is any passive activity gross income (determined without regard to §1.469–2T(f)(2) through (f)(6)) that—

(A) Is income for the year from the rental or disposition of such item of property; and

(B) In the case of income from the disposition of such item of property, is income from an activity that involved the rental of such item of property during the 12-month period ending on the date of the disposition (see §1.469–2T(c)(2)(ii)); and

(iv) The net rental activity income from an item of property for the taxable year is the excess, if any, of—

(A) The gross rental activity income from the item of property for the taxable year; over

(B) Any passive activity deductions for the taxable year (including any deduction treated as a deduction for the year under §1.469–1(f)(4)) that are reasonably allocable to the income.

(10) *Coordination with section 163(d).* Gross income that is treated as not from a passive activity under §1.469–2T(f)(3), (4), or (7) is treated as income described in section 469(e)(1)(A) and

§ 1.469–2T(c)(3)(i) except in determining whether—

(i) Any property is treated for purposes of section 469(e)(1)(A)(ii)(I) and § 1.469–2T(c)(3)(i)(C) as property that produces income of a type described in § 1.469–2T(c)(3)(i)(A);

(ii) Any property is treated for purposes of section 469(e)(1)(A)(ii)(II) and § 1.469–2T(c)(3)(i)(D) as property held for investment;

(iii) An expense (other than interest expense) is treated for purposes of section 469(e)(1)(A)(i)(II) and § 1.469–2T(d)(4) as clearly and directly allocable to portfolio income (within the meaning of § 1.469–2T(c)(3)(i); and

(iv) Interest expense is allocated under § 1.163–8T to an investment expenditure (within the meaning of § 1.163–8T(b)(3)) or to a passive activity expenditure (within the meaning of § 1.163–8T(b)(4)).

(11) [Reserved]

[T.D. 8417, 57 FR 20754, May 15, 1992, as amended by T.D. 8477, 58 FR 11538, Feb. 26, 1993; 58 FR 13706, Mar. 15, 1993; 58 FR 29536, May 21, 1993; T.D. 8495, 58 FR 58787, Nov. 4, 1993; T.D. 8417, 59 FR 45623, Sept. 2, 1994]

§ 1.469–2T Passive activity loss (temporary).

(a) *Scope of this section.* This section contains rules for determining the amount of the taxpayer's passive activity loss for the taxable year for purposes of section 469 and the regulations thereunder. The rules contained in this section—

(1) Provide general guidance for identifying items of income and deduction that are taken into account in determining the amount of the passive activity loss for the taxable year;

(2) Specify particular items of income and deduction that are not taken into account in determining the amount of the passive activity loss for the taxable year; and

(3) Specify the manner in which provisions of the Internal Revenue Code and the regulations, other than section 469 and the regulations thereunder, are applied for purposes of determining the extent to which items of deduction are taken into account for a taxable year in computing the amount of the passive activity loss for such year.

(b) *Definition of passive activity loss*—(1) *In general.* In the case of a taxpayer other than a closely held corporation (within the meaning of § 1.469–1T(g)(2)(ii)), the passive activity loss for the taxable year is the amount, if any, by which the passive activity deductions for the taxable year exceed the passive activity gross income for the taxable year.

(2) *Cross references.* See paragraph (c) of this section for the definition of ''passive activity gross income,'' paragraph (d) of this section for the definition of ''passive activity deduction,'' and § 1.469–1T(g)(4) for the computation of the passive activity loss of a closely held corporation.

(c) *Passive activity gross income*—(1) *In general.* Except as otherwise provided in the regulations under section 469, passive activity gross income for a taxable year includes an item of gross income if and only if such income is from a passive activity.

(2) *Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity*—(i) *In general*—(A) *Treatment of gain.* Except as otherwise provided in the regulations under section 469, any gain recognized upon the sale, exchange or other disposition (a ''disposition'') of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation is treated in the following manner:

(*1*) The gain is treated as gross income from such activity for the taxable year or years in which it is recognized;

(*2*) If the activity is a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as passive activity gross income for the taxable year or years in which it is recognized; and

(*3*) If the activity is not a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as not from a passive activity.

(B) *Dispositions of partnership interests and S corporation stock.* A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (c)(2). See paragraph (e)(3) of this section for rules treating the gain recognized upon the disposition of a partnership interest or S corporation stock as gain from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(C) *Interest in property.* For purposes of applying this paragraph (c)(2) to a disposition of property—

(*1*) Any material portion of the property that was used, at any time before the disposition, in any activity at a time when the remainder of the property was not used in such activity shall be treated as a separate interest in property; and

(*2*) The amount realized from the disposition and the adjusted basis of the property must be allocated among the separate interests in a reasonable manner.

(D) *Examples.* The following examples illustrate the application of this paragraph (c)(2)(i):

Example 1. A owns an interest in a trade or business activity in which A has never materially participated. In 1987, A sells equipment that was used exclusively in the activity and realizes a gain on the sale. Under paragraph (c)(2)(i)(A)(*2*) of this section, the gain is passive activity gross income.

Example 2. B owns an interest in a trade or business activity in which B materially participates for 1987. In 1987, B sells a building used in the activity in an installment sale and realizes a gain on the sale. B does not materially participate in the activity for 1988 or any subsequent year. Under paragraph (c)(2)(i)(A)(*3*) of this section, none of B's gain from the sale (including gain taken into account after 1987) is passive activity gross income.

Example 3. C enters into a contract to acquire property used by the seller in a rental activity. Before acquiring the property pursuant to the contract, C sells all rights under the contract and realizes a gain on the sale. Since C's rights under the contract are not property used in a rental activity, the gain is not income from a rental activity. The result would be the same if C owned an option to acquire the property and sold the option.

Example 4. D sells a ten-floor office building. D owned the building for three years preceding the sale and at all times during that period used seven floors of the building in a trade or business activity and three floors in a rental activity. The fair market value per square foot is substantially the same throughout the building, and D did not maintain a separate adjusted basis for any part of the building. Under paragraph (c)(2)(i)(C)(*1*) of this section, the seven floors used in the trade or business activity and the three floors used in the rental activity are treated as separate interests in property. Under paragraph (c)(2)(i)(C)(*2*) of this section, the amount realized and the adjusted basis of the building must be allocated between the separate interests in a reasonable manner. Under these facts, an allocation based on the square footage of the parts of the building used in each activity would be reasonable.

Example 5. The facts are the same as in Example 4, except that two of the seven floors used in the trade or business activity were used in the rental activity until five months before the sale. Under paragraph (c)(2)(i)(C)(*1*) of this section, the five floors used exclusively in the trade or business activity and the two floors used first in the rental activity and then in the trade or business activity are treated as separate interests in property. See paragraph (c)(2)(ii) of this section for rules for allocating amount realized and adjusted basis upon a disposition of an interest in property used in more than one activity during the 12-month period ending on the date of the disposition.

(ii) *Disposition of property used in more than one activity in 12-month period preceding disposition.* In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities on a basis that reasonably reflects the use of such interest in property during such 12-month period. For purposes of this paragraph (c)(2)(ii), an allocation of the amount realized and adjusted basis solely to the activity in which an iterest in property is predominantly used during the 12-month period ending on the date of the disposition reasonably reflects the use of such interest in property if the fair market value of such interest does not exceed the lesser of—

(A) $10,000; and

(B) 10 percent of the sum of the fair market value of such interest and the fair market value of all other property used in such activity immediately before the disposition.

The following examples illustrate the application of this paragraph (c)(2)(ii):

Example 1. The facts are the same as in Example 5 of paragraph (c)(2)(i)(D) of this section. Under paragraph (c)(2)(i)(C)(*2*) of this section, D allocates the amount realized and adjusted basis of the building 30 percent to the three floors used exclusively in the rental activity, 50 percent to the five floors used exclusively in the trade or business activity, and 20 percent to the two floors used first in the rental activity and then in the trade or business activity. Under this paragraph (c)(2)(ii), the amount realized and adjusted basis allocated to the two floors that were used in both activities during the 12-month period ending on the date of the disposition must also be allocated between such activities. Under these facts, an allocation of 7/12 of such amounts to the rental activity and 5/12 of such amounts to the trade or business activity would reasonably reflect the use of the two floors during the 12-month period ending on the date of the disposition.

Example 2. B is a limited partner in a partnership that sells a tractor-trailer. During the 12-month period ending on the date of the sale, the tractor-trailer was used in several activities, and the partnership allocates the amount realized from the disposition and the adjusted basis of the tractor-trailer among the activities based on the number of days during the 12-month period that the partnership used the tractor-trailer in each activity. Under these facts, the partnership's allocation reasonably reflects the use of the tractor-trailer during the 12-month period ending on the date of the sale.

Example 3. C sells a personal computer for $8,000. During the 12-month period ending on the date of the sale, 70 percent of C's use of the computer was in a passive activity. Immediately before the sale, the fair market value of all property used in the passive activity (including the personal computer) was $200,000. Under these facts, the computer was predominatly used in the passive activity during the 12-month period ending on the date of the sale, and the value of the computer, as measured by its sale price ($8,000), does not exceed the lesser of (a) $10,000, and (b) 10 percent of the value of all property used in the activity immediately before the sale ($20,000). C allocates the amount realized and the adjusted basis solely to the passive activity. Under this paragraph (c)(2)(ii), C's allocation reasonably reflects the use of the computer during the 12-month period ending on the date of the sale.

(iii) *Disposition of substantially appreciated property formerly used in nonpassive activity.* [Reserved]. See § 1.469–4(c)(2)(iii) for rules relating to this paragraph.

(iv) *Taxable acquisitions.* [Reserved]. See § 1.469–2(c)(iv) for rules relating to this paragraph.

(v) *Property held for sale to customers.* [Reserved]. See § 1.469–2(c)(v) for rules relating to this paragraph.

(3) *Items of portfolio income specifically excluded*—(i) *In general.* Passive activity gross income does not include portfolio income. For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to—

(A) Interest (including amounts treated as interest under paragraph (e)(2)(ii) of this section, relating to certain payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of section 856), regulated investment company (within the meaning of section 851), real estate mortgage investment conduit (within the meaning of section 860D), common trust fund (within the meaning of section 584), controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)), or cooperative (within the meaning of section 1381(a));

(B) Dividends on S corporation stock (within the meaning of section 1368(c)(2);

(C) The disposition of property that produces income of a type described in paragraph (c)(3)(i)(A) of this section; and

(D) The disposition of property held for investment (within the meaning of section 163 (d)).

(ii) *Gross income derived in the ordinary course of a trade or business.* Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only—

(A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

(B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

(C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

(D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);

(F) Amount included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

(iii) *Special rules*—(A) *Income from property held for investment by dealer.* For purposes of paragraph (c)(3)(i) of this section, a dealer's income or gain from an item of property is not dervied by the dealer in the ordinary course of a trade or business of dealing in such property if the dealer held the property for investment at any time before such income or gain is recognized.

(B) *Royalties derived in the ordinary course of the trade or business of licensing intangible property*—(*1*) *In general.* Royalties received by any person with respect to a license or other transfer of any rights in intangible property shall be considered to be derived in the ordinary course of the trade or business of licensing such property only if such person—

(*i*) Created such property; or

(*ii*) Performed substantial services or incurred substantial costs with respect to the development or marketing of such property.

(*2*) *Substantial services or costs*—(*i*) *In general.* Except as provided in paragraph (c)(3)(iii)(B)(*2*)(*ii*) of this section, the determination of whether a person has performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property shall be made on the basis of all the facts and circumstances.

(*ii*) *Exception.* A person has performed substantial services or incurred substantial costs for a taxable year with respect to the development or marketing of an item of intangible property if—

(*a*) The expenditures reasonably incurred by such person in such taxable year with respect to the development or marketing of the property exceed 50 percent of the gross royalties from licensing such property that are includible in such person's gross income for the taxable year; or

(*b*) The expenditures reasonably incurred by such person in such taxable year and all prior taxable years with respect to the development or marketing of the property exceed 25 percent of the aggregate capital expenditures (without any adjustment of amortization) made by such person with respect to the property in all such taxable years.

(*iii) Expenditures taken into account.* For purposes of paragraph (c)(3)(iii)(B)(*2*)(*ii*) of this section, expenditures in a taxable year include amounts chargeable to capital account for such year without regard to the year or years (if any) in which any deduction for such expenditure is allowed.

(*3) Passthrough entities.* For purposes of this paragraph (c)(3)(iii)(B), in the case of any intangible property held by a partnership, S corporation, estate, or trust, the determination of whether royalties from such property are derived in the ordinary course of a trade or business shall be made by applying the rules of this paragraph (c)(3)(iii)(B) to such entity and not to any holder of an interest in such entity.

(*4*) *Cross reference.* For special rules applicable to certain gross income from a trade or business of licensing intangible property, see paragraph (f)(7) of this section.

(C) *Mineral production payments.* For purposes of section 469 and the regulations thereunder—

(*1*) If a mineral production payment is treated as a loan under section 636, the portion of any payment in discharge of the production payment that is the equivalent of interest shall be treated as interest; and

(*2*) If a mineral production payment is not treated as a loan under section 636, payments in discharge of the production payment shall be treated as royalties.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(3):

Example 1. A, an individual engaged in the trade or business of farming, disposes of farmland in an installment sale. A is not engaged in a trade or business of selling farmland. Therefore, A's interest income from the installment note is not gross income derived in the ordinary course of a trade or business.

Example 2. P, a partnership, operates a rental apartment building for low-income tenants in City Y. Under Y's laws relating to the operation of low-income housing, P is required to maintain a reserve fund to pay for the maintenance and repair of the building. P invests the reserve fund in short-term interest-bearing deposits. Because P's interest income from the investment of the reserve fund is not interest income described in paragraph (c)(3)(ii) of this section, such income is not treated as derived in the ordinary course of a trade or business. Accordingly, P's interest income from the deposits is portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

Example 3. (i) B is a partner in a partnership that is engaged in an activity involving the conduct of a trade or business of dealing in securities. On February 1, the partnership acquires certain securities for investment (within the meaning of section 163(d)). On February 2, before recognizing any income with respect to the securities, the partnership determines that it would be advisable to hold the securities primarily for sale to customers and subsequently sells them to customers in the ordinary course of its business.

(ii) Under paragraph (c)(3)(iii)(A) of this section, income or gain from any security (including any security acquired pursuant to an investment of working capital) held by a dealer for investment at any time before such income or gain is recognized is not treated for purposes of paragraph (c)(3)(i) of this section as derived by the dealer in the ordinary course of its trade or business of dealing in securities. Accordingly, B's distributive share of the partnership's interest, dividends, or gains from the securities acquired by the partnership for investment on February 1 is portfolio income of B, notwithstanding that such securities were held by the partnership, subsequent to February 1, primarily for sale to customers in the ordinary course of the partnership's trade or business of dealing in securities.

Example 4. C is a partner in a partnership that is engaged in an activity of trading or dealing in royalty interests in mineral properties. The partnership derives royalty income from royalty interests held in the activity. If the activity is a trade or business activity, C's distributive share of the partnership's royalty income from such royalty interests is treated under paragraph (c)(3)(ii)(D) of this section as derived in the ordinary course of the partnership's trade or business.

Example 5. (i) D, a calendar year individual, is a partner in a calendar year partnership that is engaged in an activity of developing and marketing a design for a system that reduces air pollution in office buildings. D has a 10 percent distributive share of all items of partnership income, gain, loss, deduction, and credit. In 1987, the partnership acquired the rights to the design for $100,000. In 1987, 1988, and 1989, the partnership incurs expenditures with respect to the development and marketing of the design, and derives gross royalties from licensing the design, in the amounts set forth in the table below. The expenditures incurred in 1987 and 1988 are currently deductible expenses. The expenditures incurred in 1989 are capitalized and may be deducted only in subsequent taxable years.

Year	Gross royalties	Expenditures	Cumulative capital expenditures
1987	$20,000	$8,000	$100,000
1988	20,000	12,000	100,000
1989	60,000	15,000	115,000
1990	120,000	0	115,000

(ii) Under paragraph (c)(3)(iii)(B)(*3*) of this section, the determination of whether royalties from intangible property are derived in the ordinary course of a trade or business of a partnership is made by applying the rules of paragraph (c)(3)(iii)(B) of this section to the partnership rather than the partners. The expenditures reasonably incurred by the partnership in 1987 with respect to the development or marketing of the design ($8,000) do not exceed 50 percent of the partnership's gross royalties for such year from licensing the design ($20,000). In addition, the sum of such expenditures incurred in 1987 and all prior taxable years ($8,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such taxable years with respect to the design ($100,000). Accordingly, for 1987, the partnership is not treated under paragraph (c)(3)(iii)(B)(*2*)(*ii*) of this section as performing substantial services or incurring substantial costs with respect to the development or marketing of the design. Therefore, unless all of the facts and circumstances indicate that the partnership performed substantial services or incurred substantial costs with respect to the development or marketing of the design, D's distributive share of the partnership's royalty income for 1987 is portfolio income.

(iii) As of the end of 1988, the sum of the expenditures reasonably incurred by the partnership during such taxable year and all prior taxable years with respect to the development or marketing of the design ($20,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such years with respect to the design ($100,000). However, the amount of such expenditures incurred by the partnership in 1988 ($12,000) exceeds 50 percent of the partnership's gross royalties for such year from licensing the design ($20,000). Accordingly, for 1988, under paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income for 1988 is considered for purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(iv) The expenditures reasonably incurred by the partnership in 1989 with respect to the development or marketing of the design ($15,000) do not exceed 50 percent of the partnership's gross royalties for such year from licensing the design ($60,000). However, the sum of such expenditures incurred by the partnership in 1989 and all prior taxable years ($35,000) exceeds 25 percent of the partnership's aggregate capital expenditures made in all such years with respect to the design ($115,000). Accordingly, for 1989, under paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*b*) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income in 1989 is considered for purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(v) The result for 1990 is the same as for 1989, notwithstanding that the partnership incurs no expenditures in 1990 with respect to the development or marketing of the design.

Example 6. The facts are the same as in Example 5, except that, for 1987, D's distributive share of the partnership's development and marketing costs is 15 percent, while D's distributive share of the partnership's gross royalties is 10 percent. Although D's distributive share of the expenditures reasonably incurred by the partnership during 1987 with respect to the development and marketing of the design ($1,200) is more than 50 percent of D's distributive share of the partnership's gross royalties from licensing the design ($2,000), D is not treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design for 1987 under paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section. This is because, under paragraph (c)(3)(iii)(B)(*3*) of this section, the determination of whether the royalties are derived in the ordinary course of a trade or business is made by applying paragraph (c)(3)(iii)(B) of this section to the partnership, and not to D.

(4) *Items of personal service income specifically excluded*—(i) *In general.* Passive activity gross income does not include compensation paid to or on behalf of an individual for personal services performed or to be performed by such individual at any time. For purposes of this paragraph (c)(4), compensation for personal services includes only—

(A) Earned income (within the meaning of section 911(d)(2)(A)), including gross income from a payment described in paragraph (e)(2) of this section that represents compensation for the performance of services by a partner;

(B) Amounts includible in gross income under section 83;

(C) Amounts includible in gross income under sections 402 and 403;

(D) Amounts (other than amounts described in paragraph (c)(4)(i)(C) of this section) paid pursuant to retirement, pension, and other arrangements for deferred compensation for services;

(E) Social security benefits (within the meaning of section 86(d)) includible in gross income under section 86; and

(F) Other income identified by the Commissioner as income derived by the taxpayer from personal services;

provided, however, that no portion of a partner's distributive share of partnership income (within the meaning of section 704(b)) or a shareholder's pro rata share of income from an S corporation (within the meaning of section 1377(a)) shall be treated as compensation for personal services.

(ii) *Example.* The following example illustrates the application of this paragraph (c)(4):

Example. C owns 50 percent of the stock of X, an S corporation. X owns rental real estate, which it manages. X pays C a salary for services performed by C on behalf of X in connection with the management of X's rental properties. Under this paragraph (c)(4), although C's pro rata share of X's gross rental income is passive activity gross income (even if the salary paid to C is less than the fair market value of C's services), the salary paid to C does not constitute passive activity gross income.

(5) *Income from section 481 adjustment*—(i) *In general.* If a change in accounting method results in a positive section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (c)(5)(iii) of this section) of the amount taken into account for a taxable year as a net positive section 481 adjustment by reason of such change shall be treated as gross income from the activity for such taxable year, and such gross income shall be treated as passive activity gross income if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)).

(ii) *Positive section 481 adjustments.* For purposes of applying this paragraph (c)(5)—

(A) The term ''net positive section 481 adjustment'' means the increase (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term ''positive section 481 adjustment with respect to an activity'' means the increase (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) *Ratable portion.* The ratable portion of the amount taken into account as a net positive section 481 adjustment for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing—

(A) The positive section 481 adjustment with respect to the activity; by

(B) The sum of the positive section 481 adjustments with respect to all of the activities of the taxpayer.

(6) *Gross income from certain oil or gas properties*—(i) *In general.* [Reserved]. See §1.469–2(c)(6)(i) for rules relating to this paragraph.

(ii) *Gross and net passive income from the property.* [Reserved]. See §1.469–2(c)(6)(ii) for rules relating to this paragraph.

(iii) *Property.* [Reserved]. See 1.469–2(c)(6)(iii) for rules relating to this paragraph.

(iv) *Examples.* The following examples illustrate the application of this (c)(6):

Example 1. [Reserved]. See §1.469–2(c)(6)(iv) *Example 1.*

Example 2. [Reserved]. See §1.469–2(c)(6)(iv) *Example 2.*

Example 3. C is a general partner in partnership T and a limited partner in partnership U. T and U both own oil and gas working interests in tracts of land in County X. In 1987, T drills a well, and C's distributive share of T's losses from drilling the well is treated under §1.469–1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, T develops information indicating a significant probability that substantial oil and gas reserves underlie most portions of County X. As a result, the value of all oil and gas properties in County X is enhanced. The information developed by T does not, however, indicate that the reservoir in which T's well is drilled underlies U's tract. Under these facts, T's and U's tracts are not treated as one property for purposes of this paragraph (c)(6), because the value of U's tract is not directly enhanced by T's activities.

(7) *Other items specifically excluded.* Notwithstanding any other provision of the regulations under section 469, passive activity gross income does not include the following:

(i) Gross income of an individual from intangible property, such as a patent, copyright, or literary, musical, or artistic composition, if the taxpayer's personal efforts significantly contributed to the creation of such property;

(ii) Gross income from a qualified low-income housing project (within the meaning of section 502 of the Tax Reform Act of 1986) for any taxable year in the relief period (within the meaning of section 502(b) of such Act;

(iii) Gross income attributable to a refund of any state, local, or foreign income, war profits, or excess profits tax;

(iv) [Reserved]. See §1.469–2(c)(7)(iv) for rules relating to this paragraph (c)(7)(iv).

(v) [Reserved]. See §1.469–2(c)(7)(v) for rules relating to this paragraph (c)(7)(v).

(vi) [Reserved]. See §1.469–2(c)(7)(vi) for rules relating to this paragraph (c)(7)(vi).

(d) *Passive activity deductions*—(1) *In general*. Except as otherwise provided in section 469 and the regulations thereunder, a deduction is a passive activity deduction for a taxable year if and only if such deduction—

(i) Arises (within the meaning of paragraph (d)(8) of this section) in connection with the conduct of an activity that is a passive activity for the taxable year; or

(ii) Is treated as a deduction from an activity under §1.469–1T(f)(4) for the taxable year.

The following example illustrates the application of this paragraph (d)(1):

Example. (i) In 1987, A, a calendar year individual, acquires a partnership interest in R, a calendar year partnership. R's only activity is a trade or business activity in which A materially participates for 1987. R incurs a loss in 1987. A's distributive share of R's 1987 loss is $1,000. However, A's basis in the partnership interest at the end of 1987 (without regard to A's distributive share of partnership loss) is $600; accordingly, section 704(d) disallows any deduction in 1987 for $400 of A's distributive share of R's loss. The remainder of A's distributive share of R's loss would be allowed as a deduction for 1987 if taxable income for all taxable years were determined without regard to sections 469, 613A(d), and 1211. See paragraph (d)(8) of this section.

(ii) A does not materially participate in R's activity for 1988. In 1988, R again incurs a loss, and A's distributive share of the loss is again $1,000. At the end of 1988, A's basis in the partnership interest (without regard to A's distributive share of partnership loss) is $2,000; accordingly, in 1988 section 704(d) does not limit A's deduction for either A's $1,000 distributive share of R's 1988 loss or the $400 loss carried over from 1987 under the second sentence of section 704(d). These losses would be allowed as a deduction for 1988 if taxable income for all taxable years were determined without regard to sections 469, 613A(d) and 1211. See paragraph (d)(8) of this section.

(iii) Under these facts, only $400 of A's distributive share of R's deductions from the activity are disallowed under section 704(d) in 1987. A's remaining deductions from the activity are treated as deductions that arise in connection with the activity for 1987 under paragraph (d)(8) of this section. Because A materially participates in the activity for 1987, the activity is not a passive activity (within the meaning of §1.469–1T(e)(1)) of A for such year. Accordingly, the deductions that are not disallowed in 1987 are not passive activity deductions.

(iv) A does not materially participate in R's activity for 1988. Accordingly, the activity is a passive activity of A for such year. No portion of A's distributive share of R's deductions from the activity is disallowed under section 704(d) in 1988. Accordingly, A's distributive share of R's deductions for 1988 and the $400 of deductions carried over from 1987 are both treated under paragraph (d)(8) of this section as deductions that arise in 1988. Since the activity is a passive activity for 1988, such deductions are passive activity deductions.

(2) *Exceptions*. Passive activity deductions do not include—

(i) A deduction for an item of expense (other than interest) that is clearly and directly allocable (within the meaning of paragraph (d)(4) of this section) to portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(ii) A deduction allowed under section 243, 244, or 245 with respect to any dividend that is not included in passive activity gross income;

(iii) Interest expense (other than interest expense described in paragraph (d)(3) of this section);

(iv) A deduction for a loss from the disposition of property of a type that produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(v) A deduction that, under section 469(g) and §1.469–6T (relating to the allowance of passive activity losses upon certain dispositions of interests in passive activities), is treated as a deduction that is not a passive activity deduction;

(vi) A deduction for any state, local, or foreign income, war profits, or excess profits tax;

(vii) A miscellaneous itemized deduction (within the meaning of section 67(b)) that is subject to disallowance in whole or in part under section 67(a) (without regard to whether any amount of such deduction is disallowed under section 67);

(viii) A deduction allowed under section 170 for a charitable contribution;

(ix) [Reserved]. See §1.469–2(d)(2)(ix) for rules relating to this paragraph.

(x) [Reserved]. See §1.469–2(d)(2)(x) for rules relating to this paragraph (d)(2)(x).

(xi) [Reserved]. See §1.469–2(d)(2)(xi) for rules relating to this paragraph (d)(2)(xi).

(xii) [Reserved]. See §1.469–2(d)(2)(xii) for rules relating to this paragraph (d)(2)(xii).

(3) *Interest expense.* Except as otherwise provided in the regulations under section 469, interest expense is taken into account as a passive activity deduction if and only if such interest expense—

(i) Is allocated under §1.163–8T to a passive activity expenditure (within the meaning of §1.163–8T(b)(4)); and

(ii) Is not—

(A) Qualified residence interest (within the meaning of §1.163–10T); or

(B) Capitalized pursuant to a capitalization provision (within the meaning of §1.163–8T(m)(7)(i)).

(4) *Clearly and directly allocable expenses.* For purposes of section 469 and the regulations thereunder, an expense (other than interest expense) is clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section) if and only if such expense is incurred as a result of, or incident to, an activity in which such gross income is derived or in connection with property from which such gross income is derived. For example, general and administrative expenses and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular activity or particular property are not clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

(5) *Treatment of loss from disposition*—(i) *In general.* Except as otherwise provided in the regulations under section 469—

(A) Any loss recognized in any year upon the sale, exchange, or other disposition (a ''disposition'') of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation and any deduction allowed on account of the abandonment or worthlessness of such an interest is treated as a deduction from such activity; and

(B) Any such deduction is a passive activity deduction if and only if the activity is a passive activity of the taxpayer for the taxable year of the disposition (or other event giving rise to the deduction).

(ii) *Disposition of property used in more than one activity in 12-month period preceding disposition.* In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities in the manner described in paragraph (c)(2)(ii) of this section.

(iii) *Other applicable rules*—(A) *Applicability of rules in paragraph (c)(2).* [Reserved]. See §1.469–2(d)(5)(iii)(A) for rules relating to this paragraph.

(B) *Dispositions of partnership interests and S corporation stock.* A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (d)(5). See paragraph (e)(3) of this section for rules treating the loss recognized upon the disposition of a partnership interest or S corporation stock as loss from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(6) *Coordination with other limitations on deductions that apply before section 469*—(i) *In general.* An item of deduction from a passive activity that is disallowed for a taxable year under section 704(d), 1366(d), or 465 is not a passive activity deduction for the taxable year. Paragraphs (d)(6) (ii) and (iii) of this section provide rules for determining the extent to which items of deduction from a passive activity are disallowed for a taxable year under sections 704(d), 1366(d), and 465.

(ii) *Proration of deductions disallowed under basis limitations*—(A) *Deductions disallowed under section 704(d).* If any amount of a partner's distributive share of a partnership's loss for the taxable year is disallowed under section 704(d), a ratable portion of the partner's distributive share of each item of deduction or loss of the partnership is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(*1*) The amount of the partner's distributive share of partnership loss that is disallowed for the taxable year; by

(*2*) The sum of the partner's distributive shares of all items of deduction and loss of the partnership for the taxable year.

(B) *Deductions disallowed under section 1366(d).* If any amount of an S corporation shareholder's pro rata share of an S corporation's loss for the taxable year is disallowed under section 1366(d), a ratable portion of the taxpayer's pro rata share of each item of deduction or loss of the S corporation is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(*1*) The amount of the shareholder's pro rata share of S corporation loss that is disallowed for the taxable year; by

(*2*) The sum of the shareholder's pro rata shares of all items of deduction and loss of the corporation for the taxable year.

(iii) *Proration of deductions disallowed under at-risk limitation.* If any amount of the taxpayer's loss from an activity (within the meaning of section 465(c)) is disallowed under section 465 for the taxable year, a ratable portion of each item of deduction or loss from the activity is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(*1*) The amount of the loss from the activity that is disallowed for the taxable year; by

(*2*) The sum of all deductions from the activity for the taxable year.

(iv) *Coordination of basis and at-risk limitations.* The portion of any item of deduction or loss that is disallowed for the taxable year under section 704(d) or 1366(d) is not taken into account for the taxable year in determining the loss from an activity (within the meaning of section 465(c)) for purposes of applying section 465.

(v) *Separately identified items of deduction and loss.* In identifying the items of deduction and loss from an activity that are not disallowed under sections 704(d), 1366(d), and 465 (and that therefore may be treated as passive activity deductions), the taxpayer need not account separately for any item of deduction or loss unless such item may, if separately taken into account, result in an income tax liability different from that which would result were such item of deduction or loss taken into account separately. For related rules applicable to partnerships and S corporations, see §1.702–1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Items of deduction or loss that must be accounted for separately include (but are not limited to) items of deduction or loss that—

(A) Are attributable to separate activities (within the meaning of the rules to be contained in §1.469–4T);

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in taxable years in which the taxpayer activity participates (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in such activity;

(C) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in §1.469–9T) in such activity;

(D) Arose in a taxable year beginning before 1987 and were not allowed for such taxable year under section 704(d), 1366(d), or 465(a)(2);

(E) [Reserved]. See §1.469–2(d)(6)(v)(E) for rules relating to this paragraph.

(F) Are attributable to pre-enactment interests in activities (within the meaning of §1.469–11T(c)).

(7) *Deductions from section 481 adjustment*—(i) *In general.* If a change in accounting method results in a negative section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (d)(7)(iii) of this section) of the amount taken into account for a taxable year as a net negative section 481 adjustment by reason of such change shall be treated as a deduction from the activity for such taxable year, and such deduction shall be

treated as a passive activity deduction if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)). See the rules to be contained in §1.469–1T(k) for the treatment of passive activity deductions from an activity in taxable years in which the activity is a former passive activity.

(ii) *Negative section 481 adjustments.* For purposes of applying this paragraph (d)(7)—

(A) The term ''net negative section 481 adjustment'' means the decrease (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term ''negative section 481 adjustment with respect to an activity'' means the decrease (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) *Ratable portion.* The ratable portion of the amount taken into account as a net negative section 481 adjustments for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing—

(A) The negative section 481 adjustment with respect to the activity; by

(B) The sum of the negative section 481 adjustments with respect to all of the activities of the taxpayer.

(8) *Taxable year in which item arises.* [Reserved]. See §1.469–2(d)(8) for rules relating to this paragraph.

(e) *Special rules for partners and S corporation shareholders*—(1) *In general.* For purposes of section 469 and the regulations thereunder, the character (as an item of passive activity gross income or passive activity deduction) of each item of gross income and deduction allocated to a taxpayer from a partnership or S corporation (a ''passthrough entity'') shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in the activity (or activities) that generated such item. Such participation is determined for the taxable year of the passthrough entity (and not the taxable year of the taxpayer). The following example illustrates the application of this paragraph (e)(1):

Example. A, a calendar year individual, is a partner in a partnership that has a taxable year ending January 31. During its taxable year ending on January 31, 1988, the partnership engages in a single trade or business activity. For the period from February 1, 1987, through January 31, 1988, A does not materially participate in this activity. In A's calendar year 1988 return, A's distributive share of the partnership's gross income and deductions from the activity must be treated as passive activity gross income and passive activity deductions, without regard to A's participation in the activity from February 1, 1988, through December 31, 1988. See also §1.469–11T(a)(4) (relating to the effective date of, and transition rules under, section 469 and the regulations thereunder).

(2) *Payments under sections 707(a), 707(c), and 736(b).* Items of gross income and deduction attributable to a transaction described in section 707(a), 707(c), or 736(b) shall be characterized for purposes of section 469 and the regulations thereunder in accordance with the following rules:

(i) *Section 707(a).* Any item of gross income or deduction attributable to a transaction that is treated under section 707(a) as a transaction between a partnership and a partner acting in a capacity other than as a member of such partnership shall be characterized for purposes of section 469 and the regulations thereunder in a manner that is consistent with the treatment of such transaction under section 707(a).

(ii) *Section 707(c).* [Reserved]. See §1.469–2(e)(ii) for rules relating to this paragraph.

(iii) *Payments in liquidation of a partner's interest in partnership property.* [Reserved]. See §1.469–2(e)(iii) for rules relating to this paragraph.

(3) *Sale or exchange of interest in passthrough entity*—(i) *Application of this paragraph (e)(3).* In the case of the sale, exchange, or other disposition (a ''disposition'') of an interest in a passthrough entity, the amount of the seller's gain or loss from each activity in which such entity has an interest is determined, for purposes of section 469 and the regulations thereunder, under this paragraph (e)(3). In the case of any such disposition, except as otherwise

provided in paragraph (e)(3)(iii) or (iv) of this section, paragraph (e)(3)(ii) of this section shall apply. See paragraphs (c)(2) and (d)(5) of this section for rules for determining the character of gain or loss, respectively, recognized upon a disposition of an interest in an activity held through a passthrough entity.

(ii) *General rule*—(A) *Allocation among activities.* Except as otherwise provided in this paragraph (e)(3)(ii) or in paragraph (e)(3) (iii) or (iv) of this section, if a holder of an interest in a passthrough entity disposes of such interest, a ratable portion (within the meaning of paragraph (e)(3)(ii)(B) of this section) of any gain or loss from such disposition shall be treated as gain or loss from the disposition of an interest in each trade or business, rental, or investment activity in which such passthrough entity owns an interest on the applicable valuation date.

(B) *Ratable portion*—(*1*) *Dispositions on which gain is recognized.* The ratable portion of any gain from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such gain by the fraction obtained by dividing—

(*i*) The amount of net gain (within the meaning of paragraph (e)(3)(ii)(E)(*3*) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(*ii*) The sum of the amounts of net gain that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each appreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(*1*) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(*2*) *Dispositions on which loss is recognized.* The ratable portion of any loss from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such loss by the fraction obtained by dividing—

(*i*) The amount of net loss (within the meaning of paragraph (e)(3)(ii)(E)(*4*) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(*ii*) The sum of the amounts of net loss that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each depreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(*2*) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(C) *Default rule.* If the gain or loss recognized upon the disposition of an interest in a passthrough entity cannot be allocated under paragraph (e)(3)(ii)(A) of this section, such gain or loss shall be allocated among the activities described in paragraph (e)(3)(ii)(A) of this section in proportion to the respective fair market values of the passthrough entity's interests in such activities at the applicable valuation date, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity.

(D) *Special rules.* For purposes of this paragraph (e)(3)(ii), the following rules shall apply:

(*1*) *Applicable valuation date*—(*i*) *In general.* Except as otherwise provided in paragraph (e)(3)(ii)(D)(*1*)(*ii*) of this section, the applicable valuation date with respect to any disposition of an interest in a passthrough entity is whichever one of the following dates is selected by the passthrough entity:

(*a*) The beginning of the taxable year of the passthrough entity in which such disposition occurs; or

(*b*) The date on which such disposition occurs.

(*ii*) *Exception.* If, after the beginning of a passthrough entity's taxable year in which a holder's disposition of an interest in such passthrough entity occurs and before the time of such disposition—

(*a*) The passthrough entity disposes of more than 10 percent of its interest (by value as of the beginning of such taxable year) in any activity;

(*b*) More than 10 percent of the property (by value as of the beginning of such taxable year) used in any activity of the passthrough entity is disposed of; or

(*c*) The holder of such interest contributes to the passthrough entity substantially appreciated property or substantially depreciated property with a total fair market value or adjusted basis, respectively, which exceeds 10 percent of the total fair market value of the holder's interest in the passthrough entity as of the beginning of such taxable year;

then the applicable valuation date shall be the date immediately preceding the date on which such disposition occurs.

(*2*) *Basis adjustments.* Any adjustment to the basis of partnership property under section 743(b) made with respect to the holder of an interest in a partnership shall be taken into account in computing the net gain or net loss that would have been allocated to the holder with respect to such interest if the partnership had sold its entire interest in an activity.

(*3*) *Tiered passthrough entities.* In the case of a disposition of an interest in a passthrough entity (the ''subsidiary passthrough entity'') by a holder that is also a passthrough entity, any gain or loss from such disposition that is taken into account by any person that owns (directly or indirectly) an interest in such holder shall be allocated among the activities of the subsidiary passthrough entity by applying the rules of this paragraph (e)(3)(ii) to the person taking such gain or loss into account as if such person has been the holder of an interest in such subsidiary passthrough entity and had recognized such gain or loss as a result of a disposition of such interest.

(E) *Meaning of certain terms.* For purposes of this paragraph (e)(3)(ii)—

(*1*) An activity is an appreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net gain would have been allocated to the holder with respect to such interest if the passthrough entity has sold its entire interest in such activity for its fair market value on the applicable valuation date;

(*2*) An activity is a depreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net loss would have been allocated to the holder with respect to such interest if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date;

(*3*) The term ''net gain'' means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the gains from the sale of all of the property used by (or representing the interest of) the passthrough entity in such activity exceed the losses (if any) from such sale;

(*4*) The term ''net loss'' means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the losses from the sale of all of the property used by (or representing the interest of) the passthrough entity in such activity exceed the gains (if any) from such sale.

(iii) *Treatment of gain allocated to certain passive activities as not from a passive activity.* If, in the case of a disposition of an interest in a passthrough entity—

(A) An amount of gain recognized on account of such disposition by the holder of such interest (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) is allocated to a passive activity of such holder (or such other person) under paragraph (e)(3)(ii) of this section;

(B) [Reserved]. See §1.469–2(e)(3)(iii)(B) for rules relating to this paragraph.

(C) The amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section exceeds 10 percent of the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(A) of this section;

then the gain of the holder (or such other person) that is described in paragraph (e)(3)(iii)(A) of this section shall be treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section. For purposes of applying the preceding sentence to the disposition of an interest in a partnership, the amount of gain that would have been allocated to the holder (or such other person) if all of the property used in an activity had been sold shall be determined by taking into account any adjustment to the basis of partnership property made with respect to such holder (or such other person) under section 743(b).

(iv) *Dispositions occurring in taxable years beginning before February 19, 1988*—(A) *In general.* Except as otherwise provided in this paragraph (e)(3)(iv), if the holder of an interest in a passthrough entity sells, exchanges, or otherwise disposes of all or part of such interest during a taxable year of such entity beginning prior to February 19, 1988, any gain or loss recognized from such disposition shall be allocated among the activities of the passthrough entity under any reasonable method selected by the passthrough entity, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity. For purposes of the preceding sentence, a reasonable method shall include the method prescribed by paragraph (e)(3)(ii) of this section. In addition, a method that allocates gain or loss among the passthrough entity's activities on the basis of the fair market value, cost, or adjusted basis of the property used in such activities shall generally be considered a reasonable method for purposes of this paragraph (e)(3)(iv).

(B) *Exceptions.* This paragraph (e)(3)(iv) shall not apply to any disposition of an interest in a passthrough entity occurring after February 19, 1988, if after such date, but before the holder's disposition of such interest, the holder (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) contributes to the passthrough entity substantially appreciated portfolio assets or any other substantially appreciated property that was used in any trade or business activity (within the meaning of §1.469–1T(e)) of the holder (or such other person) during—

(*1*) The taxable year of such person in which such contribution occurs; or

(*2*) The immediately preceding taxable year of such person;

but only if such person materially participated (within the meaning of §1.469–5T) in the activity for such year.

(v) *Treatment of portfolio assets.* For purposes of the paragraph (e)(3), all portfolio assets owned by a passthrough entity shall be treated as held in a single investment activity.

(vi) *Definitions.* For purposes of this paragraph (e)(3)—

(A) The term ''portfolio asset'' means any property of a type that produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(B) The term ''substantially appreciated property'' means property with a fair market value that exceeds 120 percent of its adjusted basis; and

(C) The term ''substantially depreciated property'' means property with an adjusted basis that exceeds 120 percent of its fair market value.

(vii) *Examples.* The following examples illustrate the application of this paragraph (e)(3):

Example 1. (i) A owns a one-half interest in P, a calendar year partnership. In 1993, A sells 50 percent of such interest for $50,000. A's adjusted basis for the interest sold is $30,000. Thus, A recognizes $20,000 of gain from the sale. P is engaged in three trade or business activities, X, Y, and Z, and owns marketable securities that are portfolio assets. For 1993, A materially participates in activity Z, but does not participate in activities X and Y. Paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if, immediately before A's sale, P had disposed of all of the property used in its trade or business activities. During the portion of 1993 preceding A's sale, P did not sell any of the property used in its activities, and A did not contribute any property to P.

(ii) Under paragraph (e)(3)(ii) of this section, a ratable portion of A's $20,000 gain is allocated to each appreciated activity in which P owned an interest on the applicable valuation date (within the meaning of paragraph (e)(3)(ii)(D)(*1*) of this section). For this purpose, paragraph (e)(3)(v) of this section treats the marketable securities owned by P as a single investment activity.

(iii) P selects the beginning of 1993 as the applicable valuation date pursuant to paragraph (e)(3)(ii)(D)(*1*)(*i*) of this section. P is not required to use the date of A's sale as the applicable valuation date under paragraph (e)(3)(ii)(D)(*1*)(*ii*) of this section because during the portion of 1993 preceding A's sale, P did not sell any of its property and A did not contribute any property to P. At the beginning of 1993, the fair market value and adjusted basis of the property used in P's activities are as follows:

	Adjusted basis	Fair market value
X	$68,000	$48,000
Y	30,000	62,000
Z	20,000	80,000
Marketable securities	2,000	10,000
Total	120,000	200,000

(iv) Under paragraph (e)(3)(ii)(B) of this section, the portion of A's $20,000 gain that is allocated to an appreciated activity of P (i.e., activities Y and Z and the marketable securities) is the amount of such gain multiplied by the fraction obtained by dividing (a) the net gain that would have been allocated to A with respect to the interest sold by A if P had sold its entire interest in such activity at the beginning of 1993 by (b) the sum of the amounts of net gain that would have been allocated to A with respect to the interest sold by A if P had sold its entire interest in each appreciated activity at the beginning of 1993.

(v) If P had sold its entire interest in activities Y and Z and the marketable securities at the beginning of 1993, A would have been allocated the following amounts of net gain with respect to the interest in P that A sold in 1993:

Activity	Net gain
Y	$8,000
Z	15,000
Marketable securities	2,000
Total	25,000

(vi) Accordingly, under paragraph (e)(3)(ii) of this section, $6,400 of A's $20,000 gain ($20,000 × $8,000/$25,000) is allocated to activity Y, $12,000 of A's $20,000 gain ($20,000 × $15,000/$25,000) is allocated to activity Z, and $1,600 of A's $20,000 gain ($20,000 × $2,000/$25,000) is allocated to the marketable securities. The gain allocated to activity Y is passive activity gross income. None of that gain is treated as gain that is not from a passive activity under paragraph (e)(3)(iii) of this section because paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if P had sold all of the property used in activity Y immediately prior to A's sale.

Example 2. (i) B and C, calendar year individuals, are equal partners in calendar year partnership R, which they formed on January 1, 2005, with contributions of property and money. The only item of property (other than money) contributed by B was a building that B had used for 12 years preceding the contribution in an activity that was not a passive activity during such period. At the time of its contribution, the building had an adjusted basis of $40,000 and a fair market value of $66,000. R is engaged in a single activity: the sale of equipment to customers in the ordinary course of the business of dealing in such property. R uses the building contributed by B in the dealership activity. B did not materially participate in the dealership activity during 2005. On July 1, 2005, D purchases one-half of B's interest in R for $37,500 in cash. At the time of the sale, the balance sheet of R, which uses the accrual method of accounting, is as follows:

	Adjusted basis per books	Fair market value
ASSETS		
Cash	$30,000	$30,000
Accounts receivable:		
Dealership	20,000	18,000
Inventory:		
Dealership	52,000	66,000
Building	40,000	66,000
Total	142,000	180,000
LIABILITIES AND CAPITAL		
Liabilities	$30,000	$30,000
Capital:		
B	47,000	75,000
C	65,000	75,000
Total	142,000	180,000

Thus, B's gain from the sale is $14,000 ($45,000 amount realized from the sale (consisting of $37,500 of cash and $7,500 of liabilities assumed by the purchaser) minus B's $31,000 adjusted basis for the interest sold (one-half of B's total adjusted basis of $62,000)).

(ii) Under paragraph (e)(3)(ii) of this section, all $14,000 of B's gain from the sale is allocated to R's dealership activity, which is a passive activity of B for 2005. If, however, R had sold its interest in the building immediately prior to B's sale for its fair market value on the applicable valuation date (the valuation date selected by R is irrelevant since the building had a fair market value of $66,000 at the beginning of 2005 and at the time of the sale), B would have been allocated $13,000 of gain under section 704(c) with respect to the interest in R that B sold to D.

This gain would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) of this section and would have exceeded 10 percent of the total amount of B's gain that is allocated to the dealership activity under paragraph (e)(3)(ii) of this section. Accordingly, under paragraph (e)(3)(iii) of this section, B's gain from the sale ($14,000) is treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of gain subject to paragraph (c)(2)(iii) of this section that B would have been allocated with respect to the interest sold to D if R had sold all of the property used in the dealership activity immediately prior to B's sale ($13,000). Thus, $13,000 of B's gain from the sale is treated as gain that is not from a passive activity.

(f) *Recharacterization of passive income in certain situations*—(1) *In general.* This paragraph (f) sets forth rules that require income from certain passive activities to be treated as income that is not from a passive activity (regardless of whether such income is treated as passive activity gross income under section 469 or any other provision of the regulations thereunder). For definitions of certain terms used in this paragraph (f), see paragraph (f)(9) of this section.

(2) *Special rule for significant participation*—(i) *In general.* An amount of the taxpayer's gross income from each significant participation passive activity for the taxable year equal to a ratable portion of the taxpayer's net passive income from such activity for the taxable year shall be treated as not from a passive activity if the taxpayer's passive activity gross income from all significant participation passive activities for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from all such activities for such year. For purposes of this paragraph (f)(2), the ratable portion of the net passive income from an activity is determined by multiplying the amount of such income by the fraction obtained by dividing—

(A) The amount of the excess described in the preceding sentence; by

(B) The amount of the excess described in the preceding sentence taking into account only significant participation passive activities from which the taxpayer has net passive income for the taxable year.

(ii) *Significant participation passive activity.* For purposes of this paragraph (f)(2), the term ''significant participation passive activity'' means any trade or business activity (within the meaning of §1.469–1T(e)(2)) in which the taxpayer significantly participates (within the meaning of §1.469–5T(c)(2)) for the taxable year but in which the taxpayer does not materially participate (within the meaning of §1.469–5T) for such year.

(iii) *Example.* The following example illustrates the application of this paragraph (f)(2):

Example. (i) A owns interests in three trade or business activities, X, Y, and Z. A does not materially participate in any of these activities for the taxable year, but participates in activity X for 110 hours, in activity Y for 160 hours, and in activity Z for 125 hours. A owns no interest in any other trade or business activity in which A does not materially participate for the taxable year but in which A participates for more than 100 hours during the taxable year. A's net passive income (or loss) for the taxable year from activities X, Y, and Z is as follows:

	X	Y	Z
Passive activity gross income	$600	$700	$900
Passive activity deductions	(200)	(1,000)	(300)
Net passive income	400	(300)	600

(ii) Under paragraph (f)(2)(ii) of this section, activities X, Y, and Z are A's only significant participation passive activities for the taxable year. A's passive activity gross income from significant participation passive activities ($2,200) exceeds A's passive activity deductions from significant participation passive activities ($1,500) by $700 for such year. Therefore, under paragraph (f)(2)(i) of this section, a ratable portion of A's gross income from activities X and Z (A's significant participation passive activities with net passive income for the taxable year) is treated as gross income that is not from a passive activity. The ratable portion is determined by dividing (a) the amount by which A's passive activity gross income from significant participation passive activities exceeds A's passive activity deductions from significant participation passive activities for the taxable year ($700) by (b) such excess taking into account only A's significant participation passive activities having net passive income for the taxable year ($1,000). Accordingly, $280 of gross income from activity X ($400 × 700/1000) and $420 of gross income from activity Z ($600 × 700/1000) is treated as gross income that is not from a passive activity.

(3) *Rental of nondepreciable property.* If less than 30 percent of the unadjusted basis of the property used or held for use by customers in a rental activity (within the meaning of § 1.469–1T(e)(3)) during the taxable year is subject to the allowance for depreciation under section 167, an amount of the taxpayer's gross income from the activity equal to the taxpayer's net passive income from the activity shall be treated as not from a passive activity. For purposes of this paragraph (f)(3), the term ''unadjusted basis'' means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis. The following example illustrates the application of this paragraph (f)(3):

Example. C is a limited partner in a partnership. The partnership acquires vacant land for $300,000, constructs improvements on the land at a cost of $100,000, and leases the land and improvements to a tenant. The partnership then sells the land and improvements for $600,000, thereby realizing a gain on the disposition. The unadjusted basis of the improvements ($100,000) equals 25 percent of the unadjusted basis of all property ($400,000) used in the rental activity. Therefore, under this paragraph (f)(3), an amount of C's gross income from the activity equal to the net passive income from the activity (which is computed by taking into account the gain from the disposition, including gain allocable to the improvements) is treated as not from a passive activity.

(4) *Net interest income from passive equity-financed lending activity*—(i) *In general.* An amount of the taxpayer's gross income for the taxable year from any equity-financed lending activity equal to the lesser of—

(A) The taxpayer's equity-financed interest income from the activity for such year; and

(B) The taxpayer's net passive income from the activity for such year

shall be treated as not from a passive activity.

(ii) *Equity-financed lending activity*—(A) *In general.* For purposes of this paragraph (f)(4), an activity is an equity-financed lending activity for a taxable year if—

(*1*) The activity involves a trade or business of lending money; and

(*2*) The average outstanding balance of the liabilities incurred in the activity for the taxable year does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity for such year.

(B) *Certain liabilities not taken into account.* For purposes of paragraph (f)(4)(ii)(A)(*2*) of this section, liabilities incurred principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(A)(*2*) of this section shall not be taken into account in computing such percentage.

(iii) *Equity-financed interest income.* For purposes of this paragraph (f)(4), the taxpayer's equity-financed interest income from an activity for a taxable year is the amount of the taxpayer's net interest income from the activity for such year multiplied by the fraction obtained by dividing—

(A) The excess of the average outstanding balance for such year of the interest-bearing assets held in the activity over the average outstanding balance for such year of the liabilities incurred in the activity; by

(B) The average outstanding balance for such year of the interest-bearing assets held in the activity.

(iv) *Net interest income.* For purposes of this paragraph (f)(4), the net interest income from an activity for a taxable year is—

(A) The gross interest income from the activity for such year; reduced by

(B) Expenses from the activity (other than interest on liabilities described in paragraph (f)(4)(vi) of this section) for such year that are reasonably allocable to such gross interest income.

(v) *Interest-bearing assets.* For purposes of this paragraph (f)(4), the interest-bearing assets held in an activity include all assets that produce interest income, including loans to customers.

(vi) *Liabilities incurred in the activity.* For purposes of this paragraph (f)(4), liabilities incurred in an activity include all fixed and determinable liabilities incurred in the activity that bear interest or are issued with original issue discount other than debts secured by tangible property used in the activity. In the case of an activity conducted by an entity in which the taxpayer owns an interest, liabilities incurred in an activity include only liabilities with respect to which the entity is the borrower.

(vii) *Average outstanding balance.* For purposes of this paragraph (f)(4), the average outstanding balance of liabilities incurred in an activity or of the interest-bearing assets held in an activity may be computed on a daily, monthly, or quarterly basis at the option of the taxpayer.

(viii) *Example.* The following example illustrates the application of this paragraph (f)(4):

Example: (i) A, a calendar year individual, acquires on January 1, 1988, a limited partnership interest in P, a calendar year partnership. Under the partnership agreement, A has a one percent share of each item of income, gain, loss, deduction, and credit of P. A acquires the partnership interest for $90,000, using $50,000 of unborrowed funds and $40,000 of proceeds of a loan bearing interest at an annual rate of 10 percent. A pays $4,000 of interest on the loan in 1988.

(ii) P's sole activity is a trade or business of lending money. A does not materially participate in the activity for 1988. During 1988, the average outstanding balance of P's interest-bearing assets (including loans to customers, temporary deposits with other lending institutions, and government and corporate securities) is $20 million. P incurs numerous interest-bearing liabilities in connection with its lending activity, including liabilities for deposits taken from customers, unsecured short-term and long-term loans from other lending institutions, and a mortgage loan secured by the building, owned by P, in which P conducts its business. For 1988, the average outstanding balance of all of these liabilities (other than the mortgage loan) is $11 million. None of these liabilities was incurred by P principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(A)(*2*) of this section.

(iii) The interest income derived by P for 1988 from its interest-bearing assets is $2.2 million. The interest expense paid by P for 1988 with respect to the liabilities incurred in connection with its lending activity (other than the mortgage loan) is $990,000. P's other expenses for 1988 that are reasonably allocable to P's gross interest income (including expenses for advertising, loan processing and servicing, and insurance, and depreciation on P's building) total $250,000. P's interest expense for 1988 on the mortgage loan secured by the building used in P's lending activity is $50,000. All of the interest expense paid or incurred by P for 1988 is allocated under §1.63–8T to expeditures in connection with P's lending activity.

(iv) Under paragraph (f)(4)(ii) of this section, P's activity is an equity-financed lending activity for 1988, since, for 1988, the activity involves a trade or business of lending money and the average outstanding balance of the liabilities incurred in the activity ($11 million) does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity ($20 million). Accordingly, under paragraph (f)(4)(i) of this section, an amount of A's gross income from the activity equal to the lesser of (a) A's equity-financed interest income from the activity for 1988, or (b) A's net passive income from the activity for 1988, is treated as income that is not from a passive activity.

(v) Under paragraph (f)(4)(iii) of this section, A's equity-financed interest income from the activity for 1988 is determined by multiplying A's net interest income from the activity for 1988 by the fraction obtained by dividing $9 million (the excess of the average interest-bearing assets for 1988 over the average interest-bearing liabilities for 1988) by $20 million (the average interest-bearing assets for 1988). Under paragraph (f)(4)(iv) of this section, A's net interest income from the activity for 1988 is $19,000 (A's distributive share of $2.2 million of gross interest income less A's distributive share of $300,000 of expenses described in paragraph (f)(4)(iv)(B) of this section, including interest expense on the mortgage loan). A's distributive share of P's other interest expense ($990,000) is not taken into account in computing A's net interest income for 1988. Accordingly, A's equity-financed interest income from the activity for 1988 is $8,550 ($19,000 × $9 million/$20 million).

(vi) Under paragraph (f)(9)(i) of this section, A's net passive income from the activity for 1988 is determined by taking into account A's distributive share of P's gross income and deductions from the activity for 1988, as well as any interest expense incurred by A individually that is taken into account under §1.163–8T in determining A's income or loss from the activity for 1988. Assuming that for 1988 all $4,000 of interest expense on the loan that A used to finance the acquisition of A's interest in P is allocated under §1.163–8T to expenditures of A in connection with the lending activity for 1988, A's net passive income from the activity for 1988 is $5,100, computed as set forth in the following table:

Gross income:	
Interest income	$22,000
Deductions:	
Distributive share of P's expenses from the activity	(12,900)
Interest expense on A's acquisition debt	(4,000)
Net passive income	5,100

(vii) A's net passive income from the activity for 1988 ($5,100) is less than A's equity-financed income from the activity for 1988 ($8,550). Accordingly, under this paragraph (f)(4), $5,100 of A's gross income from the activity for 1988 is treated as not from a passive activity.

(5) *Net income from certain property rented incidental to development activity*—

(i) *In general*. [Reserved]. See §1.469–2(f)(5)(i) for rules relating to this paragraph.

(ii) *Commencement*. [Reserved]. See §1.469–2(f)(5)(ii) for rules relating to this paragraph (f)(5)(ii).

(iii) *Services performed for the purpose of enhancing the value of property*. [Reserved]. See §1.469–2(f)(5)(iii) for rules relating to this paragraph (f)(5)(iii).

(iv) *Examples*. [Reserved]. See §1.469–2(f)(5)(iv) for examples relating to this paragraph (f)(5)(iv).

(6) *Property rented to a nonpassive activity*. [Reserved]. See §1.469–2(f)(6) for rules relating to this paragraph.

(7) *Special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property*—(i) *In general*. If a taxpayer acquires an interest in an entity described in paragraph (c)(3)(iii)(B)(*3*) of this section (the ''development entity'') after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, an amount of the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income for the year from such item of property shall be treated as not from a passive activity.

(ii) *Royalty income from property*. For purposes of this paragraph (f)(7)—

(A) A taxpayer's gross royalty income for a taxable year from an item of property is the taxpayer's share of passive activity gross income for such year (determined without regard to paragraphs (f)(2) through (7) of this section) from the licensing or transfer of any right in such property; and

(B) A taxpayer's net royalty income for a taxable year from an item of property is the excess, if any, of—

(*1*) The taxpayer's gross royalty income for the taxable year from such item of property; over

(*2*) Any passive activity deductions for such taxable year (including any deduction treated as a deduction for such year under §1.469–1T (f)(4)) that are reasonably allocable to such item of property.

(iii) *Exceptions*. Paragraph (f)(7)(i) of this section shall not apply to a taxpayer's gross royalty income for a taxable year from the licensing of an item of intangible property if—

(A) The expenditures reasonably incurred by the development entity for the taxable year of the entity ending with or within the taxpayer's taxable year with respect to the development or marketing of such property satisfy paragraph (c)(3)(iii)(B)(*2*)(*ii*) (*a*) of this section; or

(B) The taxpayer's share of the expenditures reasonably incurred by the development entity with respect to the development or marketing of such property for all taxable years of the entity beginning with the taxable year of the entity in which the taxpayer acquired the interest in the entity and ending with the taxable year of the entity ending with or within the taxpayer's current taxable year exceeds 25 percent of the fair market value of the taxpayer's interest in such property at the time the taxpayer acquired the interest in the entity.

(iv) *Capital expenditures*. For purposes of paragraph (f)(7)(iii)(B) of this section, a capital expenditure shall be taken into account for the taxable year of the entity in which such expenditure is chargeable to capital account, and the taxpayer's share of such expenditure shall be determined as though such expenditure were allowed as a deduction for such year.

(v) *Example*. The following example illustrates the application of this paragraph (f)(7):

Example. (i) The facts are the same as in Example 5 in paragraph (c)(3)(iv) of this section, except that, in 1988, D's 10 percent partnership interest is sold to F for $13,000, all of which is attributable to the design licensed by the partnership.

(ii) For 1988, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design satisfy paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section. Accordingly, under paragraph (f)(7)(iii)(A) of this section, paragraph (f)(7)(i) of this section does not apply to F's distributive share of the partnership's gross income from licensing the design.

(iii) For 1989, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design do not satisfy paragraph (c)(3)(iii)(B)(*2*)(*ii*)(*a*) of this section. Moreover, F's distributive share of such expenditures reasonably incurred by the partnership for 1988 and 1989 ($27,000 × .10 = $2,700) does not exceed 25 percent of the fair market value of F's interest in the design at the time F acquired the partnership interest ($13,000). Accordingly, neither of the exceptions provided in paragraph (f)(7)(iii) of this section applies for 1989 and, under paragraph (f)(7)(i) of this section, an amount of F's gross royalty income from the design equal to F's net royalty income from the design is treated as not from a passive activity.

(8) *Limitation on recharacterized income.* The amount of gross income from an activity that is treated as not from a passive activity for the taxable year under subparagraphs (f) (2) through (4) of this paragraph (f) shall not exceed the greatest amount of gross income treated as not from a passive activity under any one of such subparagraphs.

(9) *Meaning of certain terms.* For purposes of this paragraph (f), the terms set forth below shall have the following meanings:

(i) The net passive income from an activity for a taxable year is the amount by which the taxpayer's passive activity gross income from the activity for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from the activity for such year;

(ii) The net passive loss from an activity for a taxable year is the amount by which the taxpayer's passive activity deductions from the activity for the taxable year exceeds the taxpayer's passive activity gross income from the activity for such year (determined without regard to paragraphs (f) (2) through (4) of this section).

(iii) [Reserved]. See §1.469–2(f)(9)(iii) for rules relating to this paragraph.

(iv) [Reserved]. See §1.469–2(f)(9)(iv) for rules relating to this paragraph.

(10) *Coordination with section 163(d).* [Reserved]. See paragraph 1.469–2(f)(10) for rules relating to this paragraph.

(11) *Effective date.* For the effective date of the rules in this paragraph (f), see §1.469–11T (relating to effective date and transition rules).

[T.D. 8175, 53 FR 5711, Feb. 25, 1988; 53 FR 15494, Apr. 29, 1988, as amended by T.D. 8253, 54 FR 20538, May 12, 1989; T.D. 8290, 55 FR 6981, Feb. 28, 1990; T.D. 8318, 55 FR 48108, Nov. 19, 1990; 55 FR 51688, Dec. 17, 1990; T.D. 8417, 57 FR 20758, May 15, 1992; T.D. 8477, 58 FR 11538, Feb. 26, 1993; T.D. 8495, 58 FR 58788, Nov. 4, 1993]

§ 1.469–3 Passive activity credit.

(a)–(d) [Reserved]

(e) *Coordination with section 38(b).* Any credit described in section 38(b) (1) through (5) is taken into account in computing the current year business credit for the first taxable year in which the credit is subject to section 469 and is not disallowed by section 469 and the regulations thereunder.

(f) *Coordination with section 50.* In the case of any cessation described in section 50(a) (1) or (2), the credits allocable to the taxpayer's activities under §1.469–1(f)(4) shall be adjusted by reason of the cessation.

(g) [Reserved]

[T.D. 8417, 57 FR 20758, May 15, 1992]

§ 1.469–3T Passive activity credit (temporary).

(a) *Computation of passive activity credit.* The taxpayer's passive activity credit for the taxable year is the amount (if any) by which—

(1) The sum of all of the taxpayer's credits that are subject to section 469 for such year; exceeds

(2) The taxpayer's regular tax liability allocable to all passive activities for such year.

(b) *Credits subject to section 469*—(1) *In general.* Except as otherwise provided in this paragraph (b), a credit is subject to section 469 for a taxable year if and only if—

(i) Such credit—

(A) Is attributable to such taxable year and arises in connection with the conduct of an activity that is a passive activity for such taxable year; and

(B) Is described in—

(*1*) Section 38(b) (1) through (5) (relating to general business credits);

(*2*) Section 27(b) (relating to corporations described in section 936);

(*3*) Section 28 (relating to clinical testing of certain drugs); or

(*4*) Section 29 (relating to fuel from nonconventional sources); or

(ii) Such credit is allocable to an activity for such taxable year under § 1.469–1T(f)(4).

(2) *Treatment of credits attributable to qualified progress expenditures.* Any credit attributable to an increase in qualified investment under section 46(d)(1)(A) (relating to qualified progress expenditures) with respect to progress expenditure property (as defined in section 46(d)(2)) is subject to section 469 for a taxable year if—

(i) Such credit is attributable to such taxable year;

(ii) Such credit is described in paragraph (b)(1)(i)(B) of this section; and

(iii) It is reasonable to believe that such progress expenditure property will be used in a passive activity of the taxpayer when it is placed in service.

(3) *Special rule for partners and S corporation shareholders.* The character of a credit of a taxpayer arising in connection with an activity conducted by a partnership or S corporation (as a credit subject to section 469) shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in such activity. Such participation is determined for the taxable year of the partnership or S corporation (and not the taxable year of the taxpayer). See § 1.469–2T(e)(1).

(4) *Exception for pre-1987 credits.* A credit is not subject to section 469 if it is attributable to a taxable year of the taxpayer beginning prior to January 1, 1987.

(c) *Taxable year to which credit is attributable.* A credit is attributable to the taxable year in which such credit would be (or would have been) allowed if the credits regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469.

(d) *Regular tax liability allocable to passive activities*—(1) *In general.* For purposes of paragraph (a)(2) of this section, the taxpayer's regular tax liability allocable to all passive activities for the taxable year is the excess (if any) of—

(i) The taxpayer's regular tax liability for such taxable year; over

(ii) The amount of such regular tax liability determined by reducing the taxpayer's taxable income for such year by the excess (if any) of the taxpayer's passive activity gross income for such year over the taxpayer's passive activity deductions for such year.

(2) *Regular tax liability.* For purposes of this section, the term ''regularly tax liability'' has the meaning given such term in section 26(b).

(e) *Coordination with section 38(b).* [Reserved]. See § 1.469–3(e) for rules relating to this paragraph.

(f) *Coordination with section 50.* [Reserved]. See § 1.469–3(f) for rules relating to this paragraph.

(g) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) A, a calendar year individual, is a general partner in calendar year partnership P. P purchases a building in 1987 and, in 1987, 1988, and 1989, incurs rehabilitation costs with respect to the building. The building is placed in service in the rental activity in 1989. P's rehabilitation costs are qualified rehabilitation expenditures (within the meaning of section 48(g)(2)) and are taken into account in determining the amount of the investment credit for rehabilitation expenditures. P's qualified rehabilitation expenditures are not qualified progress expenditures (within the meaning of section 46(d)).

(ii) Because, under section 46(c)(1), the credit is allowable for the taxable year in which the rehabilitated property is placed in service, the credit allowable for P's qualified rehabilitation expenditures arises in connection with the activity in which the property is placed in service. In addition, the credit is attributable to 1989, the year in which the property is placed in service, because it would be allowed for such year if A's credits allowed for all taxable years were determined without regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469. Accordingly, under paragraph (b)(1) of this section, A's distributive share of the credit is subject to section 469 for 1989 because the credit arises in connection with a rental activity for such year.

Example 2. The facts are the same as in Example 1, except that the rehabilitation costs are incurred in anticipation of placing the building in service in a rental activity, the qualified rehabilitation expenditures in 1987 and 1988 are qualified progress expenditures (''QPEs'') (within the meaning of section 46(d)(3)), the improvements resulting from the expenditures are progress expenditure property (within the meaning of paragraph (d)(2) of this section), and it is reasonable to expect that such property will be transition property (within the meaning of section 49(e)) when the property is placed in service.

Therefore, under section 46(d)(1)(A), the qualified investment for 1987 and 1988 is increased by an amount equal to the aggregate of the applicable percentage of the qualified rehabilitation expenditures incurred in such years. The credits that are based on these expenditures are attributable (under paragraph (c) of this section) to 1987 and 1988, respectively. It is reasonable to believe in 1987 and 1988 that the progress expenditure property will be used in a rental activity when it is placed in service. Accordingly, under paragraph (b)(2) of this section, A's distributive share of the credit for 1987 and 1988 is subject to section 469. Under paragraph (b)(1) of this section (as in Example 1), A's distributive share of the credit for 1989 is also subject to section 469.

Example 3. (i) B, a single individual, acquires an interest in a partnership that, in 1988, rehabilitates a building and places it in service in a trade or business activity in which B does not materially participate. For 1988, B has the following items of gross income, deduction, and credit:

Gross income:		
Income other than passive activity gross income	$110,000	
Passive activity gross income	20,000	$130,000
Deductions:		
Deductions other than passive activity deductions	23,950	
Passive activity deductions	18,000	(41,950)
Taxable income		88,050
Credits:		
Rehabilitation credit from the passive activity		8,000

(ii) For 1988, the amount by which B's passive activity gross income exceeds B's passive activity deductions (B's net passive income) is $2,000. Under paragraph (d) of this section, B's regular tax liability allocable to passive activities for 1988 is determined as follows:

(A) Taxable income	$88,050	
(B) Regular tax liability		$24,578.50
(C) Taxable income minus net passive income	86,050	
(D) Regular tax liability for taxable income of $86,050.00		23,918.50
(E) Regular tax liability allocable to passive activities ((B) minus (D))		$660.00

(iii) Under paragraph (a) of this section, B's passive activity credit for 1988 is the amount by which B's credits that are subject to section 469 for 1988 ($8,000) exceed B's regular tax liability allocable to passive activities for 1988 ($660.00). Accordingly, B's passive activity credit for 1988 is $7,340.

Example 4. (i) The facts are the same as in Example 3 except that, in 1988, B also has additional deductions of $100,000 from a trade or business activity in which B materially participates for 1988. Thus, B has a taxable loss for 1988 of $11,950, determined as follows:

Gross income:		
Income other than passive activity gross income	$110,000	
Passive activity gross income	20,000	$130,000
Deductions:		
Deductions other than passive activity deductions	123,950	
Passive activity deductions	18,000	(141,950)
Taxable income		(11,950)

(ii) Under section 26(b) and paragraph (d)(2) of this section, the regular tax liability for a taxable year cannot exceed the tax imposed by chapter 1 of subtitle A of the Internal Revenue Code for the taxable year. Therefore, under paragraph (d)(1) of this section, B's regular tax liability allocable to passive activities for 1988 is zero. Although B's net operating loss for the taxable year is reduced by B's net passive income, and B's regular tax liability for other taxable years may increase as a result of the reduction, such an increase does not change B's regular tax liability allocable to passive activities for 1988. Accordingly, B's passive activity credit for 1988 is $8,000.

[T.D. 8175, 53 FR 5724, Feb. 25, 1988; 53 FR 15494, Apr. 29, 1988; T.D. 8253, 54 FR 20542, May 12, 1989; T.D. 8417, 57 FR 20758, May 15, 1992]

§ 1.469–4 Definition of activity.

(a) *Scope and purpose.* This section sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of section 469. A taxpayer's activities include those conducted through C corporations that are subject to section 469, S corporations, and partnerships.

(b) *Definitions.* The following definitions apply for purposes of this section—

(1) *Trade or business activities. Trade or business activities* are activities, other than rental activities or activities that are treated under §1.469–1T(e)(3)(vi)(B) as incidental to an activity of holding property for investment, that—

(i) Involve the conduct of a trade or business (within the meaning of section 162);

(ii) Are conducted in anticipation of the commencement of a trade or business; or

(iii) Involve research or experimental expenditures that are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)).

(2) *Rental activities.* *Rental activities* are activities that constitute rental activities within the meaning of §1.469–1T(e)(3).

(c) *General rules for grouping activities*—(1) *Appropriate economic unit.* One or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469.

(2) *Facts and circumstances test.* Except as otherwise provided in this section, whether activities constitute an appropriate economic unit and, therefore, may be treated as a single activity depends upon all the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities. The factors listed below, not all of which are necessary for a taxpayer to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469—

(i) Similarities and differences in types of trades or businesses;

(ii) The extent of common control;

(iii) The extent of common ownership;

(iv) Geographical location; and

(v) Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

(3) *Examples.* The following examples illustrate the application of this paragraph (c).

Example 1. Taxpayer *C* has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. In this case, after taking into account all the relevant facts and circumstances, there may be more than one reasonable method for grouping *C*'s activities. For instance, depending on the relevant facts and circumstances, the following groupings may or may not be permissible: a single activity; a movie theater activity and a bakery activity; a Baltimore activity and a Philadelphia activity; or four separate activities. Moreover, once *C* groups these activities into appropriate economic units, paragraph (e) of this section requires *C* to continue using that grouping in subsequent taxable years unless a material change in the facts and circumstances makes it clearly inappropriate.

Example 2. Taxpayer *B*, an individual, is a partner in a business that sells non-food items to grocery stores (partnership *L*). *B* also is a partner in a partnership that owns and operates a trucking business (partnership *Q*). The two partnerships are under common control. The predominant portion of *Q*'s business is transporting goods for *L*, and *Q* is the only trucking business in which *B* is involved. Under this section, *B* appropriately treats *L*'s wholesale activity and *Q*'s trucking activity as a single activity.

(d) *Limitation on grouping certain activities.* The grouping of activities under this section is subject to the following limitations:

(1) *Grouping rental activities with other trade or business activities*—(i) *Rule.* A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit under paragraph (c) of this section and—

(A) The rental activity is insubstantial in relation to the trade or business activity;

(B) The trade or business activity is insubstantial in relation to the rental activity; or

(C) Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

(ii) *Examples.* The following examples illustrate the application of paragraph (d)(1)(i) of this section:

Example 1. (i) *H* and *W* are married and file a joint return. *H* is the sole shareholder of an S corporation that conducts a grocery store trade or business activity. *W* is the sole shareholder of an S corporation that owns and rents out a building. Part of the building is rented to *H*'s grocery store trade or business activity (the grocery store rental). The grocery store rental and the grocery store trade or business are not insubstantial in relation to each other.

(ii) Because they file a joint return, *H* and *W* are treated as one taxpayer for purposes of section 469. See §1.469–1T(j). Therefore, the sole owner of the trade or business activity (taxpayer *H–W*) is also the sole owner of the rental activity. Consequently, each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. Accordingly, the grocery store rental and the grocery store trade or business activity may be grouped together (under paragraph (d)(1)(i) of this section) into a single trade or business activity, if the grouping is appropriate under paragraph (c) of this section.

Example 2. Attorney *D* is a sole practitioner in town *X*. *D* also wholly owns residential real estate in town *X* that *D* rents to third parties. *D*'s law practice is a trade or business activity within the meaning of paragraph (b)(1) of this section. The residential real estate is a rental activity within the meaning of §1.469–1T(e)(3) and is insubstantial in relation to *D*'s law practice. Under the facts and circumstances, the law practice and the residential real estate do not constitute an appropriate economic unit under paragraph (c) of this section. Therefore, *D* may not treat the law practice and the residential real estate as a single activity.

(2) *Grouping real property rentals and personal property rentals prohibited.* An activity involving the rental of real property and an activity involving the rental of personal property (other than personal property provided in connection with the real property or real property provided in connection with the personal property) may not be treated as a single activity.

(3) *Certain activities of limited partners and limited entrepreneurs*—(i) *In general.* Except as provided in this paragraph, a taxpayer that owns an interest, as a limited partner or a limited entrepreneur (as defined in section 464(e)(2)), in an activity described in section 465(c)(1), may not group that activity with any other activity. A taxpayer that owns an interest as a limited partner or a limited entrepreneur in an activity described in the preceding sentence may group that activity with another activity in the same type of business if the grouping is appropriate under the provisions of paragraph (c) of this section.

(ii) *Example.* The following example illustrates the application of this paragraph (d)(3):

Example. (i) Taxpayer *A*, an individual, owns and operates a farm. *A* is also a member of *M*, a limited liability company that conducts a cattle-feeding business. *A* does not actively participate in the management of *M* (within the meaning of section 464(e)(2)(B)). In addition, *A* is a limited partner in *N*, a limited partnership engaged in oil and gas production.

(ii) Because *A* does not actively participate in the management of *M*, *A* is a limited entrepreneur in *M*'s activity. *M*'s cattle-feeding business is described in section 465(c)(1)(B) (relating to farming) and may not be grouped with any other activity that does not involve farming. Moreover, *A*'s farm may not be grouped with the cattle-feeding activity unless the grouping constitutes an appropriate economic unit for the measurement of gain or loss for purposes of section 469.

(iii) Because *A* is a limited partner in *N* and *N*'s activity is described in section 465(c)(1)(D) (relating to exploring for, or exploiting, oil and gas resources), *A* may not group *N*'s oil and gas activity with any other activity that does not involve exploring for, or exploiting, oil and gas resources. Thus, *N*'s activity may not be grouped with *A*'s farm or with *M*'s cattle-feeding business.

(4) *Other activities identified by the Commissioner.* A taxpayer that owns an interest in an activity identified in guidance issued by the Commissioner as an activity covered by this paragraph (d)(4) may not group that activity with any other activity, except as provided in the guidance issued by the Commissioner.

(5) *Activities conducted through section 469 entities*—(i) *In general.* A C corporation subject to section 469, an S corporation, or a partnership (a section 469 entity) must group its activities under the rules of this section. Once the section 469 entity groups its activities, a shareholder or partner may group those activities with each other, with activities conducted directly by the shareholder or partner, and with activities conducted through other section 469 entities, in accordance with the rules of this section. A shareholder or partner may not treat activities grouped together by a section 469 entity as separate activities.

(ii) *Cross reference.* An activity that a taxpayer conducts through a C corporation subject to section 469 may be grouped with another activity of the taxpayer, but only for purposes of determining whether the taxpayer materially or significantly participates in the other activity. See §1.469–2T(c)(3)(i)(A) and (c)(4)(i) for the rules regarding dividends on C corporation stock and compensation paid for personal services.

(e) *Disclosure and consistency requirements*—(1) *Original groupings*. Except as provided in paragraph (e)(2) of this section and §1.469–11, once a taxpayer has grouped activities under this section, the taxpayer may not regroup those activities in subsequent taxable years. Taxpayers must comply with disclosure requirements that the Commissioner may prescribe with respect to both their original groupings and the addition and disposition of specific activities within those chosen groupings in subsequent taxable years.

(2) *Regroupings*. If it is determined that a taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities and must comply with disclosure requirements that the Commissioner may prescribe.

(f) *Grouping by Commissioner to prevent tax avoidance*—(1) *Rule*. The Commissioner may regroup a taxpayer's activities if any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit and a principal purpose of the taxpayer's grouping (or failure to regroup under paragraph (e) of this section) is to circumvent the underlying purposes of section 469.

(2) *Example*. The following example illustrates the application of this paragraph (f):

Example. (i) Taxpayers *D*, *E*, *F*, *G*, and *H* are doctors who operate separate medical practices. *D* invested in a tax shelter several years ago that generates passive losses and the other doctors intend to invest in real estate that will generate passive losses. The taxpayers form a partnership to engage in the trade or business of acquiring and operating X-ray equipment. In exchange for equipment contributed to the partnership, the taxpayers receive limited partnership interests. The partnership is managed by a general partner selected by the taxpayers; the taxpayers do not materially participate in its operations. Substantially all of the partnership's services are provided to the taxpayers or their patients, roughly in proportion to the doctors' interests in the partnership. Fees for the partnership's services are set at a level equal to the amounts that would be charged if the partnership were dealing with the taxpayers at arm's length and are expected to assure the partnership a profit. The taxpayers treat the partnership's services as a separate activity from their medical practices and offset the income generated by the partnership against their passive losses.

(ii) For each of the taxpayers, the taxpayer's own medical practice and the services provided by the partnership constitute an appropriate economic unit, but the services provided by the partnership do not separately constitute an appropriate economic unit. Moreover, a principal purpose of treating the medical practices and the partnership's services as separate activities is to circumvent the underlying purposes of section 469. Accordingly, the Commissioner may require the taxpayers to treat their medical practices and their interests in the partnership as a single activity, regardless of whether the separate medical practices are conducted through C corporations subject to section 469, S corporations, partnerships, or sole proprietorships. The Commissioner may assert penalties under section 6662 against the taxpayers in appropriate circumstances.

(g) *Treatment of partial dispositions*. A taxpayer may, for the taxable year in which there is a disposition of substantially all of an activity, treat the part disposed of as a separate activity, but only if the taxpayer can establish with reasonable certainty—

(1) The amount of deductions and credits allocable to that part of the activity for the taxable year under §1.469–1(f)(4) (relating to carryover of disallowed deductions and credits); and

(2) The amount of gross income and of any other deductions and credits allocable to that part of the activity for the taxable year.

(h) *Rules for grouping rental real estate activities for taxpayers qualifying under section 469(c)(7)*. See §1.469–9 for rules for certain rental real estate activities.

[T.D. 8565, 59 FR 50487, Oct. 4, 1994, as amended by T.D. 8645, 60 FR 66499, Dec. 22, 1995]

§1.469–4T Definition of activity (temporary).

(a) *Overview*—(1) *Purpose and effect of overview*. This paragraph (a) contains a general description of the rules contained in this section and is intended solely as an aid to readers. The provisions of this paragraph (a) are not a substitute for the more detailed rules contained in the remainder of this section and cannot be relied upon in cases in which those rules qualify the general description contained in this paragraph (a).

(2) *Scope and structure of §1.469–4T*. This section provides rules under which a taxpayer's business and rental operations are treated as one or more activities for purposes of section 469 and the regulations thereunder. (See paragraph (b)(2)(ii) of this section for the definition of business and rental operations.) In general, these rules are divided into three groups:

(i) Rules that identify the business and rental operations that constitute an undertaking (the undertaking rules).

(ii) Rules that identify the undertaking or undertakings that constitute an activity (the activity rules).

(iii) Rules that apply only under certain special circumstances (the special rules).

(3) *Undertaking rules*—(i) *In general*. The undertaking is generally the smallest unit that can constitute an activity. (See paragraph (b)(1) of this section for the general rule and paragraph (k)(2)(iii) of this section for a special rule that permits taxpayers to treat a single rental real estate undertaking as multiple activities.) An undertaking may include diverse business and rental operations.

(ii) *Basic undertaking rule*. The basic undertaking rule identifies the business and rental operations that constitute an undertaking by reference to their location and ownership. Under this rule, business and rental operations that are conducted at the same location and are owned by the same person are generally treated as part of the same undertaking. Conversely, business and rental operations generally constitute separate undertakings to the extent that they are conducted at different locations or are not owned by the same person. (See paragraph (c)(2)(i) of this section.)

(iii) *Circumstances in which location is disregarded*. In some circumstances, the undertaking in which business and rental operations are included does not depend on the location at which the operations are conducted. Operations that are not conducted at any fixed place of business or that are conducted at the customer's place of business are treated as part of the undertaking with which the operations are most closely associated (see paragraph (c)(2)(iii)(C) of this section). In addition, operations that are conducted at a location but do not relate to the production of property at that location or to the transaction of business with customers at that location are treated, in effect, as part of the undertaking or undertakings that the operations support (see paragraph (c)(2)(ii) of this section).

(iv) *Rental undertakings*. The basic undertaking rule is also modified if the undertaking determined under that rule includes both rental and nonrental operations. In such cases, the rental operations and the nonrental operations generally must be treated as separate undertakings (see paragraph (d)(1) of this section). This rule does not apply if more than 80 percent of the income of the undertaking determined under the basic rule is attributable to one class of operations (*i.e.*, rental or nonrental) or if the rental operations would not be treated as part of a rental activity because of the exceptions contained in §1.469–1T(e)(3)(ii) (see paragraph (d)(2) of this section). In applying the rental undertaking rules, short-term rentals of real property (*e.g.*, hotel-room rentals) are generally treated as nonrental operations (see paragraph (d)(3)(ii) of this section).

(v) *Oil and gas wells*. Another exception to the basic undertaking rule treats oil and gas wells that are subject to the working-interest exception in §1.469–1T(e)(4) as separate undertakings (see paragraph (e) of this section).

(4) *Activity rules*—(i) *In general*. The basic activity rule treats each undertaking in which a taxpayer owns an interest as a separate activity of the taxpayer (see paragraph (b)(1) of this section). In the case of trade or business undertakings, professional service undertakings, and rental real estate undertakings, additional rules may either require or permit the aggregation of two or more undertakings into a single activity.

(ii) *Aggregation of trade or business undertakings*—(A) *Trade or business undertakings*. Trade or business undertakings include all nonrental undertakings other than oil and gas undertakings described in paragraph (a)(3)(v) of this section and professional service undertakings described in paragraph (a)(4)(iii) of this section (see paragraph (f)(1)(ii) of this section).

(B) *Similar, commonly-controlled undertakings treated as a single activity.* An aggregation rule treats trade or business undertakings that are both similar and controlled by the same interests as part of the same activity. This rule is, however, generally inapplicable to small interests held by passive investors in such undertakings, except to the extent such interests are held through the same passthrough entity. (See paragraph (f)(2) of this section.) Undertakings are similar for purposes of this rule if more than half (by value) of their operations are in the same line of business (as defined in a revenue procedure issued pursuant to paragraph (f)(4)(iv) of this section) or if the undertakings are vertically integrated (see paragraph (f)(4)(iii) of this section). All the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests for purposes of the aggregation rule (see paragraph (j)(1) of this section). If, however, each member of a group of five or fewer persons owns a substantial interest in each of the undertakings, the undertakings may be rebuttably presumed to be controlled by the same interests (see paragraph (j) (2) and (3) of this section).

(C) *Integrated businesses treated as a single activity.* Trade or business undertakings (including undertakings that have been aggregated because of their similarity and common control) are subject to a second aggregation rule. Under this rule undertakings that constitute an integrated business and are controlled by the same interests must be treated as part of the same activity. (See paragraph (g) of this section.)

(iii) *Aggregation of professional service undertakings.* Professional service undertakings are nonrental undertakings that predominantly involve the provision of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (see paragraph (h)(1)(ii) of this section). In general, professional service undertakings that are either similar, related, or controlled by the same interests must be treated as part of the same activity (see paragraph (h)(2) of this section). The rules for determining whether trade or business undertakings are controlled by the same interests also apply with respect to professional service undertakings. Professional service undertakings are similar, however, if more than 20 percent (by value) of their operations are in the same field, and two professional service undertakings are related if one of the undertakings derives more than 20 percent of its gross income from persons who are customers of the other undertaking (see paragraph (h)(3) of this section).

(iv) *Rules for rental real estate*—(A) *Taxpayers permitted to determine rental real estate activities.* The rules for aggregating rental real estate undertakings are generally elective. They permit taxpayers to treat any combination of rental real estate undertakings as a single activity. Taxpayers may also divide their rental real estate undertakings and then treat portions of the undertakings as separate activities or recombine the portions into activities that include parts of different undertakings. (See paragraph (k)(2) (i) and (iii) of this section.)

(B) *Limitations on fragmentation and aggregation of rental real estate.* Taxpayers may not fragment their rental real estate in a manner that is inconsistent with their treatment of such property in prior taxable years or with the treatment of such property by the passthrough entity through which it is held (see paragraph (k) (2)(ii) and (3) of this section). There are no comparable limitations on the aggregation of rental real estate into a single activity. If however, the income or gain from a rental real estate undertaking is subject to recharacterization under § 1.469–2T(f)(3) (relating to the rental of nondepreciable property), a coordination rule provides that the undertaking must be treated as a separate activity (see paragraph (k)(6) of this section.)

(v) *Election to treat nonrental undertakings as separate activities.* Another elective rule permits taxpayers to treat a nonrental undertaking as a separate activity even if the undertaking would be treated as part of a larger activity under the aggregation rules applicable to the undertaking (see paragraph (o)(2) of this section). This elective rule is limited by consistency requirements similar to those that apply to rental real estate operations (see paragraph (o) (3) and (4) of this section). Moreover, in cases in which a taxpayer elects to treat a nonrental undertaking as a separate activity, the taxpayer's level of participation (*i.e.*, material, significant, or otherwise) in the separate activity is the same as the taxpayer's level of participation in the larger activity in which the undertaking would be included but for the election (see paragraph (o)(6) of this section).

(5) *Special rules*—(i) *Consolidated groups and publicly traded partnerships.* Special rules apply to the business and rental operations of consolidated groups of corporations and publicly traded partnerships. Under these rules, a consolidated group is treated as one taxpayer in determining its activities and those of its members (see paragraph (m) of this section), and business and rental operations owned through a publicly traded partnership cannot be aggregated with operations that are not owned through the partnership (see paragraph (n) of this section).

(ii) *Transitional rule.* A special rule applies for taxable years ending before August 10, 1989. In those years, taxpayers may organize business and rental operations into activities under any reasonable method (see paragraph (p)(1) of this section). A taxpayer will also be permitted to use any reasonable method to allocate disallowed deductions and credits among activities for the first taxable year in which the taxpayer's activities are determined under the general rules of §1.469–4T (see paragraph (p)(3) of this section).

(b) *General rule and definitions of general application*—(1) *General rule.* Except as otherwise provided in this section, each undertaking in which a taxpayer owns an interest shall be treated as a separate activity of the taxpayer. See paragraphs (f), (g), and (h) of this section for rules requiring certain nonrental undertakings to be treated as part of the same activity and paragraph (k) of this section for rules identifying the rental real estate undertakings (or portions thereof) that are included in an activity.

(2) *Definitions of general application.* The following definitions set forth the meaning of certain terms for purposes of this section:

(i) *Passthrough entity.* The term ''passthrough entity'' means a partnership, S corporation, estate, or trust.

(ii) *Business and rental operations*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, the term ''business and rental operations'' means all endeavors that are engaged in for profit or the production of income and satisfy one or more of the following conditions for the taxable year:

(*1*) Such endeavors involve the conduct of a trade or business (within the meaning of section 162) or are conducted in anticipation of such endeavors becoming a trade or business;

(*2*) Such endeavors involve making tangible property available for use by customers; or

(*3*) Research or experimental expenditures paid or incurred with respect to such endeavors are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)).

(B) *Operations conducted through non-passthrough entities.* For purposes of applying section 469 and the regulations thereunder, a taxpayer's activities do not include operations that a taxpayer conducts through one or more entities (other than passthrough entities). The following example illustrates the operation of this paragraph (b)(2)(ii)(B):

Example. (i) A, an individual, owns stock of X, a closely held corporation (within the meaning of §1.469–1T(g)(2)(ii) that is directly engaged in the conduct of a real estate development business. A participates in X's real estate development business, but does not own any interest in the business other than through ownership of the stock of X.

(ii) X is subject to section 469 (see §1.469–1T(b)(5)) and does not hold the real estate development business through another entity. Accordingly, for purposes of section 469 and the regulations thereunder, the operations of X's real estate development business are treated as part of X's activities.

(iii) A is also subject to section 469 (see §1.469–1T(b)(1)), but A's only interest in the real estate development business is held through X. X is a C corporation and therefore is not a passthrough entity. Thus, for purposes of section 469 and the regulations thereunder, A's activities do not include the operations of X's real estate development business. Accordingly, A's participation in X's busines is not participation in an activity of A, and is not taken into account in determining whether A materially participates (within the meaning of §1.469–5T) or significantly participates (within the meaning of §1.469–1T(c)(2)) in any activity. (See, however, §1.469–1T(g)(3) for rules under which a shareholder's participation is taken into account for purposes of determining whether a corporation materially or significantly participates in an activity.

(c) *Undertaking*—(1) *In general.* Except as otherwise provided in paragraphs (d), (e), and (k)(2)(iii) of this section, business and rental operations that constitute a separate source of income production shall be treated as a single undertaking that is separate from other undertakings.

(2) *Operations treated as a separate source of income production*—(i) *In general.* Except as otherwise provided in this paragraph (c)(2), business and rental operations shall be treated for purposes of this paragraph (c) as a separate source of income production if and only if—

(A) Such operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section); and

(B) Income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) owned by such person are conducted at such location.

(ii) *Treatment of support operations*—(A) *In general.* For purposes of section 469 and the regulations thereunder—

(*1*) The support operations conducted at a location shall not be treated as part of an undertaking under paragraph (c)(2)(i) of this section; and

(*2*) The income and expenses that are attributable to such operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity or activities that include such undertaking.

(B) *Support operations.* For purposes of this paragraph (c)(2), the business and rental operations conducted at a location are treated as support operations to the extent that—

(*1*) Such operations and an undertaking that is conducted at a different location are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section);

(*2*) Such operations involve the provision of property or services to such undertaking; and

(*3*) Such operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section).

(iii) *Location.* For purposes of this paragraph (c)(2)—

(A) The term ''location'' means, with respect to any business and rental operations, a fixed place of business at which such operations are regularly conducted;

(B) Business and rental operations are conducted at the same location if they are conducted in the same physical structure or within close proximity of one another;

(C) Business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises shall be treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated;

(D) All the facts and circumstances (including, in particular, the factors listed in paragraph (c)(3) of this section) are taken into account in determining the location with which business and rental operations are most closely associated; and

(E) Oil and gas operations that are conducted for the development of a common reservoir are conducted within close proximity of one another.

(iv) *Income-producing operations.* For purposes of this paragraph (c)(2), the term ''income-producing operations'' means business and rental operations that are conducted at a location and relate to (or are conducted in reasonable anticipation of)—

(A) The production of property at such location;

(B) The sale of property to customers at such location;

(C) The performance of services for customers at such location;

(D) Transactions in which customers take physical possession at such location of property that is made available for their use; or

(E) Any other transactions that involve the presence of customers at such location.

(v) *Ownership by the same person.* For purposes of this paragraph (c)(2), business and rental operations are owned by the same person if and only if one person (within the meaning of section 7701(a)(1)) is the direct owner of such operations.

(3) *Facts and circumstances determinations.* In determining whether a location is the location with which business and rental operations are most closely associated for purposes of paragraph (c)(2)(iii)(D) of this section, the following relationships between operations that are conducted at such location and other operations are generally the most significant:

(i) The extent to which other persons conduct similar operations at one location;

(ii) Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;

(iii) The extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;

(iv) The extent to which such operations involve products or services that are commonly provided together;

(v) The extent to which such operations serve the same customers;

(vi) The extent to which the same personnel, facilities, or equipment are used to conduct such operations;

(vii) The extent to which such operations are conducted in coordination with or reliance upon each other;

(viii) The extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations;

(ix) The extent to which such operations depend on each other for their economic success; and

(x) Whether such operations are conducted under the same trade name.

(4) *Examples.* The following examples illustrate the application of this paragraph (c). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusion relate to a single taxable year.

Example 1. The taxpayer is the sole owner of a department store and a restaurant and conducts both businesses in the same building. Thus, the department store and restaurant operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, property is sold to customers and services are performed for customers on the premises of the department store). Accordingly, the department store and restaurant operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

Example 2. (i) The facts are the same as in Example 1, except that the taxpayer is also the sole owner of an automotive center that services automobiles and sells tires, batteries, motor oil, and accessories. The taxpayer operates the automotive center in a separate structure in the shopping mall in which the department store is located. Although the automotive center operations and the department store and restaurant operations are not conducted in the same physical structure, they are conducted within close proximity (within the meaning of paragraph (c)(2)(iii)(B) of this section) of one another. Thus, the department store, restaurant, and automotive center operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section).

(ii) As in Example 1, the operations conducted at the same location are owned by the same person, and the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location. Accordingly, the department store, restaurant, and automotive center operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

Example 3. (i) The facts are the same as in Example 2, except that the automotive center is located several blocks from the shopping mall. As in Example 1, the department store and restaurant operations are treating as a single undertaking that is separate from other undertakings. Because, however, the automotive center operations are not conducted within close proximity (within the meaning of paragraph (c)(2)(iii)(B) of this section) of the department store and restaurant operations, all of the taxpayer's operations are not conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section).

(ii) All of the automotive center operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, property is sold to customers and services are performed for customers on the premises of the automotive center). Accordingly, the automotive center operations are also treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (g) of this section for rules under which certain trade or business activities are treated as a single activity.

Example 4. The taxpayer is the sole owner of a building and rents residential, office, and retail space in the building to various tenants. The taxpayer manages these rental operations from an office located in the building. The rental operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, customers take physical possession in the building of property made available for their use). Accordingly, the rental operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See paragraph (d) of this section for rules for determining whether this undertaking is a rental undertaking and paragraph (k) of this section for rules for identifying rental real estate activities.

Example 5. (i) The facts are the same as in Example 4, except that the taxpayer also uses the rental office in the building (''Building #1'') to manage rental operations in another building (''Building #2'') that the taxpayer owns. The rental operations conducted in Building #2 are treated as a separate source of income production under paragraph (c)(2) of this section and as a single undertaking that is separate from other undertakings (the ''Building #2 undertaking'') under paragraph (c)(1) of this section.

(ii) The operations conducted at the rental office in Building #1 and the Building #2 undertaking are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the operations conducted at the rental office with respect to the Building #2 undertaking relate to transactions in which customers take physical possession at another location of property that is made available for their use (*i.e.*, the operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv of this section)). Thus, to the extent the operations conducted at the rental office involve the management of the Building #2 undertaking, they are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to the Building #2 undertaking.

(iii) Paragraph (c)(2)(ii)(A)(*1*) of this section provides that support operations are not treated as part of an undertaking under paragraph (c)(2)(i) of this section. Therefore, the support operations conducted at the rental office are not treated as part of the undertaking that consists of the rental operations conducted in Building #1 (the ''Building #1 undertaking''). Paragraph (c)(2)(ii)(A)(*2*) of this section provides that the income and expenses that are attributable to support operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity that includes such undertaking. Accordingly, the income and expenses of the rental office that are reasonably allocable to the Building #2 undertaking are taken into account in determining the income or loss from the activity or activities that include the Building #2 undertaking. See paragraph (k) of this section for rules for identifying rental real estate activities.

(iv) Rental office operations that involve the management of rental operations conducted in Building #1 are not support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) because they relate to an undertaking that is conducted at the same location (the ''Building #1 undertaking''). Thus, the rules for support operations in paragraph (c)(2)(ii)(A) of this section do not apply to such operations, and they are treated as part of the Building #1 undertaking.

Example 6. (i) The taxpayer conducts business and rental operations at eleven different locations (within the meaning of paragraph (c)(2)(iii) of this section). At ten of the locations the taxpayer owns grocery stores, and at the eleventh location the taxpayer owns a warehouse that receives goods and supplies them to the taxpayer's stores. The operations of each store are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at each location (*i.e.*, property is sold to customers on the store premises, and customers take physical possession on the store premises of property made available for their use). Accordingly, the operations of each of the ten grocery stores are treated as a separate source of income production (see paragraph (c)(2) of this section), and each store is treated as a single undertaking (a ''grocery store undertaking'') that is separate from other undertakings (see paragraph (c)(1) of this section). The operations conducted at the warehouse, however, do not include any income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section). Accordingly, the warehouse operations do not satisfy the requirements of paragraph (c)(2)(i) of this section and are not treated as a separate undertaking under paragraph (c)(1) of this section.

(ii) The warehouse operations and the grocery store undertakings are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations), the operations conducted at the warehouse involve the provision of property to the grocery store undertakings, and the warehouse operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section). Thus, the warehouse operations are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to the grocery store undertakings. Paragraph (c)(2)(ii)(A)(*2*) of this section provides that the income and expenses that are attributable to support operations and are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity or activities that include such undertaking. Accordingly, the income and expenses of the warehouse operations that are reasonably allocable to a grocery store undertaking are taken into account in determining the income or loss from the activity or activities that include such undertaking. See paragraph (f) of this section for rules under which certain similar, commonly-controlled undertakings are treated as a single activity.

Example 7. (i) The facts are the same as in Example 6, except that the warehouse operations also include the sale of goods to grocery stores that the taxpayer does not own (''other grocery stores''). Because of these sales, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the warehouse. The warehouse operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). Accordingly, prior to the application of the rules for support operations in paragraph (c)(2)(ii) of this section, the warehouse operations are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking (the ''separate warehouse undertaking'') that is separate from other undertakings (see paragraph (c)(1) of this section).

(ii) As in Example 6, the warehouse operations that involve supplying goods to the taxpayer's grocery store undertakings are support operations with respect to those undertakings. Therefore, those operations are not treated as part of the separate warehouse undertaking (see paragraph (c)(2)(ii)(A)(*1*) of this section), and the income and expenses of such operations are taken into account, as in Example 6, in determining the income or loss from the activity or activities that include the taxpayer's grocery store undertakings.

Example 8. (i) A partnership is formed to acquire real property and construct a building on the property. The partnership hires brokers to locate a suitable parcel of land, lawyers to negotiate zoning variances, easements, and building permits, and architects and engineers to design the improvements. After the architects and engineers have designed the improvements and other preliminaries have been completed, the partnership hires a general contractor who hires subcontractors and oversees construction. During the construction process and after construction has been completed, the partnership leases out space in the building. The partnership then operates the building as a rental property. The operations of acquiring the real property, negotiating contracts, overseeing the designing and construction of the improvements, leasing up the building, and operating the building are conducted at an office (the ''management office'') that is not at the same location (within the meaning of paragraph (c)(2)(iii) of this section) as the building.

(ii) The operations conducted at the building site (*e.g.*, excavating the land, pouring the concrete for the foundation, erecting the frame of the building, completing the exterior of the building, and building out the interior of the building) are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the partnership is the direct owner of the operations). In addition, the partnership conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, during the construction period property (the building) is produced at the building site, and during the rental period customers take physical possession in the building of property made available for their use). Accordingly, the operations conducted at the building site are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

(iii) The operations conducted at the management office and the undertaking conducted at the building site are owned by the same person (*i.e.,* the partnership is the direct owner of the operations). In addition, the operations conducted at the management office relate to transactions in which customers take physical possession at another location of property that is made available for their use (*i.e.,* the operations are not income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section)). Thus, to the extent the operations conducted at the management office involve the provision of services to the undertaking conducted at the building site, they are support operations (within the meaning of paragraph (c)(2)(ii)(B) of this section) with respect to such undertaking.

(iv) Paragraph (c)(2)(ii)(A)(*2*) of this section provides that the income and expenses of support operations that are reasonably allocable to an undertaking conducted at a different location shall be taken into account in determining the income or loss from the activity that includes such undertaking. Accordingly, the income and expenses of the management office that are reasonably allocable to the undertaking conducted at the building site are taken into account in determining the income or loss from the activity or activities that include such undertaking.

(v) Until the building is first held out for rent and is in a state of readiness for rental, the undertaking conducted at the building site is a trade or business undertaking (within the meaning of paragraph (f)(1)(ii) of this section). See paragraph (d) of this section for rules for determining whether the undertaking is a rental undertaking for periods after the building is first held out for rent and is in a state of readiness for rental and paragraph (k) of this section for rules for identifying rental real estate activities.

Example 9. The taxpayer owns 15 oil wells pursuant to a single working interest (within the meaning of §1.469–1T (e)(4)(iv). All of the wells are drilled and operated for the development of a common reservoir. Thus, all of the wells are at the same location (see paragraph (c)(2)(iii)(E) of this section). All of the wells are owned by the same person (*i.e.,* the taxpayer is the direct owner of the operations), and the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.,* oil wells are drilled in reasonable anticipation of producing oil at the location). Accordingly, the operations of the wells are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See paragraph (e) of this section for rules under which certain oil and gas operations are treated as multiple undertakings even if they would be part of the same undertaking under the rules of this paragraph (c).

Example 10. (i) Partnership X owns an automobile dealership and partnership Y owns an automobile repair shop. The dealership and repair shop operations are conducted in the same physical structure. Individuals A, B, and C are the only partners in partnerships X and Y, and each of the partners owns a one-third interest in both partnerships.

(ii) The dealership operations and the repair-shop operations are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section), but are owned by different persons (*i.e.,* X is the direct owner of the dealership operations, and Y is the direct owner of the repair-shop operations). Moreover, indirect ownership of the operations is not taken into account under paragraph (c)(2)(v) of this section. Thus, it is irrelevant that the two partnerships are owned by the same persons in identical proportions. Accordingly, the dealership and repair-shop operations are not treated as part of the same source of income production (see paragraph (c)(2) of this section) or as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (g) of this section for rules under which certain trade or business activities are treated as a single activity.

Example 11. (i) The taxpayer owns and operates a delivery service. The business consists of a central office, retail establishments, and messengers who transport packages from one place to another. Customers may bring their packages to a retail establishment for delivery elsewhere or, by calling the central office, may have packages picked up at their homes or offices. The central office dispatches messengers and coordinates all pickups and deliveries. Customers may pay for deliveries when they drop off or pick up packages at a retail establishment, or the central office will bill the customer for services rendered. In addition, many packages are routed through the central office.

(ii) The operations conducted at the central office are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.,* the taxpayer is the direct owner of the operations). The operations actually conducted at the central office, however, do not include any income-producting operations (within the meaning of paragraph (c)(2)(iv) of this section).

(iii) Under paragraph (c)(2)(iii) (C) and (D) of this section, business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises are treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated, and all the facts and circumstances are taken into account in determining the location with which business and rental operations are most closely associated. The facts and circumstances in this case (including the facts that the central office dispatches messengers, coordinates all pickups and deliveries, and is the transshipment point for many packages) establish that the operations of delivering packages from one location to another are most closely associated with the central office. Thus, the delivery operations are treated as operations that are conducted at the central office, and the deliveries are treated as income-producing operations (*i.e.*, the performance of services for customers) that the taxpayer conducts at the central office. Accordingly, the operations conducted at the central office are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section).

(iv) The operations conducted at each retail establishment are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). At each retail establishment, the taxpayer's operations include transactions that involve the presence of customers at the establishment. Thus, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv)(E) of this section) at the retail establishments. Accordingly, the operations of each retail establishment are treated as a separate source of income production (see paragraph (c)(2) of this section) and as a single undertaking that is separate from other undertakings (see paragraph (c)(1) of this section). See, however, paragraph (f) of this section for rules under which certain similar, commonly-controlled undertakings are treated as a single activity.

Example 12. (i) The taxpayer is the sole owner of a saw mill and a lumber yard. The taxpayer's business operations consist of converting timber into lumber and other wood products and selling the resulting products. The timber is processed at the saw mill, and the resulting products are transported to the lumber yard where they are sold. The saw mill and the lumber yard are at different locations (within the meaning of paragraph (c)(2)(iii) of this section). The transportation operations are managed at the saw mill.

(ii) The operations conducted at the saw mill are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, lumber is produced at the mill). Similarly, the selling operations at the lumber yard are conducted at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are owned by the same person (*i.e.*, the taxpayer is the direct owner of the operations). In addition, the taxpayer conducts income-producing operations (within the meaning of paragraph (c)(2)(iv) of this section) at the location (*i.e.*, lumber is sold to customers at the lumber yard). Thus, the milling operations and the selling operations are treated as separate sources of income production (see paragraph (c)(2) of this section) and as separate undertakings (see paragraph (c)(1) of this section).

(iii) The operations conducted at the mill involve the provision of property to the lumber-yard undertaking. Nonetheless, the milling operations are income-producing operations because they relate to the production of property at the mill, and an undertaking's income-producing operations are not treated as support operations (see paragraph (c)(2)(ii)(B)(*3*) of this section). Accordingly, the milling operations are not support operations with respect to the lumber-yard undertaking. See, however, paragraph (f) of this section for rules under which certain vertically-integrated undertakings are treated as part of the same activity.

(iv) The operations of transporting finished products from the saw mill to the lumber yard are not conducted at a fixed location. Under paragraphs (c)(2)(iii) (C) and (D) of this section, business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises are treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated, and all the facts and circumstances are taken into account in determining the location with which business and rental operations are most closely associated. The facts and circumstances in this case (including the fact that the transportation operations are managed at the saw mill) establish that the transportation operations are most closely associated with the saw mill. Thus, the transportation operations are treated as operations that are conducted at the mill and as part of the undertaking that consists of the milling operations.

(d) *Rental undertaking*—(1) *In general.* This paragraph (d) applies to operations that are treated, under paragraph (c) of this section and before the application of paragraph (d)(1)(i) of this section, as a single undertaking that is separate from other undertakings (a ''paragraph (c) undertaking''). For purposes of this section—

(i) A paragraph (c) undertaking's rental operations and its operations other than rental operations shall be treated, except as otherwise provided in paragraph (d)(2) of this section, as two separate undertakings;

(ii) The income and expenses that are reasonably allocable to an undertaking (determined after the application of paragraph (d)(1)(i) of this section) shall be taken into account in determining the income or loss from the activity or activities that include such undertaking; and

(iii) An undertaking (determined after the application of paragraph (d)(1)(i) of this section) shall be treated as a rental undertaking if and only if such undertaking, considered as a separate activity, would constitute a rental activity (within the meaning of §1.469–1T(e)(3)).

(2) *Exceptions.* Paragraph (d)(1)(i) of this section shall not apply to a paragraph (c) undertaking for any taxable year in which—

(i) The rental operations of the paragraph (c) undertaking, considered as a separate activity, would not constitute a rental activity (within the meaning of §1.469–1T(e)(3));

(ii) Less than 20 percent of the gross income of the paragraph (c) undertaking is attributable to rental operations; or

(iii) Less than 20 percent of the gross income of the paragraph (c) undertaking is attributable to operations other than rental operations.

(3) *Rental operations.* For purposes of this paragraph (d), a paragraph (c) undertaking's rental operations are determined under the following rules:

(i) *General rule.* Except as otherwise provided in paragraph (d)(3) (ii) or (iii) of this section, a paragraph (c) undertaking's rental operations are all of the undertaking's business and rental operations that involve making tangible property available for use by customers and the provision of property and services in connection therewith.

(ii) *Real property provided for short-term use.* A paragraph (c) undertaking's operations that involve making short-term real property available for use by customers and the provision of property and services in connection therewith shall not be treated as rental operations if such operations, considered as a separate activity, would not constitute a rental activity. An item of property is treated as short-term real property for this purpose if and only if such item is real property that the paragraph (c) undertaking makes available for use by customers and the average period of customer use (within the meaning of §1.469–1T(e)(3)(iii)) for all of the paragraph (c) undertaking's real property of the same type as such item is 30 days or less.

(iii) *Property made available to licensees.* A paragraph (c) undertaking's operations that involve making tangible property available during defined business hours for nonexclusive use by various customers shall not be treated as rental operations. (See §1.469–1T(e)(3)(ii)(E).)

(4) *Examples.* The following examples illustrate the application of this paragraph (d). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusions relate to a single taxable year.

Example 1. (i) The taxpayer owns a building in which the taxpayer rents office space to tenants and operates a parking garage that is used by tenants and other persons. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The taxpayer's tenants typically occupy an office for at least one year, and the services provided to tenants are those customarily provided in office buildings. Some persons (including tenants) rent spaces in the parking garage on a monthly or annual basis. In general, however, spaces are rented on an hourly or daily basis, and the average period for which all customers (including tenants) use the parking garage is less than 24 hours. The paragraph (c) undertaking derives 75 percent of its gross income from office-space rentals and 25 percent of its gross income from the parking garage. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469–1T(e)(3)(vi)).

(ii) The parking spaces are real property and the average period of customer use (within the meaning of §1.469–1T(e)(3)(iii)) for the parking spaces is 30 days or less. Thus, the parking spaces are short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section). (For this purpose, individual parking spaces that are rented on a monthly or annual basis are, nevertheless, short-term real properties because all the parking spaces are property of the same type, and the average rental period taking all parking spaces into account is 30 days or less.) In addition, the parking-garage operations involve making short-term real properties available for use by customers and the provision of property and services in connection therewith.

(iii) Paragraph (d)(3) (i) and (ii) of this section provides, in effect, that a paragraph (c) undertaking's operations that involve making short-term real properties available for use by customers and the provision of property and services in connection therewith are treated as rental operations if and only if the operations, considered as a separate activity, would constitute a rental activity (within the meaning of §1.469–1T(e)(3)). In this case, the parking-garage operations, if considered as a separate activity, would not constitute a rental activity because the average period of customer use for the parking spaces is seven days or less (see §1.469–1T(e)(3)(ii)(A)). Accordingly, the parking-garage operations are not treated as rental operations.

(iv) The paragraph (c) undertaking's remaining operations involve the provision of tangible property (the office spaces) for use by customers and the provision of property and services in connection therewith. The average period of customer use for the office spaces exceeds 30 days. Thus, the office spaces are not short-term real properties, and the undertaking's operations involving the rental of office spaces are rental operations.

(v) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, at least 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the office-space operations) and at least 20 percent is attributable to operations other than rental operations (the parking-garage operations). Thus, the exceptions in paragraph (d)(2) (ii) and (iii) of this section do not apply. In addition, the average period of customer use for the office spaces exceeds 30 days, extraordinary personal services (within the meaning of §1.469–1T(e)(3)(v)) are not provided, and the rental of the office spaces is not treated as incidental to a nonrental activity under §1.469–1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the rental operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)(2)(i) of this section does not apply. Accordingly, the rental operations and the parking-garage operations are treated as two separate undertakings (the ''office-space undertaking'' and the ''parking-garage undertaking'').

(vi) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the office-space undertaking, if considered as a separate activity, would constitute a rental activity (see (v) above), and the parking-garage undertaking, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Accordingly, the office-space undertaking is treated as a rental undertaking, and the parking-garage undertaking is not.

Example 2. (i) The taxpayer owns a building in which the taxpayer rents apartments to tenants and operates a restaurant. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The taxpayer's tenants typically occupy an apartment for at least one year, and the services provided to tenants are those customarily provided in residential apartment buildings. The paragraph (c) undertaking derives 85 percent of its gross income from apartment rentals and 15 percent of its gross income from the restaurant. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469–1T(e)(3)(vi)).

(ii) The operations with respect to apartments (the ''apartment operations'') involve the provision of tangible property (the apartments) for use by customers and the provision of property and services in connection therewith. In addition, the apartments are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469–1T(e)(3)(iii)) for the apartments exceeds 30 days. Accordingly, the apartment operations are rental operations (within the meaning of paragraph (d)(3) of this section). The restaurant operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the restaurant operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(iii) of this section applies because less than 20 percent of the paragraph

(c) undertaking's gross income is attributable to operations other than rental operations (the restaurant operations). Accordingly, the rental operations and the restaurant operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the application of paragraph (d)(1)(i) of this section) includes both the apartment operations and the restaurant operations, and the gross income of this undertaking represents amounts paid principally for the use of tangible property (the apartments). Moreover, the average period of customer use for the apartments exceeds 30 days, extraordinary personal services (within the meaning of §1.469–1T(e)(3)(v)) are not provided, and the rental of the apartments is not treated as incidental to a nonrental activity under §1.469–1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the undertaking, if considered as a separate activity, would constitute a rental activity. Accordingly, the undertaking is treated as a rental undertaking.

Example 3. (i) The taxpayer owns a building in which the taxpayer rents hotel rooms, meeting rooms, and parking spaces to customers, rents space to various retailers, and operates a restaurant and health club. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) Although some customers occupy hotel rooms for extended periods (including some customers who reside in the hotel), customers use hotel rooms for an average period of two days and meeting rooms for an average period of one day. The services provided to persons using the hotel rooms and meeting rooms are those customarily provided in hotels (including wake-up calls, valet services, and delivery of food and beverages to rooms). Some customers rent spaces in the parking garage on a monthly or annual basis. In general, however, parking spaces are rented on an hourly or daily basis, and the average period for which customers use the parking garage is less than 24 hours. Retail tenants typically occupy their space for at least one year, and the services provided to retail tenants are those customarily provided in commercial buildings. The paragraph (c) undertaking derives 45 percent of its gross income from renting hotel rooms, meeting rooms, and parking spaces, 35 percent of its gross income from renting retail space, and 20 percent of its gross income from the restaurant and health club. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469–1T(e)(3)(vi)).

(ii) The parking spaces, hotel rooms, and meeting rooms are real property of three different types, but the average period of customer use (within the meaning of §1.469–1T (e)(3)(iii)) for property of each type is 30 days or less. Thus, the parking spaces, hotel rooms, and meeting rooms are short-term real properties. (For this purpose, individual parking spaces or hotel rooms that are rented for extended periods are, nevertheless, short-term real properties if the average rental period for all parking spaces is 30 days or less and the average rental period for all hotel rooms is 30 days or less.) In addition, the parking garage operations, the operations with respect to hotel rooms (the ''hotel-room operations''), and the operations with respect to meeting rooms (the ''meeting-room operations'') involve making short-term real properties available for use by customers and the provision of property and services in connection therewith.

(iii) Paragraph (d)(3) (i) and (ii) of this section provides, in effect, that a paragraph (c) undertaking's operations that involve making short-term real properties available for use by customers and the provision of property and services in connection therewith are treated as rental operations if and only if the operations, considered as a separate activity, would constitute a rental activity (within the meaning of §1.469–1T (e)(3)). In this case the parking-garage, hotel-room and meeting-room operations, if considered as separate activities, would not constitute rental activities because the average period of customer use for parking spaces, hotel rooms, and meeting rooms does not exceed seven days (see §1.469–1T (e)(3)(ii)(A)). Accordingly, the parking-garage, hotel-room, and meeting-room operations are not treated as rental operations.

(iv) The operations with respect to retail space in the building (the ''retail-space operations'') involve the provision of tangible property (the retail spaces) for use by customers and the provision of property and services in connection therewith. In addition, the retail spaces are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469–1T (e)(3)(iii)) for the retail spaces exceeds 30 days. Accordingly, the retail-space operations are rental operations.

(v) The health-club operations involve making tangible property available for use by customers, but the property is customarily made available during defined business hours for nonexclusive use by various customers. Accordingly, the health-club operations are not rental operations (see paragraph (d)(3)(iii) of this seciton). The restaurant operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Accordingly, the restaurant operations also are not rental operations.

(vi) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, at least 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (35 percent of the paragraph (c) undertaking's gross income is from the retail-space operations) and at least 20 percent is attributable to operations other than rental operations (45 percent from the hotel-room, meeting-room and parking-garage operations and 20 percent from the restaurant and health-club operations). Thus, the exceptions in paragraph (d)(2) (ii) and (iii) of this section do not apply. In addition, the average period of customer use for the retail space exceeds 30 days, extraordinary personal services (within the meaning of §1.469–1T (e)(3)(v)) are not provided, and the rental of the retail space is not treated as incidental to a nonrental activity under §1.469–1T (e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the retail-space operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)(2)(i) of this section does not apply. Accordingly, the retail-space operations are treated as an undertaking (the ''retail-space undertaking'') and all the other operations conducted in the building (*i.e.*, renting hotel and meeting rooms and parking spaces and operating the restaurant and health club) are treated as a separate undertaking (the ''hotel undertaking'').

(vii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the retail-space undertaking, if considered as a separate activity, would constitute a rental activity (see (iv) above). Accordingly, the retail-space undertaking is treated as a rental undertaking. The hotel undertaking, if considered as a separate activity, would not constitute a rental activity because all tangible property provided for the use of customers in the hotel undertaking is either property for which the average period of customer use is seven days or less (see §1.469–1T (e)(3)(ii)(A)) or property customarily made available during defined business hours for nonexclusive use by various customers (see §1.469–1T (e)(3)(ii)(E)). Accordingly, the hotel undertaking is not treated as a rental undertaking.

Example 4. (i) A law partnership owns a ten-story building. The partnership uses eight floors of the building in its law practice and leases two floors to one or more tenants. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) Tenants typically occupy space on the two rented floors for at least one year, and the services provided to tenants are those customarily provided in office buildings. The paragraph (c) undertaking derives 90 percent of its gross income from rendering legal services and 10 percent of its gross income from renting space. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469–1T (e)(3)(vi)).

(ii) The operations with respect to the office space leased to tenants (the ''office-space operations'') involve the provision of tangible property (the office space) for use by customers and the provision of property and services in connection therewith. In addition, the office spaces are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469–1T(e)(3)(iii)) for the office space exceeds 30 days. Accordingly, the office-space operations are rental operations (within the meaning of paragraph (d)(3) of this section).

(iii) The operations that involve the performance of legal services (the ''law-practice operations'') do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Accordingly, the law-practice operations are not rental operations.

(iv) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(ii) of this section applies because less than 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the office-space operations). Accordingly, the law-practice operations and the office-space operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(v) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the application of paragraph (d)(1)(i) of this section) includes both the law-practice operations and the office-space operations, and the gross income of this undertaking does not represent amounts paid principally for the use of tangible property. Thus, the undertaking, if considered as a separate activity, would not constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example 5. (i) The facts are the same as in Example 4, except that the building is owned by a separate partnership (the ''real estate partnership''), which leases eight floors of the building to the law partnership for use in its law practice and two floors to one or more other tenants. The law partnership and real estate partnership are owned by the same individuals in identical proportions.

(ii) The operations conducted in the building are owned by two different persons (*i.e.*, the law partnership and the real estate partnership). (See paragraph (c)(2)(v) of this section.) Thus, the operations conducted in the building are not treated as a single undertaking under paragraph (c)(1) of this section. Instead, each partnership's share of such operations is treated as a separate paragraph (c) undertaking (the ''law-practice undertaking'' and the ''office-space undertaking'').

(iii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the office-space undertaking, if considered as a separate activity, would constitute a rental activity because all of the undertaking's gross income (including rents paid by the law partnership) represents amounts paid principally for the use of tangible property (the office space), the average period of customer use for the office space exceeds 30 days, extraordinary personal services (within the meaning of §1.469–1T(e)(3)(v)) are not provided, and the rental of the office space is not treated as incidental to a nonrental activity under §1.469–1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Accordingly, the office-space undertaking is treated as a rental undertaking. See, however, §1.469–2T(f)(6) (relating to certain rentals of property to a trade or business activity in which the taxpayer materially participates).

(iv) The law-practice undertaking, if considered as a separate activity, would not constitute a rental activity because none of the undertaking's gross income represents amounts paid principally for the use of tangible property. Accordingly, the law-practice undertaking is not treated as a rental undertaking.

Example 6. (i) The taxpayer owns a building in which the taxpayer operates a nursing home and a medical clinic. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The nursing-home operations consist of renting apartments in the nursing home to elderly and handicapped persons and providing medical care, meals, and social activities. (Assume that these services are extraordinary personal services (within the meaning of §1.469–1T(e)(3)(v)). The medical clinic provides medical care to nursing-home residents and other individuals. Nursing-home residents typically occupy an apartment for at least one year. The paragraph (c) undertaking derives 55 percent of its gross income from nursing-home operations (including the provision of medical services to nursing-home residents) and 45 percent of its gross income from medical-clinic operations. The operations conducted in the building are not incidental to any other activity of the taxpayer (within the meaning of §1.469–1T(e)(3)(vi)).

(ii) The paragraph (c) undertaking's nursing-home operations involve the provision of tangible property (the apartments) for use by customers and the provision of property and services in connection therewith. In addition, the apartments are not short-term real properties (within the meaning of paragraph (d)(3)(ii) of this section) because the average period of customer use (within the meaning of §1.469–1T(e)(3)(iii)) for the apartments exceeds 30 days. Accordingly, the nursing-home operations are rental operations (within the meaning of paragraph (d)(3) of this section). The medical-clinic operations do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the medical-clinic operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the nursing-home operations, if considered as a separate activity, would not constitute a rental activity because extraordinary personal services are provided in connection with making nursing-home apartments available for use by customers (see §1.469–T(e)(3)(ii)(C)). Thus, the exception in paragraph (d)(2)(i) of this section applies, and the nursing-home operations and the medical-clinic operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the nursing-home operations, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Thus, an undertaking that includes no rental operations other than the nursing-home operations would not, if considered as a separate activity, constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example 7. (i) The taxpayer rents and sells videocassettes. (Assumes that, under paragraph (c)(1) of this section, the videocassette operations are treated as a single paragraph (c) undertaking.) Renters of videocassettes typically keep the videocassettes for one or two days, and do not receive any other property or services in connection with videocassette rentals. The paragraph (c) undertaking derives 70 percent of its gross income from renting videocassettes and 30 percent of its gross income from selling videocassettes. The videocassette operations are not incidental to any other activity of the taxpayer (within the meaning of §1.469–1T(e)(3)(vi)).

(ii) The rental of videocassettes involves the provision of tangible property (the videocassettes) for use by customers. In addition, the special rules for short-term real properties contained in paragraph (d)(3)(ii) of this section do not apply in this case because the videocassettes are not real property. Thus, the operations that involve videocassette rentals are rental operations (within the meaning of paragraph (d)(3) of this section). The sale of videocassettes does not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the operations that involve videocassette sales are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the rental operations, if considered as a separate activity, would not constitute a rental activity because the average period of customer use for rented videocassettes does not exceed seven days (see §1.469–1T(e)(3)(ii)(A)). Accordingly, the exception in paragraph (d)(2)(i) of this section applies, and the videocassette-rental operations and videocassette-sales operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the videocassette-rental operations, if considered as a separate activity, would not constitute a rental activity (see (iii) above). Thus, an undertaking that includes no rental operations other than the videocassette-rental operations would not, if considered as a separate activity, constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example 8. (i) The taxpayer owns a building in which the taxpayer sells, leases, and services automobiles. (Assume that, under paragraph (c)(1) of this section, the operations conducted in the building are treated as a single paragraph (c) undertaking.) The minimum lease term for any leased automobile is 31 days, and the services provided to lessees (including periodic oil changes, lubrication, and routine services and repairs) are those customarily provided in long-term automobile leases. The paragraph (c) undertaking derives 75 percent of its gross income from selling automobiles, 15 percent of its gross income from servicing automobiles other than leased automobiles, and 10 percent of its gross income from leasing automobiles. The taxpayer's automobile operations are not incidental to any other activity of the taxpayer (within the meaning of §1.469–1T(e)(3)(vi)).

(ii) The paragraph (c) undertaking's automobile-leasing operations involve the provision of tangible property (the automobiles) for use by customers and the provision of services in connection therewith. In addition, the special rules for short-term real properties contained in paragraph (d)(3)(ii) of this section do not apply in this case because the automobiles are not real property. Accordingly, the automobile-leasing operations are rental operations (within the meaning of paragraph (d)(3) of this section). The paragraph (c) undertaking's automobile-sales operations and servicing operations for automobiles other than leased automobiles (the ''selling-and-servicing operations'') do not involve the provision of tangible property for use by customers or the provision of property or services in connection therewith. Thus, the selling-and-servicing operations are not rental operations.

(iii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, however, the exception in paragraph (d)(2)(ii) of this section applies because less than 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the ''automobile-leasing operations''). Accordingly, the rental operations and the selling-and-servicing operations are not treated as two separate undertakings under paragraph (d)(1)(i) of this section.

(iv) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the undertaking (determined after the application of paragraph (d)(1)(i) of this section) includes both the selling-and-servicing operations and the automobile-leasing operations, and the gross income of the undertaking does not represent amounts paid principally for the use of tangible property. Thus, the undertaking, if considered as a separate activity, would not constitute a rental activity. Accordingly, the undertaking is not treated as a rental undertaking.

Example 9. (i) The facts are the same as in Example 8, except that the paragraph (c) undertaking derives 60 percent of its gross income from selling automobiles, 15 percent of its gross income from servicing automobiles other than leased automobiles, and 25 percent of its gross income from leasing automobiles.

(ii) Paragraph (d)(1)(i) of this section provides, with certain exceptions, that a paragraph (c) undertaking's rental operations and its operations other than rental operations are treated as two separate undertakings. In this case, more than 20 percent of the paragraph (c) undertaking's gross income is attributable to rental operations (the automobile-leasing operations), and more than 20 percent is attributable to operations other than rental operations (the selling-and-servicing operations). Thus, the exceptions in paragraph (d)(2) (ii) and (iii) of this section do not apply. In addition, the average period of customer use for leased automobiles exceeds 30 days, extraordinary personal services (within the meaning of §1.469–1T(e)(3)(v)) are not provided, and the leasing of the automobiles is not treated as incidental to a nonrental activity under §1.469–1T(e)(3)(vi) (relating to incidental rentals that are not treated as a rental activity). Thus, the leasing operations, if considered as a separate activity, would constitute a rental activity, and the exception in paragraph (d)(2)(i) of this section does not apply. Accordingly, the rental operations and the selling-and-servicing operations are treated as two separate undertakings (the ''automobile-leasing undertaking'' and the ''automobile selling-and-servicing undertaking'').

(iii) Paragraph (d)(1)(iii) of this section provides that an undertaking (determined after the application of paragraph (d)(1)(i) of this section) is treated as a rental undertaking if and only if the undertaking, considered as a separate activity, would constitute a rental activity. In this case, the automobile-leasing undertaking would, if considered as a separate activity, constitute a rental activity, and the automobile selling-and-servicing undertaking would not, if considered as a separate activity, constitute a rental activity (see Example 8 and (ii) above). Accordingly, the automobile-leasing undertaking is treated as a rental undertaking, and the automobile selling-and-servicing undertaking is not.

(e) *Special rules for certain oil and gas operations*—(1) *Wells treated as nonpassive under §1.469–1T(e)(4)(i).* An oil or gas well shall be treated as an undertaking that is separate from other undertakings in determining the activities of a taxpayer for a taxable year if the following conditions are satisfied:

(i) The well is drilled or operated pursuant to a working interest (within the meaning of §1.469–1T(e)(4)(iv)) and at any time during such taxable year the taxpayer holds such working interest either—

(A) Directly; or

(B) Through an entity that does not limit the liability of the taxpayer with respect to the drilling or operation of such well pursuant to such working interest; and

(ii) The taxpayer would not be treated as materially participating (within the meaning of §1.469–5T) for the taxable year in the activity in which such well would be included if the taxpayer's activities were determined without regard to this paragraph (e).

(2) *Business and rental operations that constitute an undertaking.* In any case in which an oil or gas well is treated under this paragraph (e) as an undertaking that is separate from other undertakings, the business and rental operations that constitute such undertaking are the business and rental operations that are attributable to such well.

(3) *Examples.* The following examples illustrate the application of this paragraph (e). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example 1. During 1989, A directly owns an undivided interest in a working interest (within the meaning of §1.469–1T(e)(4)(iv)) in two oil wells. A does not participate in the activity in which the wells would be included if A's activities were determined without regard to this paragraph (e). Under paragraph (e)(1) of this section, each well is treated as a separate undertaking in determining A's activities for 1989 because A holds the working interest directly and would not be treated as materially participating for 1989 in the activity in which the wells would be included if A's activities were determined without regard to this paragraph (e). The aggregation rules in paragraph (f) of this section do not apply to these undertakings (see paragraph (f)(1)(ii)(B) of this section). Thus, each of the undertakings is treated as a separate activity under paragraph (b)(1) of this section. The result is the same even if A has net income from one or both wells for 1989 and even if the wells would otherwise be treated as part of the same undertaking under paragraph (c) of this section. The result would also be the same if A held the working interest through an entity, such as a general partnership, that does not limit A's liability with respect to the drilling or operation of the wells pursuant to the working interest.

Example 2. (i) During 1989, B is a general partner in a partnership that owns a working interest (within the meaning of §1.469–1T(e)(4)(iv)) in an oil well. B does not own any interest in the well other than through the partnership. At the end of 1989, however, B's partnership interest is converted into a limited partnership interest, and during 1990 B holds the working interest only as a limited partner. B does not participate in the activity in which the well would be included if B's activities were determined without regard to this paragraph (e).

(ii) Under paragraph (e)(1) of this section, the well is treated as a separate undertaking in determining B's activities for 1989 because B holds the working interest during 1989 through an entity that does not limit B's liability with respect to the drilling or operation of the well pursuant to the working interest, and B would not be treated as materially participating for 1989 in the activity in which the well would be included if B's activities were determined without regard to this paragraph (e). Throughout 1990, however, B's liability with respect to the drilling and operation of the well is limited by the entity through which B holds the working interest (*i.e.*, the limited partnership). Accordingly, paragraph (e)(1) of this section does not apply to the well in 1990, and the well may be included under paragraph (c) of this section in an undertaking that includes other operations.

Example 3. The facts are the same as in Example 2, except that B's partnership interest is converted into a limited partnership interest at the end of November 1989. An oil or gas well may be treated as a separate undertaking under paragraph (e)(1) of this section if at any time during the taxable year the taxpayer holds a working interest in the well directly or through an entity that does not limit the taxpayer's liability with respect to the drilling or operation of the well pursuant to the working interest (see §1.469–1T(e)(4)(i)). Thus, although B's liability with respect to the drilling and operation of the well is limited during December 1989, the result in both 1989 and 1990 is the same as in Example 2. In 1989, however, disqualified deductions and a ratable portion of the gross income from the well may be treated under §1.469–1T(e)(4)(ii) as passive activity deductions and passive activity gross income, respectively.

(f) *Certain trade or business undertakings treated as part of the same activity*—(1) *Applicability*—(i) *In general.* This paragraph (f) applies to a taxpayer's interests in trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section).

(ii) *Trade or business undertaking.* For purposes of this paragraph (f), the term ''trade or business undertaking'' means any undertaking in which a taxpayer has an interest, other than—

(A) A rental undertaking (within the meaning of paragraph (d) of this section);

(B) An oil or gas well treated as an undertaking that is separate from other undertakings under paragraph (e) of this section; or

(C) A professional service undertaking (within the meaning of paragraph (h) of this section).

(2) *Treatment as part of the same activity.* A taxpayer's interests in two or more trade or business undertakings that are similar (within the meaning of paragraph (f)(4) of this section) and controlled by the same interests (within the meaning of paragraph (j) of this section) shall be treated as part of the same activity of the taxpayer for any taxable year in which the taxpayer—

(i) Owns interests in each such undertaking through the same passthrough entity;

(ii) Owns a direct or substantial indirect interest (within the meaning of paragraph (f)(3) of this section) in each such undertaking; or

(iii) Materially or significantly participates (within the meaning of §1.469–5T) in the activity that would result if such undertakings were treated as part of the same activity.

(3) *Substantial indirect interest*—(i) *In general.* For purposes of this paragraph (f), a taxpayer owns a substantial indirect interest in an undertaking for a taxable year if at any time during such taxable year the taxpayer's ownership

percentage (determined in accordance with paragraph (j)(3) of this section) in a passthrough entity that directly owns such undertaking exceeds ten percent.

(ii) *Coordination rule.* A taxpayer shall be treated for purposes of this paragraph (f) as owning a substantial indirect interest in each of two or more undertakings for any taxable year in which—

(A) Such undertakings are treated as part of the same activity of the taxpayer under paragraph (f)(2)(i) of this section; and

(B) The taxpayer owns a substantial indirect interest (within the meaning of paragraph (f)(3)(i) of this section) in any such undertaking.

(4) *Similar undertakings*—(i) *In general.* Except as provided in paragraph (f)(4)(iii) of this section, two undertakings are similar for purposes of this paragraph (f) if and only if—

(A) There are predominant operations in each such undertaking; and

(B) The predominant operations of both undertakings are in the same line of business.

(ii) *Predominant operations.* For purposes of paragraph (f)(4)(i)(A) of this section, there are predominant operations in an undertaking if more than 50 percent of the undertaking's gross income is attributable to operations in a single line of business.

(iii) *Vertically-integrated undertakings.* If an undertaking (the ''supplier undertaking'') provides property or services to other undertakings (the ''recipient undertakings''), the following rules apply for purposes of this paragraph (f):

(A) *Supplier undertaking similar to recipient undertaking.* If the supplier undertaking predominantly involves the provision of property and services to a recipient undertaking that is controlled by the same interests (within the meaning of paragraph (j) of this section), the supplier undertaking shall be treated as similar to the recipient undertaking. For purposes of applying the preceding sentence—

(*1*) If a supplier undertaking and two or more recipient undertakings that are similar (within the meaning of paragraph (f)(4)(i) of this section) are controlled by the same interests, such recipient undertakings shall be treated as a single undertaking; and

(*2*) A supplier undertaking predominantly involves the provision of property and services to a recipient undertaking for any taxable year in which such recipient undertaking obtains more than 50 percent (by value) of all property and services provided by the supplier undertaking.

(B) *Recipient undertaking similar to supplier undertaking.* If the supplier undertaking is the predominant provider of property and services to a recipient undertaking that is controlled by the same interests (within the meaning of paragraph (j) of this section), the recipient undertaking shall be treated, except as otherwise provided in paragraph (f)(4)(iii)(C) of this section, as similar to the supplier undertaking. For purposes of the preceding sentence, a supplier undertaking is the predominant provider of property and services to a recipient undertaking for any taxable year in which the supplier undertaking provides more than 50 percent (by value) of all property and services obtained by the recipient undertaking.

(C) *Coordination rules.* (*1*) Paragraph (f)(4)(iii)(B) of this section does not apply if, under paragraph (f)(4)(iii)(A) of this section—

(*i*) The supplier undertaking is treated as an undertaking that is similar to any recipient undertaking;

(*ii*) The recipient undertaking is treated as a supplier undertaking that is similar to another recipient undertaking; or

(*iii*) Another supplier undertaking is treated as an undertaking that is similar to the recipient undertaking.

(*2*) If paragraph (f)(4)(iii)(A) of this section applies to a supplier undertaking, the supplier undertaking shall be treated as similar to undertakings that are similar to the recipient undertaking and shall not otherwise be treated as similar to undertakings to which the supplier undertaking would be similar without regard to paragraph (f)(4)(iii) of this section.

(*3*) If paragraph (f)(4)(iii)(B) of this section applies to a recipient undertaking, the recipient undertaking shall be treated as similar to undertakings that are similar to the supplier undertaking and shall not otherwise be treated as similar to undertakings to which the recipient undertaking would be similar without regard to paragraph (f)(4)(iii) of this section.

(iv) *Lines of business.* The Commissioner shall establish, by revenue procedure, lines of business for purposes of this paragraph (f)(4). Business and rental operations that are not included in the lines of business established by the Commissioner shall nonetheless be included in a line of business for purposes of this paragraph (f)(4). Such operations shall be included in a single line of business or in multiple lines of business on a basis that reasonably reflects—

(A) Similarities and differences in the property or services provided pursuant to such operations and in the markets to which such property or services are offered; and

(B) The treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences.

(5) *Examples.* The following examples illustrate the application of this paragraph (f). In each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusions relate to a single taxable year.

Example 1. (i) The taxpayer is a partner in partnerships A, B, C, and D and owns a five-percent interest in each partnership. Each partnership owns a single undertaking (undertakings A, B, C, and D), and the undertakings are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that are controlled by the same interests (within the meaning of paragraph (j) of this section). In addition, undertakings A, B, and D are similar (within the meaning of paragraph (f)(4) of this section). The taxpayer is not related to any of the other partners, and does not participate in any of the undertakings.

(ii) In general, each undertaking in which a taxpayer owns an interest is treated as a single activity that is separate from other activities of the taxpayer (see paragraph (b)(1) of this section). This paragraph (f) provides aggregation rules for trade or business undertakings that are similar and controlled by the same interests. These aggregation rules do not apply, however, unless the taxpayer owns interests in the undertakings through the same passthrough entity, owns direct or substantial indirect interests in the undertakings, or materially or significantly participates in the undertakings. In this case, the taxpayer does not satisfy any of these conditions, and the aggregation rules in this paragraph (f) do not apply. Accordingly, except as otherwise provided in paragraph (g) of this section (relating to an aggregation rule for integrated businesses), undertakings A, B, C, and D are treated as separate activities of the taxpayer under paragraph (b)(1) of this section.

Example 2. (i) The facts are the same as in Example 1, except that the taxpayer owns a 25-percent interest in partnership A, a 15-percent interest in partnership B, and a 40-percent interest in partnership C.

(ii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the taxpayer owns more than ten percent of partnerships A, B, and C, and these partnerships directly own undertakings A, B, and C. Thus, the taxpayer owns a substantial indirect interest in undertakings A, B, and C (see paragraph (f)(3)(i) of this section). Of these undertakings, only undertakings A and B are both similar and controlled by the same interests. Accordingly, the taxpayer's interests in undertakings A and B are treated as part of the same activity. As in Example 1, the aggregation rules in this paragraph (f) do not apply to undertakings C and D, and except as otherwise provided in paragraph (g) of this section, undertakings C and D are treated as separate activities.

Example 3. (i) The facts are the same as in Example 1, except that the taxpayer participates (within the meaning of §1.469–5T(f)) for 60 hours in undertaking A and for 60 hours in undertaking B.

(ii) Paragraph (f)(2)(iii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer materially or significantly participates (within the meaning of §1.469–5T) in the activity that would result from the treatment of similar, commonly-controlled undertakings as part of the same activity. In this case, the activity that would result from treating the similar, commonly-controlled undertakings as part of the same activity consists of undertakings A, B, and D, and the taxpayer participates for 120 hours in the activity that results from this treatment. Accordingly, undertakings A, B, and D are treated as part of the same activity because the taxpayer significantly participates (within the meaning of §1.469–5T(c)(2)) in the activity that results from this treatment. The result is the same whether the taxpayer participates in one, two, or all three of the similar, commonly-controlled undertakings, so long as the taxpayer's aggregate participation in undertakings A, B, and D exceeds 100 hours. As in Example 1, the aggregation rules in this paragraph (f) do not apply to undertaking C, and except as otherwise provided in paragraph (g) of this section, undertaking C is treated as a separate activity.

Example 4. (i) The taxpayer owns a 5-percent interest in partnership A. Partnership A owns interests in partnerships B and C, each of which owns a single undertaking (undertakings B and C). In addition, the taxpayer is a partner in partnerships C and D and directly owns a 15-percent interest in each partnership. Partnership D also owns a single undertaking (undertaking D). Undertakings B, C, and D are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that are similar (within the meaning of paragraph (f)(4) of this section) and controlled by the same interests (within the meaning of paragraph (j) of this section). The taxpayer does not participate in undertaking B, C, or D.

(ii) Paragraph (f)(2)(i) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns interests in the undertakings through the same passthrough entity. In this case, the taxpayer owns interests in undertakings B and C through partnership A. Thus, the taxpayer's interests in undertakings B and C are treated as part of the same activity.

(iii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the taxpayer owns more than ten percent of partnerships C and D, and these partnerships directly own undertakings C and D. Thus, the taxpayer owns a substantial indirect interest in undertakings C and D (see paragraph (f)(3)(i) of this section).

(iv) The coordination rule in paragraph (f)(3)(ii) of this section applies to undertakings B and C because they are treated as part of the same activity under paragraph (f)(2)(i) of this section, and the taxpayer owns a substantial indirect interest in undertaking C. Under the coordination rule, the taxpayer is treated as owning a substantial indirect interest in undertaking B as well as undertaking C. Accordingly, the taxpayer's interests in undertakings B, C, and D are treated as part of the same activity.

Example 5. (i) Undertakings A, B, C, and D are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section), each of which involves the operation of a department store, restaurants, and movie theaters. The following table shows, for each undertaking, the percentages of gross income attributable to the various operations of the undertaking.

	Department store	Restaurants	Movie Theaters
Undertaking A	70%	20%	10%
Undertaking B	60%	20%	20%
Undertaking C	35%	35%	30%
Undertaking D	35%	10%	55%

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that ''general merchandise stores,'' ''eating and drinking places,'' and ''motion picture services'' are three separate lines of business.)

(iii) Undertaking A and undertaking B each derives more than 50 percent of its gross income from department-store operations, which are in the general-merchandise-store line of business. Thus, there are predominant operations in undertaking A and undertaking B, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings A and B are similar.

(iv) Undertaking C does not derive more than 50 percent of its gross income from operations in any single line of business. Thus, there are no predominant operations in undertaking C, and undertaking C is not similar to any of the other undertakings.

(v) Undertaking D derives more than 50 percent of its gross income from movie-theater operations, which are in the motion-picture-services line of business. Thus, there are predominant operations in undertaking D. The predominant operations of undertaking D, however, are not in the same line of business as those of undertakings A and B. Accordingly, undertaking D is not similar to undertakings A and B.

Example 6. (i) Undertakings A and B are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that derive all of their gross income from the sale of automobiles. Undertakings C and D derive all of their gross income from the rental of automobiles. Undertaking C is not a rental undertaking (within the meaning of paragraph (d)(1)(iii) of this section) because the average period of customer use (within the meaning of §1.469–1T(e)(3)(iii)) for its automobiles does not exceed seven days (see §1.469–1T(e)(3)(ii)(A)). Undertaking D, on the other hand, leases automobiles for periods of one year or more and is a rental undertaking.

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that (a) ''automotive dealers and service stations'' (automotive retail) and (b) ''auto repair, services (including rentals), and parking'' (automotive services) are two separate lines of business.)

(iii) Undertakings A and B both derive more than 50 percent of their gross income from operations in the automotive-retail line of business (the automobile-sales operations). Similarly, undertakings C and D both derive more than 50 percent of their gross income from operations in the automotive-services line of business (the automobile-rental operations). Thus, there are predominant operations in each undertaking, the predominant operations of undertakings A and B are in the same line of business, and the predominant operations of undertakings C and D are in the same line of business. Accordingly, undertakings A and B are similar, undertakings C and D are similar, and undertakings A and B are not similar to undertakings C and D.

(iv) Paragraph (f)(1) of this section provides that this paragraph (f) applies only to trade or business undertakings and that a rental undertaking is not a trade or business undertaking. Accordingly, this paragraph (f) does not apply to undertaking D, and undertakings C and D, although similar, are not treated, under this paragraph (f), as part of the same activity.

Example 7. (i) Undertakings A, B, and C are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that involve real estate operations. Undertaking A derives all of its gross income from the development of real property, undertaking B derives all of its gross income from the management of real property and the performance of services as a leasing agent with respect to real property, and undertaking C derives all of its gross income from buying, selling, or arranging purchases and sales of real property. Undertaking D derives all of its gross income from the rental of residential apartments and is a rental undertaking (within the meaning of paragraph (d)(1)(iii) of this section).

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that real estate development and services (including the development and management of real property, dealing in real property, and the performance of services as a leasing agent with respect to real property) is a single line of business (the ''real-estate'' line of business).)

(iii) Undertakings A, B, and C all derive more than 50 percent of their gross income from operations in the real-estate line of business. Thus, there are predominant operations in undertakings A, B, and C, and the predominant operations of the three undertakings are in the same line of business. Accordingly, undertakings A, B, and C are similar.

(iv) Undertaking D also derives more than 50 percent of its gross income from operations in the real-estate line of business. Thus, there are predominant operations in undertaking D, and the predominant operations of undertaking D are in the same line of business as those of undertakings A, B, and C. Paragraph (f)(1) of this section provides, however, that this paragraph (f) applies only to trade or business undertakings and that a rental undertaking is not a trade or business undertaking. Accordingly, this paragraph (f) does not apply to undertaking D, and undertaking D, although similar to undertakings A, B, and C, is not treated, under this paragraph (f), as part an activity that includes undertaking A, B, or C.

Example 8. (i) Undertakings A and B are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section), both of which involve the provision of moving services. Undertaking A derives its gross income principally from local moves, and undertaking B derives its gross income principally from long-distance moves.

(ii) Paragraph (f)(4)(i) of this section provides that two undertakings are similar for purposes of this paragraph (f) if there are predominant operations in each undertaking and the predominant operations of the two undertakings are in the same line of business. Under paragraph (f)(4)(iv) of this section, operations that are not in the lines of business established by the applicable revenue procedure are nonetheless included in a line of business. In addition, such operations are included in a single line of business or in multiple lines of business on a basis that reasonably reflects (a) similarities and differences in the property or services provided pursuant to such operations and in the markets to which such property or services are offered, and (b) the treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences. (Assume that the provision of moving services is not in any line of business established by the Commissioner and that within the lines of business established by the Commissioner services that differ only in the distance over which they are performed (*e.g.,* local and long-distance telephone services) are generally treated as part of the same line of business.)

(iii) Undertakings A and B provide the same types of services to similar customers, and the only significant difference in the services provided is the distance over which they are performed. Thus, treating local and long-distance moving services as a single line of business (the ''moving-services'' line of business) reasonably reflects the treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences.

(iv) Each undertaking derives more than 50 percent of its gross income from operations in the moving-services line of business. Thus, there are predominant operations in each undertaking, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings A and B are similar.

Example 9. (i) Undertakings A, B, C, D, and E are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Undertakings A, B, and C derive all of their gross income from retail sales of dairy products, and undertakings D and E derive all of their gross income from the processing of dairy products. Undertakings D and E sell less than ten percent of their dairy products to undertakings A, B, and C, and sell the remainder to unrelated undertakings. Undertakings A, B, and C purchase less than ten percent of their inventory from undertakings D and E and purchase the remainder from unrelated undertakings.

(ii) Paragraph (f)(4)(i) of this section provides that, except as provided in paragraph (f)(4)(iii) of this section, undertakings are similar for purposes of this paragraph (f) if and only if there are predominant operations in each undertaking and the predominant operations of the undertakings are in the same line of business. (Assume that the applicable revenue procedure provides that (a) ''food stores'' and (b) ''manufacturing—food and kindred products'' are two separate lines of business.)

(iii) Undertakings A, B, and C all derive more than 50 percent of their gross income from operations in the food-store line of business (the dairy-sales operations). Thus, there are predominant operations in undertakings A, B, and C, and the predominant operations of the three undertakings are in the same line of business. Accordingly, undertakings A, B, and C are similar.

(iv) Undertakings D and E both derive more than 50 percent of their gross income from operations in the food-manufacturing line of business (the dairy-processing operations). Thus, there are predominant operations in undertakings D and E, and the predominant operations of the two undertakings are in the same line of business. Accordingly, undertakings D and E are similar. The predominant operations of undertakings D and E are not in the same line of business as those of undertakings A, B, and C. Accordingly, undertakings D and E are not similar to undertakings A, B, and C.

(v) Paragraph (f)(4)(iii) of this section provides rules under which certain undertakings whose operations are not in the same line of business nevertheless are similar to one another if one of the undertakings (the ''supplier undertaking'') provides property or services to the other undertaking (the ''recipient undertaking''), and the undertakings are controlled by the same interests. These rules apply, however, only if the supplier undertaking predominantly involves the provision of property and services to the recipient undertaking (see paragraph (f)(4)(iii)(A) of this section), or the supplier undertaking is the predominant provider of property and services to the recipient undertaking (see paragraph (f)(4)(iii)(B) of this section). In this case, undertakings D and E are supplier undertakings, and undertakings A, B, and C are recipient undertakings. Undertakings D and E, however, sell less than ten percent of their dairy products to undertakings A, B, and C and thus do not predominantly involve the provision of property and services to recipient undertakings. Similarly, undertakings D and E are not the predominant providers of property and services to undertakings A, B, and C. Thus, the rules for vertically-integrated undertakings in paragraph (f)(4)(iii) of this section do not apply in this case.

Example 10. (i) The facts are the same as in Example 9, except that undertaking D sells 75 percent of its dairy products to undertakings A, B, and C.

(ii) Paragraph (f)(4)(iii)(A) of this section applies if a supplier undertaking predominantly involves the provision of property to a recipient undertaking that is controlled by the same interests. Paragraph (f)(4)(iii)(A)(*2*) of this section provides that a supplier undertaking predominantly involves the provision of property to a recipient undertaking if the supplier undertaking provides more than 50 percent of its property to such recipient undertaking. In addition, paragraph (f)(4)(iii)(A)(*1*) of this section provides that if a supplier undertaking and two or more similar recipient undertakings are controlled by the same interests, the recipient undertakings are treated as a single undertaking for purposes of applying paragraph (f)(4)(iii)(A) of this section. Undertakings D and E both provide dairy products to undertakings A, B, and C. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertakings D and E are supplier undertakings and undertakings A, B, and C are recipient undertakings. Undertaking D predominantly involves the provision of property to undertakings A, B, and C. Moreover, undertakings

A, B, and C are treated as a single undertaking under paragraph (f)(4)(iii)(A)(*1*) of this section because undertakings A, B, and C are similar to one another under paragraph (f)(4)(i) of this section, and undertakings A, B, C, and D are controlled by the same interests. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings A, B, C, and D.

(iii) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii) (A) and (C)(*2*) of this section as an undertaking that is similar to the recipient undertakings and to undertakings to which the recipient undertakings are similar. Accordingly, undertaking D is similar, for purposes of this paragraph (f), to undertakings A, B, and C.

(iv) Undertaking E does not predominantly involve the provision of property to undertakings A, B, and C, or to any other related undertakings. Thus, paragraph (f)(4)(iii)(A) of this section does not apply to undertaking E, and undertaking E is not similar to undertakings A, B, and C. Moreover, undertakings D and E are not similar because, under paragraph (f)(4)(iii)(C)(*2*) of this section, undertaking D is not similar to any undertaking that is not similar to undertakings A, B, and C.

Example 11. (i) The facts are the same as in Example 10, except that 75 percent of undertaking D's dairy products are sold to undertakings A and B, and none are sold to undertaking C.

(ii) In this case, undertaking D is a supplier undertaking only with respect to undertakings A and B. Accordingly, paragraph (f)(4)(iii)(A) applies only to undertakings A, B, and D. As in Example 10, undertaking D is similar to undertakings A and B, and is not similar to undertaking E. In addition, if paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(C)(*2*) of this section as an undertaking that is similar to the recipient undertakings and undertakings to which the recipient undertakings are similar. Accordingly, even though undertaking D does not provide any property or services to undertaking C, undertaking D is similar to undertaking C because undertaking C is similar to undertakings A and B.

Example 12. (i) The facts are the same as in Example 9, except that undertakings A and B purchase 80 percent of their inventory from undertaking D.

(ii) Paragraph (f)(4)(iii)(B) of this section applies, except as provided in paragraph (f)(4)(iii)(C) of this section, if a supplier undertaking is the predominant provider of property to a recipient undertaking that is controlled by the same interests. Undertakings D and E both provide dairy products to undertakings A, B, and C. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertakings D and E are supplier undertakings, and undertakings A, B, and C are recipient undertakings. In addition, undertaking D is the predominant provider of property and services to undertakings A and B, and undertakings A, B and D are controlled by the same interests. Thus, except as provided in paragraph (f)(4)(iii)(C) of this section, paragraph (f)(4)(iii)(B) of this section applies to undertakings A, B, and D.

(iii) The coordination rules in paragraph (f)(4)(iii)(C)(*1*) of this section provide that paragraph (f)(4)(iii)(B) of this section does not apply in certain cases to which paragraph (f)(4)(iii)(A) of this section applies. These coordination rules would apply if undertaking D or E (or any other undertaking that is controlled by the interests that control undertakings A, B, and C) predominantly involved the provision of property and services to undertakings A, B, and C. The coordination rules in paragraph (f)(4)(iii)(C)(*1*) of this section would also apply if undertaking A, B, or D predominantly involved the provision of property or services to a recipient undertaking that is controlled by the same interests. Assume that these coordination rules do not apply in this case.

(iv) If paragraph (f)(4)(iii)(B) of this section applies to supplier and recipient undertakings, the recipient undertakings are treated under paragraph (f)(4)(iii) (B) and (C)(*3*) of this section as undertakings that are similar to the supplier undertaking and to undertakings to which the supplier undertaking is similar. Accordingly, undertakings A and B are similar, for purposes of this paragraph (f), to undertaking D and, because undertakings D and E are similar, to undertaking E.

(v) The principal providers of property and services to undertaking C are unrelated undertakings. Thus, paragraph (f)(4)(iii)(B) of this section does not apply to undertaking C, and undertaking C is not similar to undertakings D and E. Moreover, undertaking C is not similar to undertakings A and B because, under paragraph (f)(4)(iii)(C)(*3*) of this section, undertakings A and B are not similar to any undertaking that is not similar to undertaking D.

Example 13. (i) Undertakings A through Z are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Undertaking A derives all of its gross income from the manufacture and sale of men's and women's clothing, undertaking B derives all of its gross income from sales of men's and women's clothing to retail stores, and undertakings C through Z derive all of their gross income from retail sales of men's and women's clothing. Undertaking A sells clothing exclusively to undertaking B.

Undertaking B sells 75 percent of its clothing to undertakings C through Z, and sells the remainder to unrelated retail stores. Undertaking B purchases 80 percent of its inventory from undertaking A, and undertakings C through Z purchase 60 to 90 percent of their inventory from undertaking B.

(ii) Paragraph (f)(4)(iii)(A) of this section applies if a supplier undertaking predominantly involves the provision of property to a recipient undertaking that is controlled by the same interests. In addition, paragraph (f)(4)(iii)(A)(*1*) of this section provides that if a supplier undertaking and two or more similar recipient undertakings are controlled by the same interests, the recipient undertaking are treated as a single undertaking for this purpose. Undertaking B provides men's and women's clothing to undertaking C through Z. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertaking B is a supplier undertaking and undertakings C through Z are recipient undertakings. In addition, undertaking B predominantly involves the provision of property to undertakings C through Z, and undertakings C through Z are treated as a single undertaking for purposes of paragraph (f)(4)(iii)(A) of this section. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings B and C through Z.

(iii) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(A) of this section as an undertaking that is similar to the recipient undertakings. Accordingly, undertaking B is similar, for purposes of this paragraph (f), to undertakings C through Z.

(iv) Undertaking A provides men's and women's clothing to undertaking B. Thus, for purposes of paragraph (f)(4)(iii) of this section, undertaking A is a supplier undertaking and undertaking B is a recipient undertaking. In addition, undertaking A predominantly involves the provision of property to undertaking B, and undertakings A and B are controlled by the same interests. Accordingly, paragraph (f)(4)(iii)(A) of this section applies to undertakings A and B, and undertaking A is similar to undertaking B.

(v) If paragraph (f)(4)(iii)(A) of this section applies to supplier and recipient undertakings, the supplier undertaking is treated under paragraph (f)(4)(iii)(C)(*2*) of this section as an undertaking that is similar to undertakings to which the recipient undertakings are similar. Accordingly, undertaking A is also similar, for purposes of this paragraph (f), to undertakings C through Z.

(vi) The coordination rule in paragraph (f)(4)(iii)(C)(*1*)(*i*) of this section provides that paragraph (f)(4)(iii)(B) of this section does not apply if, as described above, the supplier undertaking predominantly involves the provision of property to recipient undertakings and is treated under paragraph (f)(4)(iii)(A) of this section as an undertaking that is similar to such recipient undertakings. Accordingly, paragraph (f)(4)(iii)(B) of this section does not apply to undertakings B through Z, even though undertaking B is the predominant provider of property and services to undertakings C through Z, and undertakings B through Z are controlled by the same interests. For the same reason, paragraph (f)(4)(iii)(B) of this section does not apply to undertaking A and B. (Paragraph (f)(4)(iii)(B) of this section is also inapplicable to undertakings A and B because the coordination rule in paragraph (f)(4)(iii)(C)(*1*)(*ii*) of this section applies if the recipient undertaking (undertaking B) is itself a supplier undertaking that is treated under paragraph (f)(4)(iii)(A) of this section as an undertaking that is similar to its recipient undertakings (undertakings C through Z).)

(g) *Integrated businesses*—(1) *Applicability*—(i) *In general.* This paragraph (g) applies to a taxpayer's interests in trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section).

(ii) *Trade or business activity.* For purposes of this paragraph (g), the term ''trade or business activity'' means any activity (determined without regard to this paragraph (g)) that consists of interests in one or more trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section).

(2) *Treatment as a single activity.* A taxpayer's interests in two or more trade or business activities shall be treated as a single activity if and only if—

(i) The operations of such trade or business activities constitute a single integrated business, activities constitute a single integrated business; and

(ii) Such activities are controlled by the same interests (within the meaning of paragraph (j) of this section).

(3) *Facts and circumstances test.* In determining whether the operations of two or more trade or business activities constitute a single integrated business for purposes of this paragraph (g), all the facts and circumstances are taken into account, and the following factors are generally the most significant:

(i) Whether such operations are conducted at the same location;

(ii) The extent to which other persons conduct similar operations at one location;

(iii) Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;

(iv) The extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;

(v) Whether such operations are owned by the same person (within the meaning of paragraph (c)(2)(v) of this section);

(vi) The extent to which such operations involve products or services that are commonly provided together;

(vii) The extent to which such operations serve the same customers;

(viii) The extent to which the same personnel, facilities, or equipment are used to conduct such operations;

(ix) The extent to which such operations are conducted in coordination with or reliance upon each other;

(x) The extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations;

(xi) The extent to which such operations depend on each other for their economic success; and

(xii) Whether such operations are conducted under the same trade name.

(4) *Examples.* The following examples illustrate the application of this paragraph (g). The facts, analysis, and conclusion in each example relate to a single taxable year, and the trade or business activities described in each example are controlled by the same interests (within the meaning of paragraph (j) of this section).

Example 1. (i) The taxpayer owns a number of department stores and auto-supply stores. Some of the taxpayer's department stores include auto-supply departments. In other cases, the taxpayer operates a department store and an auto-supply store at the same location (within the meaning of paragraph (c)(2)(iii) of this section), or at different locations from which the same group of customers can be served. In cases in which a department store and an auto-supply store are operated at the same location, the department-store operations are the predominant operations (within the meaning of paragraph (f)(4)(ii) of this section), and the undertaking that includes the stores is treated as a department-store undertaking for purposes of paragraph (f) of this section. Under paragraph (f) of this section, the department-store undertakings are all treated as part of the same activity of the taxpayer (the ''department-store activity''). Similarly, the auto-supply undertakings (*i.e.*, the auto-supply stores that are not operated at a department-store location) are all treated as part of the same activity (the ''auto-supply activity''). (Assume that department-store undertakings and auto-supply undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

(ii) The department stores and auto-supply stores use a common trade name and coordinate their marketing activities (*e.g.*, the stores advertise in the same catalog and the same newspaper supplements, honor the same credit cards (including credit cards issued by the department stores), and jointly conduct sales and other promotional activities). Although sales personnel generally work only in a particular store or in a particular department within a store, other employees (*e.g.*, cashiers, janitorial and maintenance workers, and clerical staff) may work in or perform services for various stores, including both department and auto-supply stores. In addition, the management of store operations is organized on a geographical basis, and managers above the level of the individual store generally supervise operations in both types of store. A central office provides payroll, financial, and other support services to all stores and establishes pricing and other business policies. Most inventory for both types of stores is acquired through a central purchasing department and inventory for all stores in an area is stored in a common warehouse.

(iii) Based on the foregoing facts and circumstances, the operations of the department-store activity and the auto-supply activity constitute an integrated business. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the conduct of department-store and auto-supply operations at the same location, the location of department and auto-supply stores at sites where the same group of customers can be served, the treatment of all such operations as a unit in the taxpayer's financial statements, the taxpayer's ownership and the common management of all such operations, the use of the same personnel, facilities, and equipment to conduct and support the operations, the use of a common trade name, and the coordination (as evidenced by the coordinated marketing activities) of department-store and auto-supply operations.

(iv) Paragraph (g)(2) of this section provides that a taxpayer's interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. The department-store activity and the auto-supply activity consist of trade or business undertakings and, thus, are trade or business activities. In addition, the activities are controlled by the same interests (the taxpayer), and the operations of the activities constitute an integrated business. Accordingly, the department-store activity and the auto-supply activity are treated as a single activity of the taxpayer.

Example 2. (i) The taxpayer owns a number of stores that sell stereo equipment and a repair shop that services stereo equipment. Under paragraph (f) of this section, the stores are all treated as part of the same activity of the taxpayer (the ''store activity''). The repair shop does not sell stereo equipment, does not predominantly involve the provision of services to the taxpayer's stores, and is treated as a separate activity (the ''repair-shop activity''). (Assume that stereo-sales undertakings and stereo-repair undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

(ii) The stores sell stereo equipment produced by manufacturers for which the stores are an authorized distributor. The repair shop's operations principally involve the servicing of stereo equipment produced by the same manufacturers. These operations include repairs on equipment under warranty for which reimbursement is received from the manufacturer and reconditioning of equipment taken as trade-ins by the taxpayer's stores. The majority of the operations, however, involve repairs that are performed for customers and are not covered by a warranty. The taxpayer's distribution agreements with manufacturers generally require the taxpayer to repair and service equipment produced by the manufacturer both during and after the warranty period. In some cases, the distribution agreements require that the taxpayer's repair facility meet the manufacturer's standards and provide for periodic inspections to ensure that these standards are met.

(iii) The stores and the repair shop use a common trade name. Sales personnel generally work only in a particular store and stereo technicians work only in the repair shop. The stores and the repair shop are, however, managed from a central office, which supervises both store and repair-shop operations, provides payroll, financial, and other support services to the stores and the repair shop, and establishes pricing and other business policies. In addition, inventory for the stores and supplies for the repair shop are acquired through a central purchasing department and are stored in a single warehouse.

(iv) Based on the foregoing facts and circumstances, the operations of the store activity and the repair-shop activity constitute an integrated business. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the treatment of all such operations as a unit in the taxpayer's financial statements, the taxpayer's ownership and the common management of all such operations, the use of the same personnel and facilities to support the operations, the use of a common trade name, the extent to which the same customers patronize both the stores and the repair shop, the similarity of the products (*i.e.*, stereo equipment) involved in both store and repair-shop operations, and the extent to which the provision of repair services contributes to the taxpayer's ability to obtain the stereo equipment sold in store operations.

(v) Paragraph (g)(2) of this section provides that a taxpayer's interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. The store activity and repair-shop activity consist of trade or business undertakings and thus are trade or business activities. In addition, the activities are controlled by the same interests (the taxpayer), and the operations of the activities constitute an integrated business. Accordingly, the store activity and the repair-shop activity are treated as a single activity of the taxpayer.

Example 3. (i) The taxpayer owns interests in three partnerships. One partnership owns a television station, the second owns a professional sports franchise, and the third owns a motion-picture production company. The operations of the partnerships are treated as three separate undertakings. Although other persons own interests in the partnerships, all three undertakings are controlled (within the meaning of paragraph (j) of this section) by the taxpayer. The operations of the partnerships are treated as three separate activities (the ''television activity,'' the ''sports activity,'' and the ''motion-picture activity''). (Assume that the undertakings are not similar and are not treated as part of the same activity under paragraph (f) of this section.)

(ii) Each partnership prepares financial statements that reflect only the results of that partnership's operations, and each of the activities is conducted under its own trade name. The taxpayer participates extensively in the management of each partnership and makes the major business decisions for all three partnerships. Each partnership, however, employs separate management and other personnel who conduct its operations on a day-to-day basis. The taxpayer generally arranges the partnerships' financing and often obtains loans for two, or all three, partnerships from the same source. Although the assets of one partnership are not used as security for loans to another partnership, the taxpayer's interest in a partnership may secure loans to the other partnerships. The television station broadcasts the sports franchise's games, and the motion-picture production company occasionally prepares programming for the television station. In addition, support staff of one partnership may, during periods of peak activity or in the case of emergency, be made available to another partnership on a temporary basis. There are no other significant transactions between the partnerships. Moreover, all transactions between the partnerships involve essentially the same terms as would be provided in transactions between unrelated persons.

(iii) Based on the foregoing facts and circumstances, the television activity, the sports activity, and the motion-picture activity constitute three separate businesses. Paragraph (g)(3) of this section provides that the factors relevant to this determination include the treatment of the activities as separate units in the partnerships' financial statements, the use of a different trade name for each activity, the separate day-to-day management of the activities, and the limited extent to which the activities contribute to or depend on each other (as evidenced by the small number of significant transactions between the partnerships and the arm's length nature of those transactions). The taxpayer's participation in management and financing are taken into account in this determination, as are the transactions between the partnerships, but these factors do not of themselves support a determination that the activities constitute an integrated business.

(iv) Paragraph (g)(2) of this section provides that a taxpayer's interests in two or more trade or business activities (within the meaning of paragraph (g)(1)(ii) of this section) are treated as a single activity of the taxpayer only if the operations of such activities constitute an integrated business and the activities are controlled by the same interests. In this case, the taxpayer's activities do not constitute an integrated business, and the aggregation rule in paragraph (g)(2) of this section does not apply. Accordingly, the television activity, the sports activity, and the motion-picture activity are treated as three separate activities of the taxpayer.

(h) *Certain professional service undertakings treated as a single activity*—(1) *Applicability*—(i) *In general.* This paragraph (h) applies to a taxpayer's interests in professional service undertakings (within the meaning of paragraph (h)(1)(ii) of this section).

(ii) *Professional service undertaking.* For purposes of this paragraph (h), an undertaking is treated as a professional service undertaking for any taxable year in which the undertaking derives more than 50 percent of its gross income from the provision of services that are treated, for purposes of section 448 (d)(2)(A) and the regulations thereunder, as services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

(2) *Treatment as a single activity*—(i) *Undertakings controlled by the same interest.* A taxpayer's interests in two or more professional service undertakings that are controlled by the same interests (within the meaning of paragraph (j) of this section) shall be treated as part of the same activity of the taxpayer.

(ii) *Undertakings involving significant similar or significant related services.* A taxpayer's interests in two or more professional service undertakings that involve the provision of significant similar services or significant related services shall be treated as part of the same activity of the taxpayer.

(iii) *Coordination rule.* (A) Except as provided in paragraph (h)(2)(iii)(B) of this section, a taxpayer's interests in two or more undertakings (the ''original undertakings'') that are treated as part of the same activity of the taxpayer under the provisions of paragraph (h)(2) (i) or (ii) of this section shall be treated as interests in a single professional service undertaking (the ''aggregated undertaking'') for purposes of reapplying such provisions.

(B) If any original undertaking included in an aggregated undertaking and any other undertaking that is not included in such aggregated undertaking involve the provision of significant similar or related services, the aggregated undertaking and such other undertaking shall be treated as undertakings that involve the provision of significant similar or related services for purposes of reapplying the provisions of paragraph (h)(2)(ii) of this section.

(3) *Significant similar or significant related services.* For purposes of this paragraph (h)—

(i) Services (other than consulting services) in any field described in paragraph (h)(1)(ii) of this section are similar to all other services in the same field;

(ii) All the facts and circumstances are taken into account in determining whether consulting services are similar;

(iii) Two professional service undertakings involve the provision of significant similar services if and only if—

(A) Each such undertaking provides significant professional services; and

(B) Significant professional services provided by one such undertaking are similar to significant professional services provided by the other such undertaking;

(iv) Services are significant professional services if and only if such services are in a field described in paragraph (h)(1)(ii) of this section and more than 20 percent of the undertaking's gross income is attributable to services in such field (or, in the case of consulting services, to similar services in such field); and

(v) Two professional service undertakings involve the provision of significant related services if and only if more than 20 percent of the gross income of one such undertaking is derived from customers that are also customers of the other such undertaking.

(4) *Examples.* The following examples illustrate the application of this paragraph (h). In each example that does not state otherwise, the taxpayer is an individual, and the facts, analysis, and conclusions relate to a single taxable year.

Example 1. (i) The taxpayer is a partner in a law partnership that has offices in various cities. Some of the partnership's offices provide a full range of legal services. Other offices, however, specialize in a particular area or areas of the law (*e.g.*, litigation, tax law, corporate law, etc.). In either case, substantially all of the office's gross income is derived from the provision of legal services. Under paragraph (c)(1) of this section, each of the law partnership's offices is treated as a single undertaking that is separate from other undertakings (a ''law-office undertaking'').

(ii) Each law-office undertaking derives more than 50 percent of its gross income from the provision of services in the field law. Thus, each such undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Each law-office undertaking derives more than 20 percent of its gross income from services in the field of law. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of law. In addition, all services in the field of law are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the law-office undertakings involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interest in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the law-office undertakings are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section even if the undertakings are not controlled by the same interests (within the meaning of paragraph (j) of this section).

Example 2. (i) The taxpayer is a partner in medical partnerships A and B. Both partnerships derive all of their gross income from the provision of medical services, but partnership A specializes in internal medicine and partnership B operates a radiology laboratory. Under paragraph (c)(1) of this section, the medical-service business of each partnership is treated as a single undertaking that is separate from other undertakings (a ''medical-service undertaking''). Partnerships A and B are not controlled by the same interests (within the meaning of paragraph (j) of this section).

(ii) Each partnership's medical-service undertaking derives more than 50 percent of its gross income from the provision of services in the field of health. Thus, each partnership's medical-service undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Each partnership's medical-service undertaking derives more than 20 percent of its gross income from services in the field of health. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of health. In addition, all services in the field of health are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the medical-services undertakings of partnerships A and B involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the medical-service undertakings of partnerships A and B are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section even though the undertakings are not controlled by the same interests.

Example 3. (i) The facts are the same as in Example 2, except that the taxpayer withdraws from partnership A in 1989 and becomes a partner in partnership B in 1990. In addition, the taxpayer was a full-time participant in the operations of partnership A from 1970 through 1989, but does not participate in the operations of partnership B.

(ii) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. This rule is not limited to cases in which the taxpayer holds such interests simultaneously. Thus, as in Example 2, the taxpayer's interests in the medical-service undertakings of partnerships A and B are treated as part of the same activity of the taxpayer.

(iii) The activity that includes the taxpayer's interests in the medical-service undertakings of partnerships A and B is a personal service activity (within the meaning of §1.469–5T(d)) because it involves the performance of personal services in the field of health. In addition, the taxpayer materially participated in the activity for three or more taxable years preceding 1990 (see §1.469–5T(j)(1)). Thus, even if the taxpayer does not work in the activity after 1989, the taxpayer is treated, under §1.469–5T(a)(6), as materially participating in the activity for 1990 and subsequent taxable years.

Example 4. (i) The taxpayer is a partner in an accounting partnership that has offices in various cities (partnership A) and in a management-consulting partnership that has a single office (partnership B). Each of partnership A's offices derives substantially all of its gross income from services in the field of accounting, and partnership B derives substantially all of its gross income from services in the field of consulting. Under paragraph (c)(1) of this section, partnership B's consulting business is treated as a single undertaking that is separate from other undertakings (the ''consulting undertaking'') and each of partnership A's offices is similarly treated (the ''accounting undertakings''). The accounting undertakings are controlled by the same interests, but partnerships A and B are not controlled by the same interests (within the meaning of paragraph (j) of this section). Partnership B's consulting business derives 50 percent of its gross income from customers of partnership A's accounting undertakings, but does not derive more than 20 percent of its gross income from the customers of any single accounting undertaking.

(ii) Each accounting undertaking derives more than 50 percent of its gross income from the provision of services in the field of accounting, and the consulting undertaking derives more than 50 percent of its gross income from the provision of services in the field of consulting. Thus, each accounting undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section), and the consulting undertaking is also treated as a professional service undertaking.

(iii) Each accounting undertaking derives more than 20 percent of its gross income from services in the field of accounting. Thus, each such undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section) in the field of accounting. In addition, all services in the field of accounting are treated as similar services under paragraph (h)(3)(i) of this section. Thus, the accounting undertakings involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2) (i) and (ii) of this section provides that a taxpayer's interests in professional service undertakings that are controlled by the same interests or that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. The accounting undertakings are controlled by the same interests (see (i) above) and involve the provision of significant similar services (see (iii) above). Accordingly, the taxpayer's interests in the accounting undertakings are treated as part of the same activity under paragraph (h)(2) (i) and (ii) of this section.

(v) The consulting undertaking derives more than 20 percent of its gross income from services in the field of consulting. If, based on all the facts and circumstances, these services are determined to be similar consulting services under paragraph (h)(3)(ii) of this section, the consulting undertaking involves significant professional services (within the meaning of paragraph (h)(3)(iv) of this section). In this case, however, the consulting undertaking and the accounting undertakings do not involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section) because consulting services and accounting services are not treated as similar services under paragraph (h)(3)(i) of this section.

(vi) The consulting undertaking does not derive more than 20 percent of its gross income from the customers of any single accounting undertaking of partnership A. If, however, partnership A's accounting undertakings are aggregated, the consulting undertaking derives more than 20 percent of its gross income from customers of the aggregated undertakings. Paragraph (h)(3)(v) of this section provides that two professional service undertakings involve the provision of significant related services if more than 20 percent of the gross income of one undertaking is derived from customers of the other undertaking. For purposes of applying this rule, partnership A's accounting undertakings are treated as a single undertaking under paragraph (h)(2)(iii) of this section because the accounting undertakings are treated as part of the same activity under paragraph (h)(2)(i) and (ii) of this section. Thus, the consulting undertaking and the accounting undertakings involve the provision of significant related services.

(vii) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant related services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in the consulting undertaking and the accounting undertakings are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section.

Example 5. (i) The facts are the same as in Example 4, except that partnership B's consulting business derives only 15 percent of its gross income from customers of partnership A's accounting undertakings.

(ii) As in Example 4, the taxpayer's interests in the accounting undertakings are treated as part of the same activity under paragraph (h)(2)(i) and (ii) of this section and are treated under paragraph (h)(2)(iii) of this section as a single undertaking for purposes of reapplying those provisions. In this case, however, the consulting undertaking does not derive more than 20 percent of its gross income from the customers of partnership A's accounting undertakings. Thus, the consulting undertaking and the accounting undertakings do not involve the provision of significant related services. Accordingly, the accounting undertakings and the consulting undertaking are not treated as part of the same activity under paragraph (h)(2)(i) or (ii) of this section because they are not controlled by the same interests and do not involve the provision of significant similar or related services.

Example 6. (i) The taxpayer is a partner in partnerships A, B, and C. Partnership A derives substantially all of its gross income from the provision of engineering services, partnership B derives substantially all of its gross income from the provision of architectural services, and partnership C derives 40 percent of its gross income from the provision of engineering services and the remainder from the provision of architectural services. Under paragraph (c)(1) of this section, each partnership's service business is treated as a single undertaking that is separate from other undertakings. Partnerships A, B, and C are not controlled by the same interests (within the meaning of paragraph (j) of this section).

(ii) Each partnership's undertaking derives more than 50 percent of its gross income from the provision of services in the fields of architecture and engineering. Thus, each such undertaking is treated as a professional service undertaking (within the meaning of paragraph (h)(1)(ii) of this section).

(iii) Partnership A's undertaking ("undertaking A") derives more than 20 percent of its gross income from services in the field of engineering, partnership B's undertaking ("undertaking B") derives more than 20 percent of its gross income from services in the field of architecture, and partnership C's undertaking ("undertaking C") derives more than 20 percent of its gross income from services in the field of engineering and more than 20 percent of its gross income from services in the field of architecture. Thus, undertaking A involves significant services in the field of engineering, undertaking B involves significant services in the field of architecture, and undertaking C involves significant services in both fields. Under paragraph (h)(3)(i) of this section, all services within each field are treated as similar services, but engineering services and architectural services are not treated as similar services. Thus, undertakings A and C, and undertakings B and C, involve the provision of significant similar services (within the meaning of paragraph (h)(3)(iii) of this section).

(iv) Paragraph (h)(2)(ii) of this section provides that a taxpayer's interests in professional service undertakings that involve the provision of significant similar services are treated as part of the same activity of the taxpayer. Accordingly, the taxpayer's interests in undertakings A and C are treated as part of the same activity of the taxpayer.

(v) Under paragraph (h)(2)(iii)(A) of this section, undertakings A and C are also treated as a single undertaking for purposes of determining whether undertaking B involves the provision of significant similar services. Paragraph (h)(2)(iii)(B) of this section in effect provides that treating undertakings A and C as a single undertaking does not affect the conclusion that the architectural services provided by undertakings B and C are significant similar services. Thus, undertaking B and the single undertaking in which undertakings A and C are included under paragraph (h)(3)(iii) of this section involve the provision of significant similar services, and the taxpayer's interests in undertakings A, B, and C are treated as part of the same activity of the taxpayer under paragraph (h)(2)(ii) of this section.

(i) [Reserved]

(j) *Control by the same interests and ownership percentage*—(1) *In general.* Except as otherwise provided in paragraph (j)(2) of this section, all the facts and circumstances are taken into account in determining, for purposes of this section, whether undertakings are controlled by the same interests. For this purpose, control includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of control that is determinative, and not its form or mode of exercise.

(2) *Presumption*—(i) *In general.* Undertakings are rebuttably presumed to be controlled by the same interests if such undertakings are part of the same common-ownership group.

(ii) *Common-ownership group.* Except as provided in paragraph (j)(2)(iii) of this section, two or more undertakings of a taxpayer are part of the same common-ownership group for purposes of this paragraph (j)(2) if and only if the sum of the common-ownership percentages of any five or fewer persons (within the meaning of section 7701(a)(1), but not including passthrough entities) with respect to such undertakings exceeds 50 percent. For this purpose, the common-ownership percentage of a person with respect to such undertakings is the person's smallest ownership percentage (determined in accordance with paragraph (j)(3) of this section) in any such undertaking.

(iii) *Special aggregation rule.* If, without regard to this paragraph (j)(2)(iii), an undertaking of a taxpayer is part of two or more common-ownership groups, any undertakings of the taxpayer that are part of any such common-ownership group shall be treated for purposes of this paragraph (j)(2) as part of a single common-ownership group in determining the activities of such taxpayer.

(3) *Ownership percentage*—(i) *In general.* For purposes of this section, a person's ownership percentage in an undertaking or in a passthrough entity shall include any interest in such undertaking or passthrough entity that the person holds directly and the person's share of any interest in such undertaking or passthrough entity that is held through one or more passthrough entities.

(ii) *Passthrough entities.* The following rules apply for purposes of applying paragraph (j)(3)(i) of this section:

(A) A partner's interest in a partnership and share of any interest in a passthrough entity or undertaking held through a partnership shall be determined on the basis of the greater of such partner's percentage interest in the capital (by value) of such partnership or such partner's largest distributive share of any item of income or gain (disregarding guaranteed payments under section 707(c)) of such partnership.

(B) A shareholder's interest in an S corporation and share of any interest in a passthrough entity or undertaking held through an S corporation shall be determined on the basis of such shareholder's stock ownership.

(C) A beneficiary's interest in a trust or estate and share of any interest in a passthrough entity or undertaking held through a trust or estate shall not be taken into account.

(iii) *Attribution rules*—(A) *In general.* Except as otherwise provided in paragraph (j)(3)(iii)(B) of this section, a person's ownership percentage in a passthrough entity or in an undertaking shall be determined by treating such person as the owner of any interest that a person related to such person owns (determined without regard to this paragraph (j)(3)(iii)) in such passthrough entity or in such undertaking.

(B) *Determination of common-ownership percentage.* The common-ownership percentage of five or fewer persons with respect to two or more undertakings shall be determined, in any case in which, after the application of paragraph (j)(3)(iii)(A) of this section, two or more such persons own the same interest in any such undertaking (the ''related-party owners'') by treating as the only owner of such interest (or portion thereof) the related-party owner whose ownership of such interest (or a portion thereof) would result in the highest common-ownership percentage.

(C) *Related person.* A person is related to another person for purposes of this paragraph (j)(3)(iii) if the relationship of such persons is described in section 267(b) or 707(b)(1).

(4) *Special rule for trade or business activities.* In determining whether two or

more trade or business activities are controlled by the same interests for purposes of paragraph (g) of this section, each such activity shall be treated as a separate undertaking in applying this paragraph (j).

(5) *Examples*. The following examples illustrate the application of this paragraph (j):

Example 1. (i) Partnership X is the sole owner of an undertaking (undertaking X), and partnership Y is the sole owner of another undertaking (undertaking Y). Individuals A, B, C, D, and E are the only partners in partnerships X and Y, and the partnership agreements of both X and Y provide that no action may be taken or decision made on behalf of the partnership without the unanimous consent of the partners. Moreover, each partner actually participates in, and agrees to, all major decisions that affect the operations of either partnership. The ownership percentages (within the meaning of paragraph (j)(3) of this section) of A, B, C, D, and E in each partnership (and in the undertaking owned by the partnership) are as follows:

Partner	Partnership/Undertaking	
	X (percent)	Y (percent)
A	15	5
B	10	60
C	10	20
D	77	12
E	8	20
	120	117

The sum of the ownership percentages exceeds 100 percent for both X and Y because, under paragraph (j)(3)(ii)(A) of this section, each partner's ownership percentage is determined on the basis of the greater of the partner's percentage interest in the capital of the partnership or the partner's largest distributive share of any item of income or gain of the partnership.

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common-ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, the common-ownership percentages of A, B, C, D, and E with respect to undertakings X and Y are as follows:

Partner	Common-ownership percentage
A	5
B	10
C	10
D	12
E	8
	45

(iii) Paragraph (j)(2)(i) of this section provides that undertakings are rebuttably presumed to be controlled by the same interests if the undertakings are part of the same common-ownership group. In general, undertakings are part of a common-ownership group only if the sum of the common-ownership percentages of any five or fewer persons with respect to such undertakings exceeds 50 percent. In this case, the sum of the partners' common-ownership percentages with respect to undertakings X and Y is only 45 percent. Thus, undertakings X and Y are not part of the same common-ownership group.

(iv) If the presumption in paragraph (j)(2)(i) of this section does not apply, all the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests (see paragraph (j)(1) of this section). In this case, all actions and decisions in both undertakings require the unanimous consent of the same persons and each of those persons actually participates in, and agrees to, all major decisions. Accordingly, undertakings X and Y are controlled by the same interests (*i.e.*, A, B, C, D, and E).

Example 2. (i) Partnerships W, X, Y, and Z are each the sole owner of an undertaking (undertakings W, X, Y, and Z). Individuals A, B, and C are partners in each of the four partnerships, and the remaining interests in each partnership are owned by a number of unrelated individuals, none of whom owns more than a one-percent interest in any of the partnerships. The ownership percentages (within the meaning of paragraph (j)(3) of this section) of A, B, and C in each partnership (and in the undertaking owned by the partnership) are as follows:

Partnership/Undertaking	Partner		
	A	B	C
W	23%	21%	40%
X	19%	30%	22%
Y	25%	25%	20%
Z	8%	4%	2%

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common-ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, the common-ownership percentages of A, B, and C in undertakings W, X, Y, and Z are as follows:

Partner	Common-ownership percentage
A	8
B	4

Partner	Common-ownership percentage
C	2
	14

(iii) The sum of the common-ownership percentages of A, B, and C with respect to undertakings W, X, Y, and Z is 14 percent, and no other person owns more than a one-percent interest in any of the undertakings. Thus, the sum of the common-ownership percentages of any five or fewer persons with respect to all four undertakings cannot exceed 50 percent. Accordingly, undertakings W, X, Y, and Z are not part of the same common-ownership group (see paragraph (j)(2)(ii) of this section) and are not rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section).

(iv) The common-ownership percentages of A, B, and C in undertakings W, X, and Y are as follows:

Partner	Common ownership percentage
A	19
B	21
C	20
	60

(v) The sum of the common-ownership percentages of A, B, and C, taking into account only undertakings W, X, and Y, is 60 percent. Because the sum of the common-ownership percentages exceeds 50 percent, undertakings W, X, and Y are part of the same common-ownership group (see paragraph (j)(2)(ii) of this section and are rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section).

Example 3. (i) Corporation X, an S corporation, is the sole owner of an undertaking (undertaking X), and corporation Y, another S corporation, is the sole owner of another undertaking (undertaking Y). Individuals A, B, and C are shareholders in corporations X and Y. Both A and B are related (within the meaning of paragraph (j)(3)(iii)(C) of this section) to C, but not to each other. A, B, and C are not related to any other person that owns an interest in either corporation X or corporation Y. The ownership percentages (determined without regard to the attribution rules of paragraph (j)(3)(iii) of this section) of A, B, and C in each corporation (and in the undertaking owned by the corporation) are as follows:

CORPORATION/UNDERTAKING

Shareholder	X (percent)	Y (percent)
A	20	....
B	....	20
C	5	5

(ii) In general, a person's ownership percentage is determined by treating the person as the owner of interests that are actually owned by related persons (see paragraph (j)(3)(iii)(A) of this section). If A, B, and C are treated as owning interests that are actually owned by related persons, their ownership percentages are as follows:

CORPORATION/UNDERTAKING

Shareholder	X (percent)	Y (percent)
A	25	5
B	5	25
C	25	25

(iii) Paragraph (j)(3)(iii)(B) of this section provides that, in determining the sum of the common-ownership percentages of any five or fewer persons with respect to any undertakings, each interest in such undertakings is counted only once. If two or more persons are treated as owners of the same interest under paragraph (j)(3)(iii)(A) of this section, the person whose ownership would result in the highest sum is treated as the only owner of the interest. In this case, C's common-ownership percentage with respect to undertakings X and Y, determined by treating C as the owner of the interests actually owned by A and B, is 25 percent. If, however, A and B are treated as the owners of the interests actually owned by C, each has a common-ownership percentage of only five percent. Thus, in determining the sum of common-ownership percentages with respect to undertakings X and Y, C is treated as the owner of the interests actually owned by A and B because this treatment results in the highest sum of common-ownership percentages with respect to such undertakings.

Example 4. (i) The ownership percentages of individuals A, B, and C in undertakings X, Y, and Z are as follows:

UNDERTAKING

Individual	X	Y	Z
A	30%	30%	30%
B	30%	30%	30%
C	....	30%	30%

No other person owns an interest in more than one of the undertakings.

(ii) Paragraph (j)(2)(ii) of this section provides that a person's common ownership percentage with respect to any two or more undertakings is the person's smallest ownership percentage in any such undertaking. Thus, A's common-ownership percentage with respect to undertakings X, Y, and Z is 30 percent, and the common-ownership percentages of B and C (and all other persons owning interests in such undertakings) with respect to such undertakings is zero. Accordingly, the sum of the common ownership percentages with respect to undertakings X, Y, and Z is only 30 percent, and undertakings X, Y, and Z are not treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section.

(iii) B's common-ownership percentage with respect to undertakings X and Y is 30 percent, and the sum of A's and B's common-ownership percentages with respect to such undertakings is 60 percent. Thus, undertakings X and Y are treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section. Similarly, C's common-ownership percentage with respect to undertakings Y and Z is 30 percent, and the sum of A's and C's common-ownership percentages with respect to such undertakings is 60 percent. Thus, undertakings Y and Z are also treated as part of the same common-ownership group under paragraph (j)(2)(ii) of this section.

(iv) Paragraph (j)(2)(iii) of this section requires the aggregation of common-ownership groups that include the same undertaking. In this case, undertaking Y is treated as part of the common-ownership group XY and as part of the common-ownership group YZ. Accordingly, undertakings X, Y, and Z are treated as part of a single common-ownership group and are rebuttably presumed to be controlled by the same interests (see paragraph (j)(2)(i) of this section) even though B does not own an interest in undertaking Z and C does not own an interest in undertaking X. The fact that B and C are not common owners with respect to undertakings X and Z is taken into account, however, in determining whether this presumption is rebutted.

(k) *Identification of rental real estate activities*—(1) *Applicability*—(i) *In general*. Except as otherwise provided in paragraph (k)(6) of this section, this paragraph (k) applies to a taxpayer's interests in rental real estate undertakings (within the meaning of paragraph (k)(1)(ii) of this section).

(ii) *Rental real estate undertaking*. For purposes of this paragraph (k), a rental real estate undertaking is a rental undertaking (within the meaning of paragraph (d) of this section) in which at least 85 percent of the unadjusted basis (within the meaning of §1.469–2T(f)(3)) of the property made available for use by customers is real property. For this purpose the term ''real property'' means any tangible property other than tangible personal property (within the meaning of §1.48–1(c)).

(2) *Identification of activities*—(i) *Multiple undertakings treated as a single activity or multiple activities by taxpayer*. Except as otherwise provided in this paragraph (k), a taxpayer may treat two or more rental real estate undertakings (determined after the application of paragraph (k)(2) (ii) and (iii) of this section) as a single activity or may treat such undertakings as separate activities.

(ii) *Multiple undertakings treated as a single activity by passthrough entity*. A taxpayer must treat two or more rental real estate undertakings as a single rental real estate undertaking for a taxable year if any passthrough entity through which the taxpayer holds such undertakings treats such undertakings as a single activity on the applicable return of the passthrough entity for the taxable year of the taxpayer.

(iii) *Single undertaking treated as multiple undertakings*. Notwithstanding that a taxpayer's interest in leased property would, but for the application of this paragraph (k)(2)(iii), be treated as used in a single rental real estate undertaking, the taxpayer may, except as otherwise provided in paragraph (k)(3) of this section, treat a portion of the leased property (including a ratable portion of any common areas or facilities) as a rental real estate undertaking that is separate from the undertaking or undertakings in which the remaining portion of the property is treated as used. This paragraph (k)(2)(iii) shall apply for a taxable year if and only if—

(A) Such portion of the leased property can be separately conveyed under applicable State and local law (taking into account the limitations, if any, imposed by any special rules or procedures, such as condominium conversion laws, restricting the separate conveyance of parts of the same structure); and

(B) The taxpayer holds such leased property directly or through one or more passthrough entities, each of which treats such portion of the leased property as a separate activity on the applicable return of the passthrough entity for the taxable year of the taxpayer.

(3) *Treatment in succeeding taxable years.* All rental real estate undertakings or portions of such undertakings that are treated, under this paragraph (k), as part of the same activity for a taxable year ending after August 9, 1989 must be treated as part of the same activity in each succeeding taxable year.

(4) *Applicable return of passthrough entity.* For purposes of this paragraph (k), the applicable return of a passthrough entity for a taxable year of a taxpayer is the return reporting the passthrough entity's income, gain, loss, deductions, and credits taken into account by the taxpayer for such taxable year.

(5) *Evidence of treatment required.* For purposes of this paragraph (k), a person (including a passthrough entity) does not treat a rental real estate undertaking as multiple undertakings for a taxable year or, except as otherwise provided in paragraph (k) (2)(ii) or (3) of this section, treat multiple rental real estate undertakings as a single undertaking for a taxable year unless such treatment is reflected on a schedule attached to the person's return for the taxable year.

(6) *Coordination rule for rental of nondepreciable property.* This paragraph (k) shall not apply to a rental real estate undertaking if less than 30 percent of the unadjusted basis (within the meaning of §1.469–2T(f)(3)) of property used or held for use by customers in such undertaking during the taxable year is subject to the allowance for depreciation under section 167.

(7) *Coordination rule for rental of dwelling unit.* For any taxable year in which section 280A(c)(5) applies to a taxpayer's use of a dwelling unit—

(i) Paragraph (k) (2) and (3) of this section shall not apply to the taxpayer's interest in such dwelling unit; and

(ii) The taxpayer's interest in such dwelling unit shall be treated as a separate activity of the taxpayer.

(8) *Examples.* The following examples illustrate the application of this paragraph (k). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example 1. (i) In 1989, the taxpayer directly owns five condominium units (units A, B, C, D, and E) in three different buildings. Units A, B, and C are in one of the buildings and constitute a single rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). Units D and E are in the other two buildings, and each of these units constitutes a separate rental real estate undertaking. Each of the units can be separately conveyed under applicable State and local law.

(ii) Paragraph (k)(2)(iii) of this section permits a taxpayer to treat a portion of the property included in a rental real estate undertaking as a separate rental real estate undertaking if the property can be separately conveyed under applicable State and local law and the taxpayer owns the property directly. Thus, the taxpayer can treat units A, B, and C as three separate undertakings. Alternatively, the taxpayer could treat two of those units (*e.g.*, units A and C) as an undertaking and the remaining unit as a separate undertaking, or could treat units A, B, and C as a single undertaking.

(iii) Paragraph (k)(2)(i) of this section permits a taxpayer to treat two or more rental real estate undertakings as a single activity, or to treat such undertakings as separate activities. Thus, the taxpayer, by combining undertakings, can treat all five units as a single activity. Alternatively, the taxpayer could treat each undertaking as a separate activity, or could combine some, but not all, undertakings. Thus, for example, the taxpayer could treat units A, B, C, and D as an activity and unit E as a separate activity.

(iv) For purposes of paragraph (k)(2)(i) of this section, a taxpayer's rental real estate undertakings are determined after the application of paragraph (k)(2)(iii) of this section. Thus, the taxpayer, by treating units as separate undertakings under paragraph (k)(2)(iii) of this section and combining them with other units under paragraph (k)(2)(i) of this section, can treat any combination of units as a single activity. For example, the taxpayer could treat units A and B as a separate rental real estate undertaking, and then treat units A, B, and D as a single activity. In that case, the taxpayer could treat units C and E either as a single activity or as two separate activities.

Example 2. (i) The facts are the same as in Example 1. In addition, the taxpayer treats all five units as a single activity for 1989 and sells unit E in 1990. (See paragraph (k)(5) of this section for a rule providing that the units are treated as a single activity only if such treatment is reflected on a schedule attached to the taxpayer's return.)

(ii) Under paragraph (k)(3) of this section, rental real estate undertakings that are treated as part of the same activity for a taxable year must be treated as part of the same activity in each succeeding year. In this case, all five units were treated as part of the same activity for 1989 and must therefore be treated as part of the same activity for 1990. Accordingly, the taxpayer's sale of unit E in 1990 cannot be treated as a disposition of the taxpayer's entire interest in an activity for purposes of section 469(g) and the rules to be contained in §1.469–6T (relating to the treatment of losses upon certain dispositions of passive and former passive activities).

Example 3. (i) The facts are the same as in Example 1, except that the taxpayer is a partner in a partnership that is the direct owner of the five condominium units. In its return for its taxable year ending on November 30, 1989, the partnership treats the five units as a single activity. (See paragraph (k)(5) of this section for a rule providing that the units are treated as a single activity only if such treatment is reflected on a schedule attached to the partnership's return.) The partnership sells unit E on November 1, 1990.

(ii) Paragraph (k)(2)(ii) of this section provides that a taxpayer who holds rental real estate undertakings through a passthrough entity must treat those undertakings as a single rental real estate undertaking if they are treated as a single activity on the applicable return of the passthrough entity. Under paragraph (k)(4) of this section, the applicable return of the partnership for the taxpayer's 1989 taxable year is the partnership's return for its taxable year ending on November 30, 1989. Accordingly, the taxpayer must treat the five condominium units as a single rental real estate undertaking (and thus as part of the same activity) for 1989 because they are treated as a single activity on the partnership's return for its taxable year ending in 1989.

(iii) Under paragraph (k)(3) of this section, the taxpayer must continue treating the condominium units as part of the same activity for taxable years after 1989. Accordingly, as in Example 2, the five condominium units are treated as part of the same activity for 1990, and the sale of unit E in 1990 cannot be treated as a disposition of the taxpayer's interest in an activity for purposes of section 469(g) and the rules to be contained in §1.469–6T.

Example 4. (i) The taxpayer owns a shopping center and a vacant lot that are separate rental real estate undertakings (within the meaning of paragraph (k)(1)(ii) of this section). The taxpayer rents space in the shopping center to various tenants and rents the vacant lot to a parking lot operator. Most of the unadjusted basis of the property used in the shopping-center undertaking (taking into account the land on which the shopping center is built) is subject to the allowance for depreciation, but no depreciable property is used in the parking-lot undertaking.

(ii) This paragraph (k) provides rules for identifying rental real estate activities (including the rule in paragraph (k)(2)(i) of this section that permits a taxpayer to treat two or more rental real estate undertakings as a single activity). Paragraph (k)(6) of this section provides, however, that these rules do not apply to a rental real estate undertaking if less than 30 percent of the unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation. Thus, the taxpayer may not combine the parking-lot undertaking, which includes no depreciable property, with the shopping-center undertaking or any other rental real estate undertaking under paragraph (k)(2)(i) of this section. Accordingly, the parking lot undertaking is treated as a separate activity under paragraph (b)(1) of this section.

Example 5. (i) The facts are the same as in Example 4, except that the shopping center and the vacant lot are at the same location (within the meaning of paragraph (c)(2)(iii) of this section) and are part of the same rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). Taking into account the property used in the shopping center operations (including the land on which the shopping center is built) and the vacant lot, 50 percent of the unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation.

(ii) In this case, the vacant lot is used in a rental real estate undertaking in which depreciable property is also used. Moreover, the exception in paragraph (k)(6) of this section does not apply to the undertaking consisting of the shopping center and the parking lot because at least 30 percent of unadjusted basis of the property used in the undertaking is subject to the allowance for depreciation. Accordingly, the taxpayer may combine the undertaking with other rental real estate undertakings and treat the combined undertakings as a single activity under paragraph (k)(2)(i) of this section.

(l) [Reserved]

(m) *Consolidated groups*—(1) *In general.* The activities of a consolidated group (within the meaning of §1.469–1T(h)(2)(ii)) and of each member of such group shall be determined under this section as if the consolidated group were one taxpayer.

(2) *Examples.* The following examples illustrate the application of this paragraph (m). In each example, the facts, analysis, and conclusions relate to a single taxable year.

Example 1. (i) Corporations M, N, and O are the members of a consolidated group (within the meaning of §1.469–1T(h)(2)(ii)). Under §1.469–1T(h)(4)(i)(A) and (ii), the consolidated group and its members are treated as closely held corporations (within the meaning of

§1.469–1T(g)(2)(ii)). Each member of the consolidated group owns a two-percent interest in partnership X and a two-percent interest in partnership Y, and owns interests in a number of trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) through the partnerships. Each of these undertakings is directly owned by partnership X or Y, and all the undertakings of partnerships X and Y are controlled by the same interests (within the meaning of paragraph (j) of this section) and are similar (within the meaning of paragraph (f)(4) of this section). The employees of the consolidated group and the shareholders of its common parent do not participate in the undertakings that the member corporations own through the partnerships.

(ii) Paragraph (f)(2)(i) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns interests in the undertakings through the same passthrough entity. In this case, the member corporations own interests in similar, commonly-controlled undertakings through both partnerships, and such interests are treated under this paragraph (m) as interests owned by one taxpayer (the consolidated group). Accordingly, the member corporations' interests in the undertakings owned through partnership X are treated as part of the same activity of the consolidated group, and their interests in the undertakings owned through partnership Y are treated similarly.

Example 2. (i) The facts are the same as in Example 1, except that each member of the consolidated group owns a five-percent interest in partnership X and a five-percent interest in partnership Y.

(ii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the member corporations own, in the aggregate, a 15-percent interest in partnership X and a 15-percent interest in partnership Y, and such interests are treated under this paragraph (m) as interests owned by one taxpayer (the consolidated group). Thus, the consolidated group owns a substantial indirect interest in the similar, commonly-controlled undertakings owned by partnerships X and Y (see paragraph (f)(3)(i) of this section). Accordingly, the member corporations' interests in the undertakings owned through partnerships X and Y are treated as part of the same activity of the consolidated group.

(n) *Publicly traded partnerships.* The rules of this section shall apply to a taxpayer's interest in business and rental operations held through a publicly traded partnership (within the meaning of section 469(k)(2)) as if the taxpayer had no interest in any other business and rental operations. The following example illustrates the application of this paragraph (n):

Example. (i) The taxpayer, an individual, owns a 20-percent interest in partnership X and a 15-percent interest in partnership Y. Partnership X directly owns a hotel (''hotel 1'') and a commercial office building (''building 1''). Partnership Y directly owns two hotels (''hotels 2 and 3'') and two commercial office buildings (''buildings 2 and 3''). Each of the three hotels is a separate trade or business undertaking (within the meaning of paragraph (f)(1)(ii) of this section), and each of the three office buildings is a separate rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section). The three hotel undertakings are similar (within the meaning of paragraph (f)(4) of this section) and are controlled by the same interests (within the meaning of paragraph (j) of this section). Partnership X is not a publicly traded partnership (within the meaning of section 469(k)(2)). Partnership Y, however, is a publicly traded partnership and is not treated as a corporation under section 7704.

(ii) This paragraph (n) provides that the rules of this section apply to a taxpayer's interest in business and rental operations held through a publicly traded partnership as if the taxpayer had no interest in any other business and rental operations. Thus, undertakings owned through partnership Y may be treated as part of the same activity under the rules of this section, but an undertaking owned through partnership Y and an undertaking that is not owned through partnership Y may not be treated as part of the same activity.

(iii) Paragraph (f)(2)(i) of this section provides that a taxpayer's interests in two or more trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity if the taxpayer owns interests in each undertaking through the same passthrough entity. Partnership Y's hotel undertakings (*i.e.*, hotels 2 and 3) are similar and are controlled by the same interests. In addition, the taxpayer owns interests in both undertakings through the same partnership. Accordingly, the taxpayer's interests in partnership Y's hotel undertakings are treated as part of the same activity.

(iv) The hotel undertaking owned through partnership X (*i.e.*, hotel 1) and the hotel undertakings owned through partnership Y are similar and controlled by the same interests, and the taxpayer owns a substantial indirect interest in each of the undertakings (see paragraph (f)(3)(i) of this section). Thus, the three undertakings would ordinarily be treated as part of the same activity under paragraph (f)(2)(ii) of this section. Under this paragraph (n), however, undertakings that are owned through a publicly traded partnership cannot be treated as part of the same activity as any undertaking not owned through that partnership. Accordingly, the hotel undertaking that the taxpayer owns through partnership X and the hotel undertakings that the taxpayer owns through partnership Y are treated as two separate activities.

(v) Paragraph (k)(2)(i) of this section provides that, with certain exceptions, a taxpayer may treat two or more rental real estate undertakings as a single activity or as separate activities. Thus, the taxpayer's interests in the rental real estate undertakings owned through partnership Y (*i.e.*, buildings 2 and 3) may be treated as a single activity or as separate activities. Under this paragraph (n), however, undertakings that are owned through a publicly traded partnership cannot be treated as part of the same activity as any undertaking not owned through that partnership. Accordingly, the taxpayer's interest in the rental real estate undertaking owned through partnership X (building 1) cannot be treated as part of an activity that includes any rental real estate undertaking owned through partnership Y.

(o) *Elective treatment of undertakings as separate activities*—(1) *Applicability*. This paragraph applies to a taxpayer's interest in any undertaking (other than a rental real estate undertaking (within the meaning of paragraph (k)(1)(ii) of this section)) that would otherwise be treated under this section as part of an activity that includes the taxpayer's interest in any other undertaking.

(2) *Undertakings treated as separate activities*. Except as otherwise provided in this paragraph (o), a person (including a passthrough entity) shall treat an undertaking to which this paragraph (o) applies as an activity separate from the remainder of the activity in which such undertaking would otherwise be included for a taxable year if and only if, for such taxable year or any preceding taxable year, such person made an election with respect to such undertaking under this paragraph (o).

(3) *Multiple undertakings treated as a single activity by passthrough entity*. A person (including a passthrough entity) must treat interests in two or more undertakings as part of the same activity for a taxable year if any passthrough entity through which the person holds such undertakings treats such undertakings as part of the same activity on the applicable return of the passthrough entity for the taxable year of such person.

(4) *Multiple undertakings treated as a single activity for a preceding taxable year*. If a person (including a passthrough entity) treats undertakings as part of the same activity on such person's return for a taxable year ending after August 9, 1989, such person may not treat such undertakings as part of different activities under this paragraph (o) for any subsequent taxable year.

(5) *Applicable return of passthrough entity*. For purposes of this paragraph (o), the applicable return of a passthrough entity for a taxable year of a taxpayer is the return reporting the passthrough entity's income, gain, loss, deductions, and credits taken into account by the taxpayer for such taxable year.

(6) *Participation*. The following rules apply to multiple activities (the "separate activities") that would be treated as a single activity (the "original activity") if the taxpayer's activities were determined without regard to this paragraph (o):

(i) The taxpayer shall be treated as materially participating (within the meaning of §1.469–5T) for the taxable year in the separate activities if and only if the taxpayer would, but for the application of this paragraph (o), be treated as materially participating for the taxable year in the original activity.

(ii) The taxpayer shall be treated as significantly participating (within the meaning of §1.469–5T(c)(2)) for the taxable year in the separate activities if and only if the taxpayer would, but for the application of this paragraph (o), be treated as significantly participating for the taxable year in the original activity.

(7) *Election*—(i) *In general*. A person makes an election with respect to an undertaking under this paragraph (o) by attaching the written statement described in paragraph (o)(7)(ii) of this section to such person's return for the taxable year for which the election is

made (see paragraph (o)(2) of this section).

(ii) *Written statement.* The written statement required by paragraph (o)(7)(i) of this section must—

(A) State the name, address, and taxpayer identification number of the person making the election;

(B) Contain a declaration that an election is being made under §1.469–4T(o);

(C) Identify the undertaking with respect to which such election is being made; and

(D) Identify the remainder of the activity in which such undertaking would otherwise be included.

(8) *Examples.* The following examples illustrate the application of this paragraph (o):

Example 1. (i) During 1989, the taxpayer, an individual whose taxable year is the calendar year, acquires and is the direct owner of ten grocery stores. The operations of each grocery store are treated under paragraph (c)(1) of this section as a single undertaking that is separate from other undertakings (a ''grocery-store undertaking''), and the taxpayer's interests in the grocery-store undertakings would be treated as part of the same activity of the taxpayer under paragraph (f)(2) of this section.

(ii) Paragraph (o)(2) of this section provides that, with certain exceptions, undertakings that would be treated as part of the same activity under other rules in this section may, at the election of the taxpayer, be treated as separate activities. Thus, the taxpayer may elect to treat each grocery-store undertaking as a separate activity for 1989. Alternatively, the taxpayer may combine grocery-store undertakings in any manner and treat each combination of undertakings (and each uncombined undertaking) as a separate activity for 1989. In either case, the election must be made by attaching the written statement described in paragraph (o)(7)(ii) of this section to the taxpayer's 1989 return.

Example 2. (i) The facts are the same as in Example 1. In addition, the taxpayer, in 1989, elects to treat each grocery-store undertaking as a separate activity and participates for 15 hours in each of the grocery-store undertakings.

(ii) The taxpayer's interest in each grocery-store undertaking is treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1989 (a ''grocery-store activity''). In 1989, however, the taxpayer participates for more than 100 hours in the activity in which the undertakings would be included (but for the election to treat the grocery-store undertakings as separate activities) and would be treated under §1.469–5T(c)(2) as significantly participating in such activity. Accordingly, the taxpayer is treated under paragraph (o)(6)(ii) of this section as significantly participating in each of the grocery-store activities for 1989.

Example 3. (i) The facts are the same as in Example 1. In addition, the taxpayer, in 1989, elects to treat each grocery-store undertaking as a separate activity. The taxpayer does not participate in any of the grocery-store undertakings in 1989 or 1990, and sells one of the grocery stores in 1990.

(ii) As in Example 2, the taxpayer's interests in each grocery-store undertaking is treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1989. Because the taxpayer elected to treat the undertakings as separate activities for a preceding taxable year (1989), each grocery-store undertaking is also treated, under paragraph (o)(2) of this section, as a separate activity of the taxpayer for 1990. In addition, each of the taxpayer's grocery-store activities is a passive activity for 1989 and 1990 because the taxpayer does not participate in any of the grocery store undertakings for 1989 and 1990. Accordingly, the taxpayer's sale of the grocery store will generally be treated as a disposition of the taxpayer's entire interest in a passive activity for purposes of section 469(g) and the rules to be contained in §1.469–6T (relating to the treatment of losses upon certain dispositions of passive and former passive activities).

Example 4. (i) The facts are the same as in Example 3, except that the taxpayer elects to treat the grocery-store undertakings as two separate activities. One of the activities includes three grocery-store undertakings, and the store sold in 1990 is part of this activity. The other activity includes the seven remaining grocery-store undertakings.

(ii) Paragraph (o)(4) of this section provides that a person who treats undertakings as part of the same activity for a taxable year ending after August 9, 1989, may not elect to treat those undertakings as separate activities for a subsequent taxable year. The grocery store sold in 1990 was treated for 1989 as part of an activity that includes two other grocery stores. Thus, those three stores must be treated as part of the same activity for 1990. Accordingly, the taxpayer's sale of the grocery store cannot be treated as a disposition of the taxpayer's entire interest in a passive activity for purposes of section 469(g) and the rules to be contained in §1.469–6T.

Example 5. (i) The facts are the same as in Example 1, except that the taxpayer is a partner in a partnership that acquires and is the direct owner of the ten grocery stores. The taxable year of the partnership ends on November 30, and the partnership acquires the grocery stores in its taxable year ending on November 30, 1989. In its return for that taxable year, the partnership treats the grocery-store undertakings as a single activity.

(ii) Paragraph (o)(3) of this section provides that a person who holds undertakings through a passthrough entity may not elect to treat those undertakings as separate activities if they are treated as part of the same activity on the applicable return of the passthrough entity. Under paragraph (o)(5) of this section, the applicable return of the partnership for the taxpayer's 1989 taxable year is the partnership's return for its taxable year ending on November 30, 1989. Accordingly, the taxpayer must treat the grocery-store undertakings as a single activity for 1989 because those undertakings are treated as a single activity on the partnership's return for its taxable year ending in 1989.

(iii) Under paragraph (o)(4) of this section, the taxpayer must continue treating the grocery-store undertakings as part of the same activity for taxable years after 1989. This rule applies even if the partnership subsequently distributes its interest in the grocery stores to the taxpayer, and the taxpayer becomes the direct owner of the grocery-store undertakings.

(p) Special rule for taxable years ending before August 10, 1989—(1) *In general*. For purposes of applying section 469 and the regulations thereunder for a taxable year ending before August 10, 1989, a taxpayer's business and rental operations may be organized into activities under the rules or paragraphs (b) through (n) of this section or under any other reasonable method. For example, for such taxable years a taxpayer may treat each of the taxpayer's undertakings as a separate activity, or a taxpayer may treat undertakings that involve the provision of similar goods or services as a single activity.

(2) *Unreasonable methods*. A method of organizing business and rental operations into activities is not reasonable if such method—

(i) Treats rental operations (within the meaning of paragraph (d)(3) of this section) that are not ancillary to a trade or business activity (within the meaning of §1.469–1T(e)(2)) as part of a trade or business activity;

(ii) Treats operations that are not rental operations and are not ancillary to a rental activity (within the meaning of §1.469–1T(e)(3)) as part of a rental activity;

(iii) Includes in a passive activity of a taxpayer any oil or gas well that would be treated, under paragraph (e)(1) of this section, as a separate undertaking in determining the taxpayer's activities;

(iv) Includes in a passive activity of a taxpayer any interest in a dwelling unit that would be treated, under paragraph (K)(7) of this section, as a separate activity of the taxpayer; or

(v) Is inconsistent with the taxpayer's method of organizing business and rental operations into activities for the taxpayer's first taxable year beginning after December 31, 1986.

(3) *Allocation of dissallowed deductions in succeeding taxable year*. If any of the taxpayer's passive activity deductions or the taxpayer's credits from passive activities are disallowed under §1.469–1T for the last taxable year of the taxpayer ending before August 10, 1989, such disallowed deductions or credits shall be allocated among the taxpayer's activities for the first taxable year of the taxpayer ending after August 9, 1989, using any reasonable method. See §1.469–1T(f)(4).

[T.D. 8253, 54 FR 20542, May 12, 1989]

§ 1.469–5 Material participation.

(a)–(e) [Reserved]

(f) *Participation*—(1) *In general*. Except as otherwise provided in this paragraph (f), any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity.

(f)(2)–(h)(2) [Reserved]

(h)(3) *Coordination with rules governing the treatment of passthrough entities*. If a taxpayer takes into account for a taxable year of the taxpayer any item of gross income or deduction from a partnership or S corporation that is characterized as an item of gross income or deduction from an activity in which the taxpayer materially participated under §1.469–2T(e)(1), the taxpayer is treated as materially participating in the activity for the taxable year for purposes of applying §1.469–5T(a)(5) and (6) to any succeeding taxable year of the taxpayer.

(i) [Reserved]

(j) *Material participation for preceding taxable years*—(1) *In general*. For purposes of §1.469–5T(a)(5) and (6), a taxpayer has materially participated in an activity for a preceding taxable year if the activity includes significant section 469 activities that are substantially the same as significant section 469 activities that were included in an activity in which the taxpayer materially participated (determined without regard to §1.469–5T(a)(5)) for the preceding taxable year.

(2) *Material participation for taxable years beginning before January 1, 1987*. In any case in which it is necessary to determine whether an individual materially participated in any activity for a taxable year beginning before January 1, 1987 (other than a taxable year of a partnership, S corporation, estate, or trust ending after December 31, 1986), the determination shall be made without regard to paragraphs (a)(2) through (7) of this section.

(k) *Examples*. Example 1—Example 4 [Reserved]

Example 5. In 1993, D, an individual, acquires stock in an S corporation engaged in a trade or business activity (within the meaning of §1.469–1(e)(2)). For every taxable year from 1993 through 1997, D is treated as materially participating (without regard to §1.469–5T(a)(5)) in the activity. D retires from the activity at the beginning of 1998, and would not be treated as materially participating in the activity for 1998 and subsequent taxable years if material participation of those years were determined without regard to §1.469–5T(a)(5). Under §1.469–5T(a)(5) of this section, however, D is treated as materially participating in the activity for taxable years 1998 through 2003 because D materially participated in the activity (determined without regard to §1.469–5T(a)(5) for five taxable years during the ten taxable years that immediately precede each of those years. D is not treated under §1.469–5T(a)(5) as materially participating in the activity for taxable years beginning after 2003 because for those years D has not materially participated in the activity (determined without regard to §1.469–5T(a)(5) for five of the last ten immediately preceding taxable years.

[T.D. 8417, 57 FR 20758, May 15, 1992]

§1.469–5T Material participation (temporary).

(a) *In general*. Except as provided in paragraphs (e) and (h)(2) of this section, an individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if—

(1) The individual participates in the activity for more than 500 hours during such year;

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

(4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

(b) *Facts and circumstances*—(1) *In general*. [Reserved]

(2) *Certain participation insufficient to constitute material participation under this paragraph (b)*—(i) *Participation satisfying standards not contained in section 469*. Except as provided in section 469(h)(3) and paragraph (h)(2) of this

section (relating to certain retired individuals and surviving spouses in the case of farming activities), the fact that an individual satisfies the requirements of any participation standard (whether or not referred to as ''material participation'') under any provision (including sections 1402 and 2032A and the regulations thereunder) other than section 469 and the regulations thereunder shall not be taken into account in determining whether such individual materially participates in any activity for any taxable year for purposes of section 469 and the regulations thereunder.

(ii) *Certain management activities.* An individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section unless, for such taxable year—

(A) No person (other than such individual) who performs services in connection with the management of the activity receives compensation described in section 911(d)(2)(A) in consideration for such services; and

(B) No individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

(iii) *Participation less than 100 hours.* If an individual participates in an activity for 100 hours or less during the taxable year, such individual shall not be treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section.

(c) *Significant participation activity*—(1) *In general.* For purposes of paragraph (a)(4) of this section, an activity is a significant participation activity of an individual if and only if such activity—

(i) Is a trade or business activity (within the meaning of §1.469–1T(e)(2)) in which the individual significantly participates for the taxable year; and

(ii) Would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this section.

(2) *Significant participation.* An individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year.

(d) *Personal service activity.* An activity constitutes a personal service activity for purposes of paragraph (a)(6) of this section if such activity involves the performance of personal services in—

(1) The fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or

(2) Any other trade or business in which capital is not a material income-producing factor.

(e) *Treatment of limited partners*—(1) *General rule.* Except as otherwise provided in this paragraph (e), an individual shall not be treated as materially participating in any activity of a limited partnership for purposes of applying section 469 and the regulations thereunder to—

(i) The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to a limited partnership interest in the partnership; and

(ii) Any gain or loss from such activity recognized upon a sale or exchange of such an interest.

(2) *Exceptions.* Paragraph (e)(1) of this section shall not apply to an individual's share of income, gain, loss, deduction, and credit for a taxable year from any activity in which the individual would be treated as materially participating for the taxable year under paragraph (a)(1), (5), or (6) of this section if the individual were not a limited partner for such taxable year.

(3) *Limited partnership interest*—(i) *In general.* Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), a partnership interest shall be treated as a limited partnership interest if—

(A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or

(B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractural obligations to make additional capital contributions to the partnership).

(ii) *Limited partner holding general partner interest.* A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest).

(f) *Participation*—(1) [Reserved]. See §1.469–5(f)(1) for rules relating to this paragraph.

(2) *Exceptions*—(i) *Certain work not customarily done by owners.* Work done in connection with an activity shall not be treated as participation in the activity for purposes of this section if—

(A) Such work is not of a type that is customarily done by an owner of such an activity; and

(B) One of the principal purposes for the performance of such work is to avoid the disallowance, under section 469 and the regulations thereunder, of any loss or credit from such activity.

(ii) *Participation as an investor*—(A) *In general.* Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day-to-day management or operations of the activity.

(B) *Work done in individual's capacity as an investor.* For purposes of this paragraph (f)(2)(ii), work done by an individual in the individual's capacity as an investor in an activity includes—

(*1*) Studying and reviewing financial statements or reports on operations of the activity;

(*2*) Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and

(*3*) Monitoring the finances or operations of the activity in a non-managerial capacity.

(3) *Participation of spouse.* In the case of any person who is a married individual (within the meaning of section 7703) for the taxable year, any participation by such person's spouse in the activity during the taxable year (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) shall be treated, for purposes of applying section 469 and the regulations thereunder to such person, as participation by such person in the activity during the taxable year.

(4) *Methods of proof.* The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

(g) *Material participation of trusts and estates.* [Reserved]

(h) *Miscellaneous rules*—(1) *Participation of corporations.* For rules relating to the participation in an activity of a personal service corporation (within the meaning of §1.468–1T(g)(2)(i)) or a closely held corporation (within the meaning of §1.469–1T(g)(2)(ii)), see §1.469–1T(g)(3).

(2) *Treatment of certain retired farmers and surviving spouses of retired or disabled farmers.* An individual shall be treated as materially participating for a taxable year in any trade or business activity of farming if paragraph (4) or (5) of section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity

had the individual died during such taxable year.

(3) *Coordination with rules governing the treatment of passthrough entities.* [Reserved]. See § 1.469–5(h)(3) for rules relating to this paragraph.

(i) [Reserved]

(j) *Material participation for preceding taxable years.* [Reserved]. See § 1.469–5(j) for rules relating to this paragraph.

(k) *Examples.* The following examples illustrate the application of this section:

Example 1. A, a calendar year individual, owns all of the stock of X, a C corporation. X is the general partner, and A is the limited partner, in P, a calendar year partnership. P has a single activity, a restaurant, which is a trade or business activity (within the meaning of § 1.469–1T(e)(2)). During the taxable year, A works for an average of 30 hours per week in connection with P's restaurant activity. Under paragraphs (a)(1) and (e)(2) of this section, A is treated as materially participating in the activity for the taxable year because A participates in the restaurant activity during such year for more than 500 hours. In addition, under § 1.469–1T(g)(3)(i), A's participation will cause X to be treated as materially participating in the restaurant activity.

Example 2. The facts are the same as in Example 1, except that the partnership agreement provides that P's restaurant activity is to be managed by X, and A's work in the activity is performed pursuant to an employment contract between A and X. Under paragraph (f)(1) of this section, work done by A in connection with the activity in any capacity is treated as participation in the activity by A. Accordingly, the conclusion is the same as in Example 1. The conclusion would be the same if A owned no stock in X at any time, although in that case A's participation would not be taken into account in determining whether X materially participates in the restaurant activity.

Example 3. B, an individual, is employed fulltime as a carpenter. B also owns an interest in a partnership which is engaged in a van conversion activity, which is a trade or business activity (within the meaning of § 1.469–1T(e)(2)). B and C, the other partner, are the only participants in the activity for the taxable year. The activity is conducted entirely on Saturdays. Each Saturday throughout the taxable year, B and C work for eight hours in the activity. Although B does not participate in the activity for more than 500 hours during the taxable year, under paragraph (a)(3) of this section, B is treated for such year as materially participating in the activity because B participates in the activity for more than 100 hours during the taxable year, and B's participation in the activity for such year is not less than the participation of any other person in the activity for such year.

Example 4. C, an individual, is employed full-time as an accountant. C also owns interests in a restaurant and a shoe store. The restaurant and shoe store are trade or business activities (within the meaning of § 1.469–1T(e)(2)) that are treated as separate activities under the rules to be contained in § 1.469–4T. Each activity has several full-time employees. During the taxable year, C works in the restaurant activity for 400 hours and in the shoe store activity for 150 hours. Under paragraph (c) of this section, both the restaurant and shoe store activities are significant participation activities of C for the taxable year. Accordingly, since C's aggregate participation in the restaurant and shoe store activities during the taxable year exceeds 500 hours, C is treated under paragraph (a)(4) of this section as materially participating in both activities.

Example 5. [Reserved]. See § 1.469–5(k) *Example 5* for this example.

Example 6. The facts are the same as in Example 5, except that D does not acquire any stock in the S corporation until 1994. Under paragraph (f)(1) of this section, D is not treated as participating in the activity for any taxable year prior to 1994 because D does not own as interest in the activity for any such taxable year. Accordingly, D materially participates in the activity for only one taxable year prior to 1995, and D is not treated under paragraph (a)(5) of this section as materially participating in the activity for 1995 or subsequent taxable years.

Example 7. (i) E, a married individual filing a separate return for the taxable year, is employed full-time as an attorney. E also owns an interest in a professional football team that is a trade or business activity (within the meaning of § 1.469–1T(e)(2)). E does no work in connection with this activity. E anticipates that, for the taxable year, E's deductions from the activity will exceed E's gross income from the activity and that, if E does not materially participate in the activity for the taxable year, part or all of F's passive activity loss for the taxable year will be disallowed under § 1.469–1T(a)(1)(i). Accordingly, E pays E's spouse to work as an office receptionist in connection with the activity for an average of 15 hours per week during the taxable year.

(ii) Under paragraph (f)(3) of this section any participation in the activity by E's spouse is treated as participation in the activity by E. However, under paragraph (f)(2)(i) of this section, the work done by E's spouse is not treated as participation in the activity because work as an office receptionist is not work of a type customarily done by an owner of a football team, and one of E's principal purposes for paying E's spouse to do this work is to avoid the disallowance under §1.469–1T(a)(1)(i) of E's passive activity loss. Accordingly, E is not treated as participating in the activity for the taxable year.

Example 8. (i) F, an individual, owns an interest in a partnership that feeds and sells cattle. The general partner of the partnership periodically mails F a letter setting forth certain proposed actions and decisions with respect to the cattle-feeding operation. Such actions and decisions include, for example, what kind of feed to purchase, how much to purchase, and when to purchase it, how often to feed cattle, and when to sell cattle. The letters explain the proposed actions and decisions, emphasize that taking or not taking a particular action or decision is solely within the discretion of F and other partners, and ask F to indicate a decision with respect to each proposed action by answering certain questions. The general partner receives a fee that constitutes earned income (within the meaning of section 911 (d)(2)(A)) for managing the cattle-feeding operation. F is not treated as materially participating in the cattle-feeding operation under paragraph (a) (1) through (6) of this section.

(ii) F's only participation in the cattle-feeding operation is to make certain managerial decisions. Under paragraph (b)(2)(ii) of this section, such management services are not taken into account in determining whether the taxpayer is treated as materially participating in the activity for a taxable year under paragraph (a)(7) of this section, if any other person performs services in connection with the management of the activity and receives compensation described in section 911(d)(2)(A) for such services. Therefore, F is not treated as materially participating for the taxable year in the cattle-feeding operation.

[T.D. 8175, 53 FR 5725, Feb. 25, 1988; 53 FR 15494, Apr. 29, 1988, as amended by T.D. 8253, 54 FR 20565, May 12, 1989; T.D. 8417, 57 FR 20759, May 15, 1992; 61 FR 14247, Apr. 1, 1996]

§ 1.469–6 Treatment of losses upon certain dispositions. [Reserved]

§ 1.469–7 Treatment of self-charged items of interest income and deduction.

(a) *In general*—(1) *Applicability and effect of rules.* This section sets forth rules that apply, for purposes of section 469 and the regulations thereunder, in the case of a lending transaction (including guaranteed payments for the use of capital under section 707(c)) between a taxpayer and a passthrough entity in which the taxpayer owns a direct or indirect interest, or between certain passthrough entities. The rules apply only to items of interest income and interest expense that are recognized in the same taxable year. The rules—

(i) Treat certain interest income resulting from these lending transactions as passive activity gross income;

(ii) Treat certain deductions for interest expense that is properly allocable to the interest income as passive activity deductions; and

(iii) Allocate the passive activity gross income and passive activity deductions resulting from this treatment among the taxpayer's activities.

(2) *Priority of rules in this section.* The character of amounts treated under the rules of this section as passive activity gross income and passive activity deductions and the activities to which these amounts are allocated are determined under the rules of this section and not under the rules of §§1.163–8T, 1.469–2(c) and (d), and 1.469–2T(c) and (d).

(b) *Definitions.* The following definitions set forth the meaning of certain terms for purposes of this section:

(1) *Passthrough entity.* The term *passthrough entity* means a partnership or an S corporation.

(2) *Taxpayer's share.* A *taxpayer's share* of an item of income or deduction of a passthrough entity is the amount treated as an item of income or deduction of the taxpayer for the taxable year under section 702 (relating to the treatment of distributive shares of partnership items as items of partners) or section 1366 (relating to the treatment of pro rata shares of S corporation items as items of shareholders).

(3) *Taxpayer's indirect interest.* The taxpayer has an indirect interest in an entity if the interest is held through one or more passthrough entities.

(4) *Entity taxable year.* In applying this section for a taxable year of a taxpayer, the term *entity taxable year* means the taxable year of the passthrough entity for which the entity reports items that are taken into account under section 702 or section 1366 for the taxpayer's taxable year.

(5) *Deductions for a taxable year.* The term *deductions for a taxable year* means deductions that would be allowable for

the taxable year if the taxpayer's taxable income for all taxable years were determined without regard to sections 163(d), 170(b), 469, 613A(d), and 1211.

(c) *Taxpayer loans to passthrough entity*—(1) *Applicability.* Except as provided in paragraph (g) of this section, this paragraph (c) applies with respect to a taxpayer's interest in a passthrough entity (borrowing entity) for a taxable year if—

(i) The borrowing entity has deductions for the entity taxable year for interest charged to the borrowing entity by persons that own direct or indirect interests in the borrowing entity at any time during the entity taxable year (the borrowing entity's self-charged interest deductions);

(ii) The taxpayer owns a direct or an indirect interest in the borrowing entity at any time during the entity taxable year and has gross income for the taxable year from interest charged to the borrowing entity by the taxpayer or a passthrough entity through which the taxpayer holds an interest in the borrowing entity (the taxpayer's income from interest charged to the borrowing entity); and

(iii) The taxpayer's share of the borrowing entity's self-charged interest deductions includes passive activity deductions.

(2) *General rule.* If any of the borrowing entity's self-charged interest deductions are allocable to an activity for a taxable year in which this paragraph (c) applies, the passive activity gross income and passive activity deductions from that activity are determined under the following rules—

(i) The applicable percentage of each item of the taxpayer's income for the taxable year from interest charged to the borrowing entity is treated as passive activity gross income from the activity; and

(ii) The applicable percentage of each deduction for the taxable year for interest expense that is properly allocable (within the meaning of paragraph (f) of this section) to the taxpayer's income from the interest charged to the borrowing entity is treated as a passive activity deduction from the activity.

(3) *Applicable percentage.* In applying this paragraph (c) with respect to a taxpayer's interest in a borrowing entity, the applicable percentage is separately determined for each of the taxpayer's activities. The percentage applicable to an activity for a taxable year is obtained by dividing—

(i) The taxpayer's share for the taxable year of the borrowing entity's self-charged interest deductions that are treated as passive activity deductions from the activity by

(ii) The greater of—

(A) The taxpayer's share for the taxable year of the borrowing entity's aggregate self-charged interest deductions for all activities (regardless of whether these deductions are treated as passive activity deductions); or

(B) The taxpayer's aggregate income for the taxable year from interest charged to the borrowing entity for all activities of the borrowing entity.

(d) *Passthrough entity loans to taxpayer*—(1) *Applicability.* Except as provided in paragraph (g) of this section, this paragraph (d) applies with respect to a taxpayer's interest in a passthrough entity (lending entity) for a taxable year if—

(i) The lending entity has gross income for the entity taxable year from interest charged by the lending entity to persons that own direct or indirect interests in the lending entity at any time during the entity taxable year (the lending entity's self-charged interest income);

(ii) The taxpayer owns a direct or an indirect interest in the lending entity at any time during the entity taxable year and has deductions for the taxable year for interest charged by the lending entity to the taxpayer or a passthrough entity through which the taxpayer holds an interest in the lending entity (the taxpayer's deductions for interest charged by the lending entity); and

(iii) The taxpayer's deductions for interest charged by the lending entity include passive activity deductions.

(2) *General rule.* If any of the taxpayer's deductions for interest charged by the lending entity are allocable to an activity for a taxable year in which this paragraph (d) applies, the passive activity gross income and passive activity deductions from that activity are determined under the following rules—

(i) The applicable percentage of the taxpayer's share for the taxable year of each item of the lending entity's self-charged interest income is treated as passive activity gross income from the activity.

(ii) The applicable percentage of the taxpayer's share for the taxable year of each deduction for interest expense that is properly allocable (within the meaning of paragraph (f) of this section) to the lending entity's self-charged interest income is treated as a passive activity deduction from the activity.

(3) *Applicable percentage.* In applying this paragraph (d) with respect to a taxpayer's interest in a lending entity, the applicable percentage is separately determined for each of the taxpayer's activities. The percentage applicable to an activity for a taxable year is obtained by dividing—

(i) The taxpayer's deductions for the taxable year for interest charged by the lending entity, to the extent treated as passive activity deductions from the activity; by

(ii) The greater of—

(A) The taxpayer's aggregate deductions for all activities for the taxable year for interest charged by the lending entity (regardless of whether these deductions are treated as passive activity deductions); or

(B) The taxpayer's aggregate share for the taxable year of the lending entity's self-charged interest income for all activities of the lending entity.

(e) *Identically-owned passthrough entities*—(1) *Applicability.* Except as provided in paragraph (g) of this section, this paragraph (e) applies with respect to lending transactions between passthrough entities if each owner of the borrowing entity has the same proportionate ownership interest in the lending entity.

(2) *General rule.* To the extent an owner shares in interest income from a loan between passthrough entities described in paragraph (e)(1) of this section, the owner is treated as having made the loan to the borrowing passthrough entity and paragraph (c) of this section applies to determine the applicable percentage of portfolio income of properly allocable interest expense that is recharacterized as passive.

(3) *Example.* The following example illustrates the application of this paragraph (e):

Example. (i) A and B, both calendar year taxpayers, each own a 50-percent interest in the capital and profits of partnerships RS and XY, both calendar year partnerships. Under the partnership agreements of RS and XY, A and B are each entitled to a 50-percent distributive share of each partnership's income, gain, loss, deduction, or credit. RS makes a $20,000 loan to XY and XY pays RS $2,000 of interest for the taxable year. A's distributive share of interest income attributable to this loan is $1,000 (50 percent × $2,000). XY uses all of the proceeds received from RS is a passive activity. A's distributive share of interest expense attributable to the loan is $1,000 (50 percent × $2,000).

(ii) This paragraph (e) applies in determining A's passive activity gross income because RS and XY are identically-owned passthrough entities as described in paragraph (e)(1) of this section. Under paragraph (e)(2) of this section, the RS-to-XY loan is treated as if A made the loan to XY. Therefore, A must apply paragraph (c) of this section to determine the applicable percentage of portfolio income that is recharacterized as passive income.

(iii) Paragraph (c) of this section applies in determining A's passive activity gross income because: XY has deductions for interest charged to XY by RS for the taxable year (XY's self-charged interest deductions); A owns an interest in XY during XY's taxable year and has gross income for the taxable year from interest charged to XY by RS; and A's share of XY's self-charged interest deductions includes passive activity deductions. See paragraph (c)(1) of this section.

(iv) Under paragraph (c)(2)(i) of this section, the applicable percentage of A's interest income is recharacterized as passive activity gross income from the activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing A's share for the taxable year of XY's self-charged interest deductions that are treated as passive activity deductions from the activity ($1,000) by the greater of A's share for the taxable year of XY's self-charged interest deductions ($1,000), or A's income for the year from interest charged to XY ($1,000). Thus, A's applicable percentage is 100 percent ($1,000/$1,000), and $1,000 (100 percent × $1,000) of A's income from interest charged to XY is treated as passive activity gross income from the passive activity.

(f) *Identification of properly allocable deductions.* For purposes of this section, interest expense is properly allocable to an item of interest income if the interest expense is allocated under §1.163–8T to an expenditure that—

(1) Is properly chargeable to capital account with respect to the investment producing the item of interest income; or

(2) May reasonably be taken into account as a cost of producing the item of interest income.

(g) *Election to avoid application of the rules of this section*—(1) *In general*. Paragraphs (c), (d) and (e) of this section shall not apply with respect to any taxpayer's interest in a passthrough entity for a taxable year if the passthrough entity has made, under this paragraph (g), an election that applies to the entity's taxable year.

(2) *Form of election*. A passthrough entity makes an election under this paragraph (g) by attaching to its return (or amended return) a written statement that includes the name, address, and taxpayer identification number of the passthrough entity and a declaration that an election is being made under this paragraph (g).

(3) *Period for which election applies*. An election under this paragraph (g) made with a return (or amended return) for a taxable year applies to that taxable year and all subsequent taxable years that end before the date on which the election is revoked.

(4) *Revocation*. An election under this paragraph (g) may be revoked only with the consent of the Commissioner.

(h) *Examples*. The following examples illustrate the principles of this section. The examples assume for purposes of simplifying the presentation, that the lending transactions described do not result in foregone interest (within the meaning of section 7872(e)(2)), original issue discount (within the meaning of section 1273), or total unstated interest (within the meaning of section 483(b)).

Example 1. (i) A and B, two calendar year individuals, each own 50-percent interests in the capital, profits and losses of AB, a calendar year partnership. AB is engaged in a single rental activity within the meaning of §1.469–1T(e)(3). AB borrows $50,000 from A and uses the loan proceeds in the rental activity. AB pays $5,000 of interest to A for the taxable year. A and B each incur $2,500 of interest expense as their distributive share of AB's interest expense.

(ii) AB has self-charged interest deductions for the taxable year (*i.e.*, the deductions for interest charged to AB by A); A owns a direct interest in AB during AB's taxable year and has income for A's taxable year from interest charged to AB; and A's share of AB's self-charged interest deductions includes passive activity deductions. Accordingly, paragraph (c) of this section applies in determining A's passive activity gross income. See paragraph (c)(1) of this section.

(iii) Under paragraph (c)(2)(i) of this section, the applicable percentage of A's interest income is recharacterized as passive activity gross income from AB's rental activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing A's share for the taxable year of AB's self-charged interest deductions that are treated as passive activity deductions from the activity ($2,500) by the greater of A's share for the taxable year of AB's self-charged interest deductions ($2,500), or A's income for the taxable year from interest charged to AB ($5,000). Thus, A's applicable percentage is 50 percent ($2,500/$5,000), and $2,500 (50 percent × $5,000) of A's income from interest charged to AB is treated as passive activity gross income from the passive activity A conducts through AB.

(iv) Because B does not have any gross income for the year from interest charged to AB, this section does not apply to B. See paragraph (c)(1)(ii) of this section.

Example 2. (i) C and D, two calendar year taxpayers, each own 50-percent interests in the capital and profits of CD, a calendar year partnership. CD is engaged in a single rental activity, within the meaning of §1.469–1T(e)(3). C obtains a $10,000 loan from a third-party lender, and pays the lender $900 in interest for the taxable year. C lends the $10,000 to CD, and receives $1,000 of interest income from CD for the taxable year. D lends $20,000 to CD and receives $2,000 of interest income from CD for the taxable year. CD uses all of the proceeds in the rental activity. C and D are each allocated $1,500 (50 percent × $3,000) of interest expense as their distributive share of CD's interest expense for the taxable year.

(ii) CD has self-charged interest deductions for the taxable year (i.e., deductions for interest charged to CD by C and D); C and D each own direct interests in CD during CD's taxable year and have gross income for the taxable year from interest charged to CD; and both C's and D's shares of CD's self-charged interest deductions include passive activity deductions. Accordingly, paragraph (c) of this section applies in determining C's and D's passive activity gross income. See paragraph (c)(1) of this section.

(iii) Under paragraph (c)(2)(i) of this section, the applicable percentage of each partner's interest income is recharacterized as passive activity gross income from CD's rental activity. Paragraph (c)(3) of this section provides that C's applicable percentage is obtained by dividing C's share for the taxable year of CD's self-charged interest deductions that are treated as passive activity deductions from the activity ($1,500) by the greater of C's share for the taxable year of CD's self-charged interest deductions ($1,500), or C's income for the taxable year from interest charged to CD ($1,000). Thus, C's applicable percentage is 100 percent ($1,500/$1,500), and all of C's income from interest charged to CD ($1,000) is treated as passive activity gross income from the passive activity C conducts through CD. Similarly, D's applicable percentage is obtained by dividing D's share for the taxable year of CD's self-charged interest deductions that are treated as passive activity deductions from the activity ($1,500) by the greater of D's share for the taxable year of CD's self-charged interest deductions ($1,500), or D's income for the taxable year from interest charged to CD ($2,000). Thus, D's applicable percentage is 75 percent ($1,500/$2,000), and $1,500 (75 percent × $2,000) of D's income from interest charged to CD is treated as passive activity gross income from the rental activity.

(iv) The $900 of interest expense that C pays to the third-party lender is allocated under §1.163–8T(c)(1) to an expenditure that is properly chargeable to capital account with respect to the loan to CD. Thus, the expense is properly allocable to the interest income C receives from CD (see paragraph (f) of this section). Under paragraph (c)(2)(ii) of this section, the applicable percentage of C's deductions for the taxable year for interest expense that is properly allocable to C's income from interest charged to CD is recharacterized as a passive activity deduction from CD's rental activity. Accordingly, all of C's $900 interest deduction is treated as a passive activity deduction from the rental activity.

Example 3. (i) E and F, calendar year taxpayers, each own 50 percent of the stock of X, a calendar year S corporation. E borrows $30,000 from X, and pays X $3,000 of interest for the taxable year. E uses $15,000 of the loan proceeds to make a personal expenditure (as defined in §1.163–8T(b)(5)), and uses $15,000 of loan proceeds to purchase a trade or business activity in which E does not materially participate (within the meaning of §1.469–5T) for the taxable year. E and F each receive $1,500 as their pro rata share of X's interest income from the loan for the taxable year.

(ii) X has gross income for X's taxable year from interest charged to E (X's self-charged interest income); E owns a direct interest in X during X's taxable year and has deductions for the taxable year for interest charged by X; and E's deductions for interest charged by X include passive activity deductions. Accordingly, paragraph (d) of this section applies in determining E's passive activity gross income. See paragraph (d)(1) of this section.

(iii) Under the rules in paragraph (d)(2)(i) of this section, the applicable percentage of E's share of X's self-charged interest income is recharacterized as passive activity gross income from the activity. Paragraph (d)(3) of this section provides that the applicable percentage is obtained by dividing E's deductions for the taxable year for interest charged by X, to the extent treated as passive activity deductions from the activity ($1,500), by the greater of E's deductions for the taxable year for interest charged by X, regardless of whether those deductions are treated as passive activity deductions ($3,000), or E's share for the taxable year of X's self-charged interest income ($1,500). Thus, E's applicable percentage is 50 percent ($1,500/$3,000), and $750 (50 percent × $1,500) of E's share of X's self-charged interest income is treated as passive activity gross income.

(iv) Because F does not have any deductions for the taxable year for interest charged by X, this section does not apply to F. See paragraph (d)(1)(ii) of this section.

Example 4. (i) This *Example 4* illustrates the application of this section to a partner that has a different taxable year from the partnership. The facts are the same as in *Example 1* except as follows: Partnership AB has properly adopted a fiscal year ending June 30 for federal tax purposes; AB borrows the $50,000 from A on October 1, 1990; and under the terms of the loan, AB must pay A $5,000 in interest annually, in quarterly installments, for a term of 2 years.

(ii) For A's taxable years from 1990 through 1993 and AB's corresponding entity taxable years (as defined in paragraph (b)(4) of this section) A's interest income and AB's interest deductions from the loan are as follows:

	A's interest income	AB's interest deductions
1990	$1,250	0
1991	5,000	$3,750
1992	3,750	5,000
1993	0	1,250

(iii) For A's taxable year ending December 31, 1990, the corresponding entity taxable year is AB's taxable year ending June 30, 1990. Because AB does not have any deductions for the entity taxable year for interest charged to AB by A, paragraph (c) of this section does not apply in determining A's passive activity gross income for 1990 (see paragraph (c)(1)(i) of this section). Accordingly, A reports $1,250 of portfolio income on A's 1990 income tax return.

(iv) For A's taxable year ending December 31, 1991, the corresponding entity taxable year ends on June 30, 1991. AB has $3,750 of deductions for the entity taxable year for interest charged to AB by A (AB's self-charged interest deductions); A owns a direct interest in AB during the entity taxable year and has $5,000 of interest income for A's taxable year from interest charged to AB; and A's share of AB's self-charged interest deductions includes passive activity deductions. Accordingly, paragraph (c) of this section applies in determining A's passive activity gross income.

(v) Under paragraph (c)(2)(i) of this section, the applicable percentage of A's 1991 interest income is recharacterized as passive activity gross income from the activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing A's share for A's 1991 taxable year of AB's self-charged interest deductions that are treated as passive activity deductions from the activity (50 percent × $3,750 = $1,875) by the greater of A's share for A's taxable year of AB's self-charged interest deductions ($1,875), or A's income for A's taxable year from interest charged to AB ($5,000). Thus, A's applicable percentage is 37.5 percent ($1,875/$5,000), and $1,875 (37.5 percent × $5,000) of A's income from interest charged to AB is treated as passive activity gross income from the passive activity A conducts through AB.

(vi) For A's taxable year ending December 31, 1992, the corresponding entity taxable year ends on June 30, 1992. AB has $5,000 of deductions for the entity taxable year for interest charged to AB by A (AB's self-charged interest deductions); A owns a direct interest in AB during the entity taxable year and has $3,750 of gross income for A's taxable year from interest charged to AB; and A's share of AB's self-charged interest deductions includes passive activity deductions. Accordingly, paragraph (c) of this section applies in determining A's passive activity gross income.

(vii) The applicable percentage for 1992 is obtained by dividing A's share for A's 1992 taxable year of AB's self-charged interest deductions that are treated as passive activity deductions from the activity ($2,500) by the greater of A's share for A's taxable year of AB's self-charged interest deductions ($2,500), or A's income for A's taxable year from interest charged to AB ($3,750). Thus, A's applicable percentage is 66⅔ percent ($2,500/$3,750), and $2,500 (66⅔ percent × $3,750) of A's income from interest charged to AB is treated as passive activity gross income from the passive activity A conducts through AB.

(viii) Paragraph (c) of this section does not apply in determining A's passive activity gross income for the taxable year ending December 31, 1993, because A has no gross income for the taxable year from interest charged to AB (see paragraph (c)(1)(ii) of this section). A's share of AB's self-charged interest deductions for the entity taxable year ending June 30, 1993 ($625) is taken into account as a passive activity deduction on A's 1993 income tax return.

(ix) Because B does not have any gross income from interest charged to AB for any of the taxable years, this section does not apply to B. See paragraph (c)(1)(ii) of this section.

Example 5. (i) This *Example 5* illustrates the application of the rules of this section in the case of a taxpayer who has an indirect interest in a partnership. G, a calendar year taxpayer, is an 80-percent partner in partnership UTP. UTP owns a 25-percent interest in the capital and profits of partnership LTP. UTP and LTP are both calendar year partnerships. The partners of LTP conduct a single passive activity through LTP. UTP obtains a $10,000 loan from a bank, and pays the bank $1,000 of interest per year. G's distributive share of the interest paid to the bank is $800 (80 percent × $1,000). UTP uses the $10,000 debt proceeds and another $10,000 of cash to make a loan to LTP, and LTP pays UTP $2,000 of interest for the taxable year. G's distributive share of interest income attributable to the UTP-to-LTP loan is $1,600 (80 percent × $2,000). LTP uses all of the proceeds received from UTP in the passive activity. UTP's distributive share of interest expense attributable to the UTP-to-LTP loan is $500 (25 percent × $2,000). G's distributive share of interest expense attributable to the UTP-to-LTP loan is $400 (80 percent × $500).

(ii) LTP has deductions for interest charged to LTP by UTP for the taxable year (LTP's self-charged interest deductions); G owns an indirect interest in LTP during LTP's taxable year and has gross income for the taxable year from interest charged to LTP by a passthrough entity (UTP) through which G owns an interest in LTP; and G's share of LTP's self-charged interest deductions includes passive activity deductions. Accordingly, paragraph (c) of this section applies in determining G's passive activity gross income. See paragraph (c)(1) of this section.

(iii) Under paragraph (c)(2)(i) of this section, the applicable percentage of G's interest income is recharacterized as passive activity gross income from the activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing G's share for the taxable year of LTP's self-charged interest deductions that are treated as passive activity deductions from the activity ($400) by the greater of G's share for the taxable year of LTP's self-charged interest deductions ($400), or G's income for the year from interest charged to LTP ($1,600). Thus, G's applicable percentage is 25 percent ($400/$1,600), and $400 (25 percent × $1,600) of G's income from interest charged to LTP is treated as passive activity gross income from the passive activity that G conducts through UTP and LTP.

(iv) G's $800 distributive share of the interest expense that UTP pays to the third-party lender is allocated under § 1.163–8T(c)(1) to an expenditure that is properly chargeable to capital account with respect to the loan to LTP. Thus, the expense is a deduction properly allocable to the interest income that G receives as a result of the UTP-to-LTP loan (see paragraph (f) of this section). Under paragraph (c)(2)(ii) of this section, the applicable percentage of G's deductions for the taxable year for interest expense that is properly allocable to G's income from interest charged by UTP to LTP is recharacterized as a passive activity deduction from LTP's passive activity. Accordingly, $200 (25 percent × $800) of G's interest deduction is treated as a passive activity deduction from LTP's activity.

Example 6. (i) This *Example 6* illustrates the application of the rules of this section in the case of a taxpayer who conducts two passive activities through a passthrough entity. J, a calendar year taxpayer, is the 100-percent shareholder of Y, a calendar year S corporation. J conducts two passive activities through Y: a rental activity and a trade or business activity in which J does not materially participate. Y borrows $80,000 from J, and uses $60,000 of the loan proceeds in the rental activity and $20,000 of the loan proceeds in the passive trade or business activity. Y pays $8,000 of interest to J for the taxable year, and J incurs $8,000 of interest expense as J's distributive share of Y's interest expense.

(ii) Y has self-charged interest deductions for the taxable year (i.e., the deductions for interest charged to Y by J); J owns a direct interest in Y during Y's taxable year and has gross income for J's taxable year from interest charged to Y; and J's share of Y's self-charged interest deductions includes passive activity deductions. Accordingly, paragraph (c) of this section applies in determining J's passive activity gross income. See paragraph (c)(1) of this section.

(iii) Under paragraph (c)(2)(i) of this section, the applicable percentage of J's interest income is recharacterized as passive activity gross income attributable to the rental activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing J's share for the taxable year of Y's self-charged interest deductions that are treated as passive activity deductions from the rental activity ($6,000) by the greater of J's share for the taxable year of Y's self-charged interest deductions ($8,000), or J's income for the taxable year from interest charged to Y ($8,000). Thus, J's applicable percentage is 75 percent ($6,000/$8,000), and $6,000 (75 percent × $8,000) of J's income from interest charged to Y is treated as passive activity gross income from the rental activity J conducts through Y.

(iv) Under paragraph (c)(2)(i) of this section, the applicable percentage of J's interest income is recharacterized as passive activity gross income attributable to the passive trade or business activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing J's share for the taxable year of Y's self-charged interest deductions that are treated as passive activity deductions from the passive trade or business activity ($2,000) by the greater of J's share for the taxable year of Y's self-charged interest deductions ($8,000), or J's income for the taxable year from interest charged to Y ($8,000). Thus, J's applicable percentage is 25 percent ($2,000/$8,000), and $2,000 of J's income from interest charged to Y is treated as passive activity gross income from the passive trade or business activity J conducts through Y.

[T.D. 9013, 67 FR 54089, Aug. 21, 2002]

§ 1.469–8 Application of section 469 to trust, estates, and their beneficiaries. [Reserved]

§ 1.469–9 Rules for certain rental real estate activities.

(a) *Scope and purpose*. This section provides guidance to taxpayers engaged in certain real property trades or businesses on applying section 469(c)(7) to their rental real estate activities.

(b) *Definitions*. The following definitions apply for purposes of this section:

(1) *Trade or business*. A *trade or business* is any trade or business determined by treating the types of activities in § 1.469–4(b)(1) as if they involved the conduct of a trade or business, and any interest in rental real estate, including any interest in rental real estate that gives rise to deductions under section 212.

(2) *Real property trade or business*. *Real property trade or business* is defined in section 469(c)(7)(C).

(3) *Rental real estate*. *Rental real estate* is any real property used by customers or held for use by customers in a rental activity within the meaning of § 1.469–1T(e)(3). However, any rental real estate that the taxpayer grouped with a trade or business activity under § 1.469–4(d)(1)(i)(A) or (C) is not an interest in rental real estate for purposes of this section.

(4) *Personal services*. *Personal services* means any work performed by an individual in connection with a trade or business. However, personal services do not include any work performed by an individual in the individual's capacity

as an investor as described in §1.469–5T(f)(2)(ii).

(5) *Material participation. Material participation* has the same meaning as under §1.469–5T. Paragraph (f) of this section contains rules applicable to limited partnership interests in rental real estate that a qualifying taxpayer elects to aggregate with other interests in rental real estate of that taxpayer.

(6) *Qualifying taxpayer.* A *qualifying taxpayer* is a taxpayer that owns at least one interest in rental real estate and meets the requirements of paragraph (c) of this section.

(c) *Requirements for qualifying taxpayers*—(1) *In general.* A qualifying taxpayer must meet the requirements of section 469(c)(7)(B).

(2) *Closely held C corporations.* A closely held C corporation meets the requirements of paragraph (c)(1) of this section by satisfying the requirements of section 469(c)(7)(D)(i). For purposes of section 469(c)(7)(D)(i), gross receipts do not include items of portfolio income within the meaning of §1.469–2T(c)(3).

(3) *Requirement of material participation in the real property trades or businesses.* A taxpayer must materially participate in a real property trade or business in order for the personal services provided by the taxpayer in that real property trade or business to count towards meeting the requirements of paragraph (c)(1) of this section.

(4) *Treatment of spouses.* Spouses filing a joint return are qualifying taxpayers only if one spouse separately satisfies both requirements of section 469(c)(7)(B). In determining the real property trades or businesses in which a married taxpayer materially participates (but not for any other purpose under this paragraph (c)), work performed by the taxpayer's spouse in a trade or business is treated as work performed by the taxpayer under §1.469–5T(f)(3), regardless of whether the spouses file a joint return for the year.

(5) *Employees in real property trades or businesses.* For purposes of paragraph (c)(1) of this section, personal services performed during a taxable year as an employee generally will be treated as performed in a trade or business but will not be treated as performed in a real property trade or business, unless the taxpayer is a five-percent owner (within the meaning of section 416(i)(1)(B)) in the employer. If an employee is not a five-percent owner in the employer at all times during the taxable year, only the personal services performed by the employee during the period the employee is a five-percent owner in the employer will be treated as performed in a real property trade or business.

(d) *General rule for determining real property trades or businesses*—(1) *Facts and circumstances.* The determination of a taxpayer's real property trades or businesses for purposes of paragraph (c) of this section is based on all of the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services. Depending on the facts and circumstances, a real property trade or business consists either of one or more than one trade or business specifically described in section 469(c)(7)(C). A taxpayer's grouping of activities under §1.469–4 does not control the determination of the taxpayer's real property trades or businesses under this paragraph (d).

(2) *Consistency requirement.* Once a taxpayer determines the real property trades or businesses in which personal services are provided for purposes of paragraph (c) of this section, the taxpayer may not redetermine those real property trades or businesses in subsequent taxable years unless the original determination was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original determination clearly inappropriate.

(e) *Treatment of rental real estate activities of a qualifying taxpayer*—(1) *In general.* Section 469(c)(2) does not apply to any rental real estate activity of a taxpayer for a taxable year in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section. Instead, a rental real estate activity of a qualifying taxpayer is a passive activity under section 469 for the taxable year unless the taxpayer materially participates in the activity. Each interest in rental real estate of a qualifying taxpayer will be treated as a separate rental real estate activity, unless the taxpayer makes an election under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity. Each separate rental real estate activity, or the single combined rental real estate activity if the taxpayer makes an election under paragraph (g), will be an activity of the taxpayer for all purposes of section 469, including the former passive activity rules under section 469(f) and the disposition rules under section 469(g). However, section 469 will continue to be applied separately with respect to each publicly traded partnership, as required under section 469(k), notwithstanding the rules of this section.

(2) *Treatment as a former passive activity.* For any taxable year in which a qualifying taxpayer materially participates in a rental real estate activity, that rental real estate activity will be treated as a former passive activity under section 469(f) if disallowed deductions or credits are allocated to the activity under §1.469–1(f)(4).

(3) *Grouping rental real estate activities with other activities*—(i) *In general.* For purposes of this section, a qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer. For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity. Thus, only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity under §1.469–5T.

(ii) *Special rule for certain management activities.* A qualifying taxpayer may participate in a rental real estate activity through participation, within the meaning of §§1.469–5(f) and 5T(f), in an activity involving the management of rental real estate (even if this management activity is conducted through a separate entity). In determining whether the taxpayer materially participates in the rental real estate activity, however, work the taxpayer performs in the management activity is taken into account only to the extent it is performed in managing the taxpayer's own rental real estate interests.

(4) *Example.* The following example illustrates the application of this paragraph (e).

Example. (i) Taxpayer *B* owns interests in three rental buildings, *U*, *V* and *W*. In 1995, *B* has $30,000 of disallowed passive losses allocable to Building *U* and $10,000 of disallowed passive losses allocable to Building *V* under §1.469–1(f)(4). In 1996, *B* has $5,000 of net income from Building *U*, $5,000 of net losses from Building *V*, and $10,000 of net income from Building *W*. Also in 1996, *B* is a qualifying taxpayer within the meaning of paragraph (c) of this section. Each building is treated as a separate activity of *B* under paragraph (e)(1) of this section, unless *B* makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. If the buildings are treated as separate activities, material participation is determined separately with respect to each building. If *B* makes the election under paragraph (g) to treat the buildings as a single activity, all participation relating to the buildings is aggregated in determining whether *B* materially participates in the combined activity.

(ii) Effective beginning in 1996, *B* makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. *B* works full-time managing the three buildings and thus materially participates in the combined activity in 1996 (even if *B* conducts this management function through a separate entity, including a closely held C corporation). Accordingly, the combined activity is not a passive activity of *B* in 1996. Moreover, as a result of the election under paragraph (g), disallowed passive losses of $40,000 ($30,000 + $10,000) are allocated to the combined activity. B's net income from the activity for 1996 is $10,000 ($5,000 − $5,000 + $10,000). This net income is nonpassive income for purposes of section 469. However, under section 469(f), the net income from a former passive activity may be offset with the disallowed passive losses from the same activity. Because Buildings *U*, *V* and *W* are treated as one activity for all purposes of section 469 due to the election under paragraph (g), and this activity is a former passive activity under section 469(f), *B* may offset the $10,000 of net income from the buildings with an equal amount of disallowed passive losses allocable to the buildings, regardless of which buildings produced the income or losses. As a result, *B* has $30,000

($40,000 − $10,000) of disallowed passive losses remaining from the buildings after 1996.

(f) *Limited partnership interests in rental real estate activities*—(1) *In general.* If a taxpayer elects under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity, and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest (within the meaning of §1.469–5T(e)(3)), the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of determining material participation. Accordingly, the taxpayer will not be treated under this section as materially participating in the combined rental real estate activity unless the taxpayer materially participates in the activity under the tests listed in §1.469–5T(e)(2) (dealing with the tests for determining the material participation of a limited partner).

(2) *De minimis exception.* If a qualifying taxpayer elects under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity, and the taxpayer's share of gross rental income from all of the taxpayer's limited partnership interests in rental real estate is less than ten percent of the taxpayer's share of gross rental income from all of the taxpayer's interests in rental real estate for the taxable year, paragraph (f)(1) of this section does not apply. Thus the taxpayer may determine material participation under any of the tests listed in §1.469–5T(a) that apply to rental real estate activities.

(g) *Election to treat all interests in rental real estate as a single rental real estate activity*—(1) *In general.* A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. This election is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section, even if there are intervening years in which the taxpayer is not a qualifying taxpayer. The election may be made in any year in which the taxpayer is a qualifying taxpayer, and the failure to make the election in one year does not preclude the taxpayer from making the election in a subsequent year. In years in which the taxpayer is not a qualifying taxpayer, the election will not have effect and the taxpayer's activities will be those determined under §1.469–4. If there is a material change in the taxpayer's facts and circumstances, the taxpayer may revoke the election using the procedure described in paragraph (g)(3) of this section.

(2) *Certain changes not material.* The fact that an election is less advantageous to the taxpayer in a particular taxable year is not, of itself, a material change in the taxpayer's facts and circumstances. Similarly, a break in the taxpayer's status as a qualifying taxpayer is not, of itself, a material change in the taxpayer's facts and circumstances.

(3) *Filing a statement to make or revoke the election.* A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's original income tax return for the taxable year. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to section 469(c)(7)(A). The taxpayer may make this election for any taxable year in which section 469(c)(7) is applicable. A taxpayer may revoke the election only in the taxable year in which a material change in the taxpayer's facts and circumstances occurs or in a subsequent year in which the facts and circumstances remain materially changed from those in the taxable year for which the election was made. To revoke the election, the taxpayer must file a statement with the taxpayer's original income tax return for the year of revocation. This statement must contain a declaration that the taxpayer is revoking the election under section 469(c)(7)(A) and an explanation of the nature of the material change.

(h) *Interests in rental real estate held by certain passthrough entities*—(1) *General rule.* Except as provided in paragraph (h)(2) of this section, a qualifying taxpayer's interest in rental real estate held by a partnership or an S corporation (passthrough entity) is treated as a single interest in rental real estate if the passthrough entity grouped its rental real estate as one rental activity under § 1.469–4(d)(5). If the passthrough entity grouped its rental real estate into separate rental activities under § 1.469–4(d)(5), each rental real estate activity of the passthrough entity will be treated as a separate interest in rental real estate of the qualifying taxpayer. However, the qualifying taxpayer may elect under paragraph (g) of this section to treat all interests in rental real estate, including the rental real estate interests held through passthrough entities, as a single rental real estate activity.

(2) *Special rule if a qualifying taxpayer holds a fifty-percent or greater interest in a passthrough entity.* If a qualifying taxpayer owns, directly or indirectly, a fifty-percent or greater interest in the capital, profits, or losses of a passthrough entity for a taxable year, each interest in rental real estate held by the passthrough entity will be treated as a separate interest in rental real estate of the qualifying taxpayer, regardless of the passthrough entity's grouping of activities under § 1.469–4(d)(5). However, the qualifying taxpayer may elect under paragraph (g) of this section to treat all interests in rental real estate, including the rental real estate interests held through passthrough entities, as a single rental real estate activity.

(3) *Special rule for interests held in tiered passthrough entities.* If a passthrough entity owns a fifty-percent or greater interest in the capital, profits, or losses of another passthrough entity for a taxable year, each interest in rental real estate held by the lower-tier entity will be treated as a separate interest in rental real estate of the upper-tier entity, regardless of the lower-tier entity's grouping of activities under § 1.469–4(d)(5).

(i) [Reserved]

(j) *$25,000 offset for rental real estate activities of qualifying taxpayers*—(1) *In general.* A qualifying taxpayer's passive losses and credits from rental real estate activities (including prior-year disallowed passive activity losses and credits from rental real estate activities in which the taxpayer materially participates) are allowed to the extent permitted under section 469(i). The amount of losses or credits allowable under section 469(i) is determined after the rules of this section are applied. However, losses allowable by reason of this section are not taken into account in determining adjusted gross income for purposes of section 469(i)(3).

(2) *Example.* The following example illustrates the application of this paragraph (j).

Example. (i) Taxpayer *A* owns building *X* and building *Y*, both interests in rental real estate. In 1995, *A* is a qualifying taxpayer within the meaning of paragraph (c) of this section. *A* does not elect to treat *X* and *Y* as one activity under section 469(c)(7)(A) and paragraph (g) of this section. As a result, *X* and *Y* are treated as separate activities pursuant to section 469(c)(7)(A)(ii). *A* materially participates in *X* which has $100,000 of passive losses disallowed from prior years and produces $20,000 of losses in 1995. *A* does not materially participate in *Y* which produces $40,000 of income in 1995. *A* also has $50,000 of income from other nonpassive sources in 1995. *A* otherwise meets the requirements of section 469(i).

(ii) Because *X* is not a passive activity in 1995, the $20,000 of losses produced by *X* in 1995 are nonpassive losses that may be used by *A* to offset part of the $50,000 of nonpassive income. Accordingly, *A* is left with $30,000 ($50,000–$20,000) of nonpassive income. In addition, A may use the prior year disallowed passive losses of *X* to offset any income from *X* and passive income from other sources. Therefore, *A* may offset the $40,000 of passive income from *Y* with $40,000 of passive losses from *X*.

(iii) Because *A* has $60,000 ($100,000–$40,000) of passive losses remaining from *X* and meets all of the requirements of section 469(i), *A* may offset up to $25,000 of nonpassive income with passive losses from *X* pursuant to section 469(i). As a result, *A* has $5,000 ($30,000–$25,000) of nonpassive income remaining and disallowed passive losses from *X* of $35,000 ($60,000–$25,000) in 1995.

[T.D. 8645, 60 FR 66499, Dec. 22, 1995]

§ 1.469–10 Application of section 469 to publicly traded partnerships.

(a) [Reserved]

(b) *Publicly traded partnership*—(1) *In general.* For purposes of section 469(k), a partnership is a publicly traded partnership only if the partnership is a publicly traded partnership as defined in § 1.7704–1.

(2) *Effective date.* This section applies for taxable years of a partnership beginning on or after December 17, 1998.

[T.D. 8799, 63 FR 69553, Dec. 17, 1998]

§ 1.469–11 Effective date and transition rules.

(a) *Generally applicable effective dates.* Except as otherwise provided in this section—

(1) The rules contained in §§ 1.469–1, 1.469–1T, 1.469–2, 1.469–2T, 1.469–3, 1.469–3T, 1.469–4, 1.469–5, and 1.469–5T apply for taxable years ending after May 10, 1992.

(2) The rules contained in 26 CFR 1.469–1T, 1.469–2T, 1.469–3T, 1.469–4T, 1.469–5T, 1.469–11T (b) and (c) (as contained in the CFR edition revised as of April 1, 1992) apply for taxable years beginning after December 31, 1986, and ending on or before May 10, 1992;

(3) The rules contained in § 1.469–9 apply for taxable years beginning on or after January 1, 1995, and to elections made under § 1.469–9(g) with returns filed on or after January 1, 1995;

(4) The rules contained in § 1.469–7 apply for taxable years ending after December 31, 1986; and

(5) This section applies for taxable years beginning after December 31, 1986.

(b) *Additional effective dates*—(1) *Application of 1992 amendments for taxable years beginning before October 4, 1994.* Except as provided in paragraph (b)(2) of this section, for taxable years that end after May 10, 1992, and begin before October 4, 1994, a taxpayer may determine tax liability in accordance with Project PS–1–89 published at 1992–1 C.B. 1219 (see § 601.601(d)(2)(ii)(b) of this chapter).

(2) *Additional transition rule for 1992 amendments.* If a taxpayer's first taxable year ending after May 10, 1992, begins on or before that date, the taxpayer may treat the taxable year, for purposes of paragraph (a) of this section, as a taxable year ending on or before May 10, 1992.

(3) *Fresh starts under consistency rules*—(i) *Regrouping when tax liability is first determined under Project PS–1–89.* For the first taxable year in which a taxpayer determines its tax liability under Project PS–1–89, the taxpayer may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year and must regroup its activities if the grouping in the preceding taxable year is inconsistent with the rules of Project PS–1–89.

(ii) *Regrouping when tax liability is first determined under § 1.469–4.* For the first taxable year in which a taxpayer determines its tax liability under § 1.469–4, rather than under the rules of Project PS–1–89, the taxpayer may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year and must regroup its activities if the grouping in the preceding taxable year is inconsistent with the rules of § 1.469–4.

(iii) *Regrouping when taxpayer is first subject to section 469(c)(7).* For the first taxable year beginning after December 31, 1993, a taxpayer may regroup its activities to the extent necessary or appropriate to avail itself of the provisions of section 469(c)(7) and without regard to the manner in which the activities were grouped in the preceding taxable year.

(iv) *Regrouping for taxpayers subject to section 1411*—(A) *In general.* If an individual, estate, or trust meets the Eligibility Criteria, as defined in paragraph (b)(3)(iv)(B) of this section, such individual, estate, or trust, in the first taxable year beginning after December 31, 2013, in which section 1411 would apply to such taxpayer, may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year. For this purpose, the determination of whether a taxpayer meets the Eligibility Criteria is made without regard to the effect of regrouping. The regrouping must be made in the manner prescribed by forms, instructions, or in other guidance on an original return for the taxable year for which the regrouping is done. A taxpayer that is an individual, estate, or trust may regroup its activities for any taxable year that begins during 2013, if the individual, estate, or trust meets the Eligibility Criteria for such year. A taxpayer may regroup activities only once pursuant to this paragraph (b)(3)(iv), and a regrouping made pursuant to this paragraph (b)(3)(iv) will apply to the taxable year for which the regrouping is done and all subsequent years.

(B) *Eligibility criteria.* The term *Eligibility Criteria* means that an individual, estate, or trust has net investment income (as defined in §1.1411–4) and such individual's (as defined in §1.1411–2(a)) modified adjusted gross income (as defined in §1.1411–2(c)) exceeds the applicable threshold in §1.1411–2(d) or such estate's or trust's (as defined in §1.1411–3(a)(1)(i)) adjusted gross income exceeds the amount described in §1.1411–3(a)(1)(ii)(B)(*2*).

(C) *Consequences of amended returns and examination adjustments*—(*1*) *Taxpayers first subject to section 1411.* An individual, estate, or trust also may regroup activities, in the manner described in paragraph (b)(3)(iv)(A) of this section, on an amended return only if the changes reported on such amended return cause the taxpayer to meet the Eligibility Criteria for the first time beginning in the taxable year for which the amended return is applicable and that the taxable year is not closed by the period of limitations on assessments under section 6501. If the amended return is for a tax year that precedes a tax year for which a taxpayer had regrouped its activities pursuant to paragraph (b)(3)(iv)(A) of this section, the regrouping on such amended return must be consistent with the taxpayer's subsequent year's regrouping. If a regrouping on an amended return is inconsistent with a subsequent year's grouping, the subsequent year's grouping is invalid under §1.469–4(e)(1) unless a material change in facts and circumstances occurred in the subsequent year such that the subsequent year's grouping constitutes a permissible regrouping under §1.469–4(e)(2). Similar rules also apply for any taxable year that begins during 2013.

(*2*) *Taxpayers ceasing to be subject to section 1411.* In the event a taxpayer regroups activities pursuant to paragraphs (b)(3)(iv)(A) or (C) of this section and it is subsequently determined that such taxpayer does not meet the Eligibility Criteria for the year of such regrouping, such regrouping will have no effect for that year and all future years. Appropriate adjustments should be made to reflect the voiding of the ineffective regrouping. However, notwithstanding the previous sentence, if an individual, estate, or trust meets the Eligibility Criteria in a subsequent year, such taxpayer is deemed to treat such regrouping as being made in such subsequent year unless the taxpayer either regroups in a different manner (so long as such alternative regrouping is permissible under §1.469–4) or properly reflects the ineffective regrouping in the previous year. The subsequent year's regrouping may be made on an original or on an amended return for that year. This paragraph (b)(3)(iv)(C)(*2*) shall not apply if a taxpayer does not meet the Eligibility Criteria for the year of such regrouping as a result of the carryback of a net operating loss pursuant to section 172. Similar rules also apply for any taxable year that begins during 2013.

(*3*) *Examples.* The following examples illustrate the principles of paragraph (b)(3)(iv)(C) of this section. In each example, unless otherwise indicated, the taxpayer uses a calendar taxable year, the taxpayer is a United States citizen, and Year 1 is a taxable year in which section 1411 is in effect:

Example 1. In Year 1, X, a single individual, reports modified adjusted gross income (as defined in §1.1411–2(c)) of $198,000 (including $12,000 of net investment income (as defined in §1.1411–4)); thus is not subject to 1411. After X filed his original return, X receives a corrected Form 1099–DIV, which increases his modified adjusted gross income (as defined in §1.1411–2(c)) and his net investment income by $2,500. X files an amended return for Year 1 in Year 2 reporting modified adjusted gross income of $200,500 and net investment income of $14,500. Pursuant to paragraph (b)(3)(iv)(C)(*1*) of this section, X may regroup his passive activities on an amended return, because X now has MAGI above the applicable threshold amount and net investment income.

Example 2. Same facts as *Example 1,* except that the $2,500 increase to modified adjusted gross income and net investment income was a result of an examination of X's Year 1 return. Pursuant to paragraph (b)(3)(iv)(C)(*1*) of this section, X may regroup his passive activities on an amended return.

Example 3. In Year 1, Y, a single individual reported modified adjusted gross income (as defined in §1.1411–2(c)) of $205,000 and net investment income (as defined in §1.1411–4) of $500. Pursuant to paragraph (b)(3)(iv)(A) of this section, Y regrouped his four passive activities, A, B, C, and D, into a single activity group. Prior to the Year 1 regrouping, Y had grouped A and B into one group, and treated each of C and D as separate activities. Y did not meet the Eligibly Criteria in any year prior to Year 1 or Year 2. In Year 3, Y's employer issued Y a corrected Year 1 Form W–2, which reduced Y's taxable wages by $6,000. As a result, Y no longer meets the Eligibility Criteria in Year 1 because Y's modified adjusted gross income is now $199,000. Therefore, Y's Year 1 regrouping is no longer effective and the prior groupings are in effect (that is, Activity A and B are one group and Activity C and Activity D separately). Appropriate adjustments should be made to reflect the ineffective regrouping. However, if Y had a material change in facts and circumstances such that Y could regroup in Year 1 or a subsequent year, as applicable, by reason of §1.469–4(e)(2), then the regrouping will be deemed to occur. Y could designate a different regrouping for the year of the material change in facts and circumstances.

Example 4. Same facts as *Example 3,* except that Y met the Eligibly Criteria in Year 2. In this case, Y's Year 1 regrouping is no longer effective and Y must report his income consistent with the pre-Year 1 groupings. In Year 2, Y has three options. First, without any action by Y, Y's activities are regrouped as originally reported in Year 1. In this case, the regrouping from the Year 1 return is deemed to occur on the Year 2 return. This option is the default option. Second, pursuant to paragraph (b)(3)(iv)(C)(*2*) of this section, Y may file an amended return to report his income consistent with groupings in effect prior to Year 1. Third, Y may file an original or an amended return to regroup in a manner different from groupings in effect prior to Year 1 and different from the Year 1 groupings (for example, Y could choose to group Activity C and D into a single activity, thus causing Y to have two groups; Group A–B and Group C–D).

(D) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012.

(4) *Certain investment credit property.* (i) The rules contained in §1.469–3(f) apply with respect to property placed in service after December 31, 1990 (other than property described in section 11813 (c)(2) of the Omnibus Reconciliation Act of 1990 (P.L. 101–508)).

(ii) The rules contained in 26 CFR 1.469–3T(f) (as contained in the CFR edition revised as of April 1, 1992) apply with respect to property placed in service on or before December 31, 1990, and property described in section 11813(c)(2) of the Omnibus Reconcilation Act of 1990.

(c) *Special rules*—(1) *Application of certain income recharacterization rules and self-charged rules*—(i) *Certain recharacterization rules inapplicable in 1987.* No amount of gross income shall be treated under §1.469–2T(f)(3) through (7) as income that is not from a passive activity for any taxable year of the taxpayer beginning before January 1, 1988.

(ii) *Property rented to a nonpassive activity.* In applying §1.469–2(f)(6) or §1.469–2T(f)(6) to a taxpayer's rental of an item of property, the taxpayer's net rental activity income (within the meaning of §1.469–2(f)(9)(iv) or §1.469–2T(f)(9)(iv)) from the property for any taxable year beginning after December 31, 1987, does not include the portion of the income (if any) that is attributable to the rental of that item of property pursuant to a written binding contract entered into before February 19, 1988.

(iii) *Self-charged rules.* For taxable years beginning before June 4, 1991—

(*1*) A taxpayer is not required to apply the rules in §1.469–7 in computing the taxpayer's passive activity loss and passive activity credit; and

(*2*) A taxpayer that owns an interest in a passthrough entity may use any reasonable method of offsetting items of interest income and interest expense from lending transactions between the passthrough entity and its owners or between identically-owned passthrough entities (as defined in §1.469–7(e)) to compute the taxpayer's passive activity loss and passive activity credit. Items from nonlending transactions cannot be offset under the self-charged rules.

(2) *Qualified low-income housing projects.* For a transitional rule concerning the application of section 469 to losses from qualified low-income housing projects, see section 502 of the Tax Reform Act of 1986.

(3) *Effect of events occurring in years prior to 1987.* The treatment for a taxable year beginning after December 31, 1986, of any item of income, gain, loss, deduction, or credit as an item of passive activity gross income, passive activity deduction, or credit from a passive activity, is determined as if section 469 and the regulations thereunder

had been in effect for taxable years beginning before January 1, 1987, but without regard to any passive activity loss or passive activity credit that would have been disallowed for any taxable year beginning before January 1, 1987, if section 469 and the regulations thereunder had been in effect for that year. For example, in determining whether a taxpayer materially participates in an activity under §1.469–5T(a)(5) (relating to taxpayers who have materially participated in an activity for five of the ten immediately preceding taxable years) for any taxable year beginning after December 31, 1986, the taxpayer's participation in the activity for all prior taxable years (including taxable years beginning before 1987) is taken into account. See §1.469–5(j) (relating to the determination of material participation for taxable years beginning before January 1, 1987).

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

Example 1. A, a calendar year individual, is a partner in a partnership with a taxable year ending on January 31. During its taxable year ending January 31, 1987, the partnership was engaged in a single activity involving the conduct of a trade or business. In applying section 469 and the regulations thereunder to A for calendar year 1987, A's distributive share of partnership items for the partnership's taxable year ending January 31, 1987, is taken into account. Therefore, under §1.469–2T(e)(1) and paragraph (c)(3) of this section, A's participation in the activity throughout the partnership's taxable year beginning February 1, 1986, and ending January 31, 1987, is taken into account for purposes of determining the character under section 469 of the items of gross income, deduction, and credit allocated to A for the partnership's taxable year ending January 31, 1987.

Example 2. B, a calendar year individual, is a beneficiary of a trust described in section 651 that has a taxable year ending January 31. The trust conducts a rental activity (within the meaning of §1.469–1T(e)(3)). Because the trust's taxable year ending January 31, 1987, began before January 1, 1987, section 469 and the regulations thereunder do not applying to the trust for that year. Section 469 and the regulations thereunder do apply, however, to B for B's calendar year 1987. Therefore, income of the trust from the rental activity for the trust's taxable year ending January 31, 1987, that is included in B's gross income for 1987 is taken into account in apply section 469 to B for 1987.

[T.D. 8417, 57 FR 20759, May 15, 1992, as amended by T.D. 8417, 59 FR 45623, Sept. 2, 1994; T.D. 8565, 59 FR 50489, Oct. 4, 1994; T.D. 8645, 60 FR 66501, Dec. 22, 1995; T.D. 9013, 67 FR 54093, Aug. 21, 2002; T.D. 9644, 78 FR 72421, Dec. 2, 2013; 79 FR 18159, Apr. 1, 2014]

INVENTORIES

§ 1.471–1 Need for inventories.

In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see §1.472–1.)

[T.D. 6500, 25 FR 11724, Nov. 26, 1960]

§ 1.471–2 Valuation of inventories.

(a) Section 471 provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with §§1.471–1 through 1.471–11.

(c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see §1.471–5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

(d) In respect of normal goods, whichever method is adopted must be applied with reasonable consistency to the entire inventory of the taxpayer's trade or business except as to those goods inventoried under the last-in, first-out method authorized by section 472 or to animals inventoried under the elective unit, livestock-price-method authorized by §1.471–6. See paragraph (d) of §1.446–1 for rules permitting the use of different methods of accounting if the taxpayer has more than one trade or business. Where the taxpayer is engaged in more than one trade or business the Commissioner may require that the method of valuing inventories with respect to goods in one trade or business also be used with respect to similar goods in other trades or businesses if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income. Taxpayers were given an option to adopt the basis of either (1) cost or (2) cost or market, whichever is lower, for their 1920 inventories. The basis properly adopted for that year or any subsequent year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made in writing and filed with the Commissioner as provided in paragraph (e) of §1.446–1. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. But see section 472 as to last-in, first-out inventories. Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

(e) Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the district director, and the taxpayer must satisfy the district director of the correctness of the prices adopted.

(f) The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the regulations in this part:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

(6) Segregating indirect production costs into fixed and variable production cost classifications (as defined in §1.471–11(b)(3)(ii)) and allocating only the variable costs to the cost of goods produced while treating fixed costs as period costs which are currently deductible. This method is commonly referred to as the ''direct cost'' method.

(7) Treating all or substantially all indirect production costs (whether classified as fixed or variable) as period costs which are currently deductible. This method is generally referred to as the ''prime cost'' method.

[T.D. 6500, 25 FR 11724, Nov. 26, 1960, as amended by T.D. 7285, 38 FR 26185, Sept. 19, 1973]

§ 1.471–3 Inventories at cost.

Cost means:

(a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods. For taxpayers acquiring merchandise for resale that are subject to the provisions of section 263A, see §§1.263A–1 and 1.263A–3 for additional amounts that must be included in inventory costs.

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit. See §§1.263A–1 and 1.263A–2 for more specific rules regarding the treatment of production costs.

(d) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are:

(1) Farmers and raisers of livestock (see §1.471–6);

(2) Miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see §1.471–7); and

(3) Retail merchants who use what is known as the ''retail method'' in ascertaining approximate cost (see §1.471–8).

(e) *Sales-based vendor allowances*—(1) *Treatment of sales-based vendor chargebacks*—(i) *In general*. A sales-based vendor chargeback is an allowance, discount, or price rebate that a taxpayer becomes unconditionally entitled to by selling a vendor's merchandise to specific customers identified by the vendor at a price determined by the vendor. A sales-based vendor chargeback decreases cost of goods sold and does not reduce the cost of goods on hand at the end of the taxable year.

(ii) *Example.* The following example illustrates the provisions of this paragraph (e)(1).

Example. (i) W is a wholesaler of pharmaceuticals. W purchases Drug X from the manufacturer, M, for $10x per unit. M has agreements with specific customers that allow those customers to acquire Drug X from M's wholesalers for $6x per unit. Under an agreement between W and M, W is required to sell Drug X to specific customers at the prices M has negotiated with such customers ($6x per unit) and, in exchange, M agrees to provide a price rebate to W equal to the difference between W's cost for Drug X and the price W is required to charge specific customers under the agreement (a difference of $4x per unit). W sells Drug X to specific customer Y for $6x. Under the agreement between W and M, the price rebate can be paid to W, credited against M's invoice to W for W's purchase of Drug X, or it can be credited to W's future purchases of drugs from M.

(ii) Under the terms of the agreement, W is unconditionally entitled to the price rebate of Drug X when it sells Drug X to specific customer Y, a specifically identified customer of M. The price rebate received by W for the sale of Drug X to Y is a sales-based vendor chargeback. Therefore, the amount of the sales-based vendor charge back, $4x per unit for Drug X, whether paid to W, credited against M's invoice to W for W's purchase of Drug X or credited against a future purchase, decreases cost of goods sold and does not reduce the cost of Drug X on hand at the end of the taxable year.

(2) *Treatment of other sales-based vendor allowances.* [Reserved]

(f) Notwithstanding the other rules of this section, cost shall not include an amount which is of a type for which a deduction would be disallowed under section 162 (c), (f), or (g) and the regulations thereunder in the case of a business expense.

(g) *Effective/applicability date.* Paragraph (f) of this section applies to taxable years ending on or after January 13, 2014.

[T.D. 6500, 25 FR 11725, Nov. 26, 1960, as amended by T.D. 7285, 38 FR 26185, Sept. 19, 1973; T.D. 7345, 40 FR 7439, Feb. 20, 1975; T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8482, 58 FR 42233, Aug. 9, 1993; T.D. 9652, 79 FR 2098, Jan. 13, 2014]

§ 1.471–4 Inventories at cost or market, whichever is lower.

(a) *In general*—(1) *Market definition.* Under ordinary circumstances and for normal goods in an inventory, *market* means the aggregate of the current bid prices prevailing at the date of the inventory of the basic elements of cost reflected in inventories of goods purchased and on hand, goods in process of manufacture, and finished manufactured goods on hand. The basic elements of cost include direct materials, direct labor, and indirect costs required to be included in inventories by the taxpayer (e.g., under section 263A and its underlying regulations for taxpayers subject to that section). For taxpayers to which section 263A applies, for example, the basic elements of cost must reflect all direct costs and all indirect costs properly allocable to goods on hand at the inventory date at the current bid price of those costs, including but not limited to the cost of purchasing, handling, and storage activities conducted by the taxpayer, both prior to and subsequent to acquisition or production of the goods. The determination of the current bid price of the basic elements of costs reflected in goods on hand at the inventory date must be based on the usual volume of particular cost elements purchased (or incurred) by the taxpayer.

(2) *Fixed price contracts.* Paragraph (a)(1) of this section does not apply to any goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss. Any such goods must be inventoried at cost.

(3) *Examples.* The valuation principles in paragraph (a)(1) of this section are illustrated by the following examples:

Example 1. (i) Taxpayer A manufactures tractors. A values its inventory using cost or market, whichever is lower, under paragraph (a)(1) of this section. At the end of 1994, the cost of one of A's tractors on hand is determined as follows:

Direct materials	$3,000
Direct labor	4,000
Indirect costs under section 263A	3,000
Total section 263A costs (cost)	$10,000

(ii) A determines that the aggregate of the current bid prices of the materials, labor, and overhead required to reproduce the tractor at the end of 1994 are as follows:

Direct materials	$3,100
Direct labor	4,100

Indirect costs under section 263A	3,100
Total section 263A costs (market)	$10,300

(iii) In determining the lower of cost or market value of the tractor, A compares the cost of the tractor, $10,000, with the market value of the tractor, $10,300, in accordance with paragraph (c) of this section. Thus, under this section, A values the tractor at $10,000.

Example 2. (i) Taxpayer B purchases and resells several lines of shoes and is subject to section 263A. B values its inventory using cost or market, whichever is lower, under paragraph (a)(1) of this section. At the end of 1994, the cost of one pair of shoes on hand is determined as follows:

Acquisition cost	$200
Indirect costs under section 263A	10
Total section 263A costs (cost)	$210

(ii) B determines the aggregate current bid prices prevailing at the end of 1994 for the elements of cost (both direct costs and indirect costs incurred prior and subsequent to acquisition of the shoes) based on the volume of the elements usually purchased (or incurred) by B as follows:

Acquisition cost	$178
Indirect costs under section 263A	12
Total § 263A costs (market)	$190

(iii) In determining the lower of cost or market value of the shoes, B compares the cost of the pair of shoes, $210, with the market value of the shoes, $190, in accordance with paragraph (c) of this section. Thus, under this section, B values the shoes at $190.

(b) *Inactive markets.* Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

(c) *Comparison of cost and market.* Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

(d) *Effective date.* This section applies to inventory valuations for taxable years beginning after December 31, 1993. For taxable years beginning before January 1, 1994, taxpayers must take reasonable positions on their federal income tax returns with respect to the application of section 263A, and must have otherwise complied with § 1.471–4 (as contained in the 26 CFR part 1 edition revised April 1, 1993). For purposes of this paragraph (d), a reasonable position as to the application of section 263A is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1994. (See § 601.601(d)(2)(ii)(*b*) of this chapter.)

[T.D. 6500, 25 FR 11725, Nov. 26, 1960, as amended by T.D. 8482, 58 FR 42233, Aug. 9, 1993]

§ 1.471–5 Inventories by dealers in securities.

A dealer in securities who in his books of account regularly inventories unsold securities on hand either—

(a) At cost,

(b) At cost or market, whichever is lower, or

(c) At market value,

may make his return upon the basis upon which his accounts are kept, provided that a description of the method employed is included in or attached to the return, that all the securities are inventoried by the same method, and that such method is adhered to in subsequent years, unless another method is authorized by the Commissioner pursuant to a written application therefor filed as provided in paragraph (e) of § 1.446–1. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purposes of this section, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as provided in this section may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this section. See §§ 1.263A–1 and 1.263A–3 for rules regarding the treatment of costs with respect to property acquired for resale.

[T.D. 6500, 25 FR 11725, Nov. 26, 1960, as amended by T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8482, 58 FR 42234, Aug. 9, 1993]

§ 1.471–6 Inventories of livestock raisers and other farmers.

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of § 1.446–1.

(b) In any change of accounting method from the cash receipts and disbursements method to an inventory method, adjustments shall be made as provided in section 481 (relating to adjustments required by change in method of accounting) and the regulations thereunder.

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the ''farm-price method'', and farmers raising livestock may value their inventories of animals according to either the ''farm-price method'' or the ''unit-livestock-price method''. In addition, these inventory methods may be used to account for the costs of property produced in a farming business that are required to be capitalized under section 263A regardless of whether the property being produced is otherwise treated as inventory by the taxpayer, and regardless of whether the taxpayer is otherwise using the cash or an accrual method of accounting.

(d) The ''farm-price method'' provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuation is used, it generally must be applied to all property produced by the taxpayer in the trade or business of farming, except as to livestock accounted for, at the taxpayer's election, under the unit livestock method of accounting. However, see § 1.263A–4(c)(3) for an exception to this rule. If the use of the ''farm-price method'' of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446–1.

(e) The ''unit-livestock-price method'' provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the district director upon examination of the taxpayer's return.

(f) A taxpayer that elects to use the ''unit-livestock-price method'' must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. The inventoriable costs of animals raised for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or treated as property used in a trade or business subject to depreciation after maturity. *See* §1.263A–4 for rules regarding the computation of inventoriable costs for purposes of the unit-livestock-price method. Once established, the methods of accounting used by the taxpayer to determine unit prices and to classify animals must be consistently applied in all subsequent taxable years. A taxpayer that uses the unit-livestock-price method must annually reevaluate its unit prices and adjust the prices either upward to reflect increases, or downward to reflect decreases, in the costs of raising livestock. The consent of the Commissioner is not required to make such upward or downward adjustments. No other changes in the classification of animals or unit prices may be made without the consent of the Commissioner. *See* §1.446–1(e) for procedures for obtaining the consent of the Commissioner. The provisions of this paragraph (f) apply to taxable years ending after October 28, 2002.

(g) A livestock raiser who uses the ''unit-livestock-price method'' must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as property used in a trade or business subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.

(h) If a taxpayer using the ''farm-price method'' desires to adopt the ''unit-livestock-price method'' in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in paragraph (e) of §1.446–1. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market whichever is lower, may adopt the ''unit-livestock-price method'' for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the district director upon examination of the taxpayer's return. A livestock raiser who has adopted a constant unit-price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the ''unit-livestock-price method''.

(i) If returns have been made in which the taxable income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding taxable year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding taxable year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

[T.D. 6500, 25 FR 11726, Nov. 26, 1960, as amended by T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8729, 62 FR 44551, Aug. 22, 1997; T.D. 8897, 65 FR 50650, Aug. 21, 2000; T.D. 9019, 67 FR 65698, Oct. 28, 2002]

§1.471–7 Inventories of miners and manufacturers.

A taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product, which in the aggregate will absorb the total cost of production, may, with the consent of the Commissioner, use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds, sizes, or grades of product. See section 472 as to last-in, first-out inventories.

[T.D. 6500, 25 FR 11726, Nov. 26, 1960]

§ 1.471–8 Inventories of retail merchants.

(a) *In general.* A taxpayer that is a retail merchant may use the retail inventory method of accounting described in this section. The retail inventory method uses a formula to convert the retail selling price of ending inventory to an approximation of cost (retail cost method) or an approximation of lower of cost or market (retail LCM method). A taxpayer may use the retail inventory method instead of valuing inventory at cost under §1.471–3 or lower of cost or market under §1.471–4.

(b) *Computation*—(1) *In general.* A taxpayer computes the value of ending inventory under the retail inventory method by multiplying a cost complement by the retail selling prices of the goods on hand at the end of the taxable year.

(2) *Cost complement*—(i) *In general.* The cost complement is a ratio computed as follows:

(A) The numerator is the value of beginning inventory plus the cost (as determined under §1.471–3, except as otherwise provided in this section) of goods purchased during the taxable year.

(B) The denominator is the retail selling prices of beginning inventory plus the retail selling prices of goods purchased during the year (that is, the bona fide retail selling prices of the items at the time acquired), adjusted for all permanent markups and markdowns, including markup and markdown cancellations and corrections. The denominator is not adjusted for temporary markups or markdowns.

(ii) *Vendor allowances required to reduce only cost of goods sold.* A taxpayer may not reduce the numerator of the cost complement by the amount of an allowance, discount, or price rebate that is required under §1.471–3(e) to reduce only cost of goods sold.

(3) *Additional rules for cost complement for retail LCM method*—(i) *In general*—(A) *Margin protection payments.* A taxpayer using the retail LCM method may not reduce the numerator of the cost complement by the amount of an allowance, discount, or price rebate that is related to or intended to compensate for a permanent reduction in the taxpayer's retail selling price of inventory (a margin protection payment).

(B) *Markdowns.* A taxpayer using the retail LCM method does not adjust the denominator of the cost complement for markdowns (and markdown cancellations or corrections). Markups must be reduced by the markdowns made to cancel or correct them.

(ii) *Alternative methods for computing cost complement*—(A) *In general.* In lieu of the method described in paragraph (b)(3)(i) of this section, a taxpayer using the retail LCM method may compute the cost complement using one of the alternative methods described in this paragraph (b)(3)(ii). A taxpayer using an alternative method under this paragraph (b)(3)(ii) must use that method for all cost complements.

(B) *Adjust numerator and denominator.* A taxpayer using the retail LCM method may reduce the numerator of the cost complement by the amount of all margin protection payments if the taxpayer also reduces the denominator of the cost complement by the amount of the permanent reduction in retail selling price to which the margin protection payments relate (related markdowns).

(C) *Deemed adjustment to denominator.* A taxpayer using the retail LCM method that is able to determine the amount of all margin protection payments but cannot determine the amount of the related markdowns may reduce the numerator of the cost complement by the amount of all margin protection payments if the taxpayer also reduces the denominator by the amount that, in conjunction with the reduction of the numerator for the margin protection payments, maintains what would have been the cost complement percentage before taking into account the margin protection payment and the related markdown. A taxpayer that can determine the amount of a related markdown but not the associated margin protection payments may not use this method to compute an adjustment to the numerator.

(iii) *Statistical sampling.* A taxpayer using the retail LCM method may use statistical sampling in accordance with Rev. Proc. 2011–42 or any successor (see §601.601(d) of this chapter), in conjunction with any method of computing the cost complement described in this paragraph (b)(3), to determine the amount of margin protection payments and related markdowns. A taxpayer using statistical sampling must use it for all margin protection payments and related markdowns associated with the inventory items valued by a particular cost complement, but is not required to use it for every cost complement.

(4) *Ending inventory retail selling prices.* A taxpayer must include all permanent markups and markdowns but may not include temporary markups or markdowns in determining the retail selling prices of goods on hand at the end of the taxable year. A taxpayer may not include a markdown that is not an actual reduction of retail selling price.

(c) *Special rules for LIFO taxpayers.* A taxpayer using the last-in, first-out (LIFO) inventory method with the retail inventory method uses the retail cost method. See §1.472–1(k) for additional adjustments for a taxpayer using the LIFO inventory method with the retail cost method.

(d) *Scope of retail inventory method.* A taxpayer may use the retail inventory method to value ending inventory for a department, a class of goods, or a stock-keeping unit. A taxpayer maintaining more than one department or dealing in classes of goods with different percentages of gross profit must compute cost complements separately for each department or class of goods.

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

Example 1. (i) R, a retail merchant who uses the retail LCM method and uses a calendar taxable year, has no beginning inventory in 2012. R purchases 40 tables during 2012 for $60 each for a total of $2,400. R offers the tables for sale at $100 each for an aggregate retail selling price of $4,000. R does not sell any tables at a price of $100, so R permanently marks down the retail selling price of its tables to $90 each. As a result of the $10 markdown, R's supplier provides R a $6 per table margin protection payment. R sells 25 tables during 2012 and has 15 tables in ending inventory at the end of 2012.

(ii) Under paragraph (b)(2)(i)(A) of this section, the numerator of the cost complement is the aggregate cost of the tables, $2,400. Under paragraph (b)(3)(i)(A) of this section, R may not reduce the numerator of the cost complement by the amount of the margin protection payment. Under paragraph (b)(2)(i)(B) of this section, the denominator of the cost complement is the aggregate of the bona fide retail selling prices of all the tables at the time acquired, $4,000. Under paragraph (b)(3)(i)(B) of this section, R does not adjust the denominator of the cost complement for the markdown. Therefore, R's cost complement is $2,400/$4,000, or 60%.

(iii) Under paragraph (b)(4) of this section, R includes the permanent markdown in determining year-end retail selling prices. Therefore, the aggregate retail selling price of R's ending table inventory is $1,350 (15 * $90). Approximating LCM under the retail method, the value of R's ending table inventory is $810 (60% * $1,350).

Example 2. (i) The facts are the same as in *Example 1,* except that R permanently reduces the retail selling price of all 40 tables to $50 per unit and the 15 tables on hand at the end of the year are marked for sale at that price. The additional $40 markdown is unrelated to a margin protection payment or other allowance.

(ii) Under paragraph (b)(3)(i)(B) of this section, R does not adjust the denominator of the cost complement for the markdown. Therefore, R's cost complement is $2,400/ $4,000, or 60%.

(iii) Under paragraph (b)(4) of this section, R includes the permanent markdowns in determining year-end retail selling prices. Therefore, the aggregate retail selling price of R's ending inventory is $750 (15 * $50). Approximating LCM under the retail method, the value of R's ending inventory is $450 (60% * $750).

Example 3. (i) The facts are the same as in *Example 1,* except that R computes the cost complement using the alternative method under paragraph (b)(3)(ii)(B) of this section.

(ii) R reduces the numerator of the cost complement by the margin protection payments of $240 ($6 * 40) and reduces the denominator of the cost complement by the related markdowns of $400 ($10 * 40). Therefore, R's cost complement is $2,160/$3,600, or 60%.

(iii) Under paragraph (b)(4) of this section, R includes the permanent markdown in determining year-end retail selling prices. Therefore, the aggregate retail selling price of R's ending table inventory is $1,350 (15 * $90). Approximating LCM under the retail method, the value of R's ending table inventory is $810 (60% * $1,350).

Example 4. (i) The facts are the same as in *Example 1*, except that R cannot determine the amount of its related markdowns and computes the cost complement using the alternative method under paragraph (b)(3)(ii)(C) of this section.

(ii) R reduces the numerator of the cost complement by the margin protection payments of $240 ($6 * 40). R reduces the denominator of the cost complement by the amount that, in conjunction with the reduction in the numerator, maintains the cost complement percentage before taking into account the margin protection payments and the related markdowns. R's original cost complement was 60% ($2,400/$4,000). The numerator of R's new cost complement is $2,160 ($2,400 − $240). Therefore, R reduces the denominator by $400, which maintains the cost complement of 60% ($2,160/$3,600).

(iii) Under paragraph (b)(4) of this section, R includes the permanent markdowns in determining year-end retail selling prices. Therefore, the aggregate retail selling price of R's ending table inventory is $1,350 (15 * $90). Approximating LCM under the retail method, the value of R's ending table inventory is $810 (60% * $1,350).

Example 5. (i) The facts are the same as in *Example 1*, except that R uses the LIFO inventory method. R must value inventories at cost and, under paragraph (c) of this section, uses the retail cost method.

(ii) Under paragraph (b)(2)(i)(A) of this section, R reduces the numerator of the cost complement by the amount of the margin protection payment. Under paragraph (b)(2)(i)(B) of this section, R includes the permanent markdown in the denominator of the cost complement. Therefore, R's cost complement is $2,160/$3,600, or 60%.

(iii) Under paragraph (b)(4) of this section, R includes the permanent markdown in determining year-end retail selling prices. Therefore, the aggregate retail selling price of R's ending inventory is $1,350 (15 * $90). Approximating cost under the retail method, the value of R's ending inventory is $810 (60% * $1,350).

(f) *Effective/applicability date*. This section applies to taxable years beginning after December 31, 2014. For taxable years beginning before January 1, 2015, see § 1.471–8 as contained in 26 CFR part 1, revised April 1, 2014.

[T.D. 9688, 79 FR 48036, Aug. 15, 2014]

§ 1.471–9 Inventories of acquiring corporations.

For additional rules in the case of certain corporate acquisitions specified in section 381(a), see section 381(c)(5) and the regulations thereunder.

[T.D. 6500, 25 FR 11727, Nov. 26, 1960]

§ 1.471–10 Applicability of long-term contract methods.

See § 1.460–2 for rules providing for the application of the long-term contract methods to certain manufacturing contracts.

[T.D. 8067, 51 FR 393, Jan. 6, 1986, as amended by T.D. 8929, 66 FR 2240, Jan. 11, 2001]

§ 1.471–11 Inventories of manufacturers.

(a) *Use of full absorption method of inventory costing*. In order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income (as required by section 471 of the Code), both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with the ''full absorption'' method of inventory costing. Under the full absorption method of inventory costing production costs must be allocated to goods produced during the taxable year, whether sold during the taxable year or in inventory at the close of the taxable year determined in accordance with the taxpayer's method of identifying goods in inventory. Thus, the taxpayer must include as inventoriable costs all direct production costs and, to the extent provided by paragraphs (c) and (d) of this section, all indirect production costs. For purposes of this section, the term ''financial reports'' means financial reports (including consolidated financial statements) to shareholders, partners, beneficiaries or other proprietors and for credit purposes. See also § 1.263A–1T with respect to the treatment of production costs incurred in taxable years beginning after December 31, 1986, and before January 1, 1994. See also §§ 1.263A–1 and 1.263A–2 with respect to the treatment of production costs incurred in taxable years beginning after December 31, 1993.

(b) *Production costs*—(1) *In general.* Costs are considered to be production costs to the extent that they are incident to and necessary for production or manufacturing operations or processes. Production costs include direct production costs and fixed and variable indirect production costs.

(2) *Direct production costs.* (i) Costs classified as ''direct production costs'' are generally those costs which are incident to and necessary for production or manufacturing operations or processes and are components of the cost of either direct material or direct labor. Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product. See §1.471–3 for the elements of direct material costs. Direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor. For the treatment of rework labor, scrap, spoilage costs, and any other costs not specifically described as direct production costs see §1.471–11(c)(2).

(ii) Under the full absorption method, a taxpayer must take into account all items of direct production cost in his inventoriable costs. Nevertheless, a taxpayer will not be treated as using an incorrect method of inventory costing if he treats any direct production costs as indirect production costs, provided such costs are allocated to the taxpayer's ending inventory to the extent provided by paragraph (d) of this section. Thus, for example, a taxpayer may treat direct labor costs as part of indirect production costs (for example, by use of the conversion cost method), provided all such costs are allocated to ending inventory to the extent provided by paragraph (d) of this section.

(3) *Indirect production costs*—(i) *In general.* The term ''indirect production costs'' includes all costs which are incident to and necessary for production or manufacturing operations or processes other than direct production costs (as defined in subparagraph (2) of this paragraph). Indirect production costs may be classified as to kind or type in accordance with acceptable accounting principles so as to enable convenient identification with various production or manufacturing activities or functions and to facilitate reasonable groupings of such costs for purposes of determining unit product costs.

(ii) *Fixed and variable classifications.* For purposes of this section, fixed indirect production costs are generally those costs which do not vary significantly with changes in the amount of goods produced at any given level of production capacity. These fixed costs may include, among other costs, rent and property taxes on buildings and machinery incident to and necessary for manufacturing operations or processes. On the other hand, variable indirect production costs are generally those costs which do vary significantly with changes in the amount of goods produced at any given level of production capacity. These variable costs may include, among other costs, indirect materials, factory janitorial supplies, and utilities. Where a particular cost contains both fixed and variable elements, these elements should be segregated into fixed and variable classifications to the extent necessary under the taxpayer's method of allocation, such as for the application of the practical capacity concept (as described in paragraph (d) (4) of this section).

(c) *Certain indirect and production costs*—(1) *General rule.* Except as provided in paragraph (c)(3) of this section and in paragraph (d)(6)(v) of §1.451–3, in order to determine whether indirect production costs referred to in paragraph (b) of this section must be included in a taxpayer's computation of the amount of inventoriable costs, three categories of costs have been provided in subparagraph (2) of this paragraph. Costs described in subparagraph (2)(i) of this paragraph must be included in the taxpayer's computation of the amount of inventoriable costs, regardless of their treatment by the taxpayer in his financial reports. Costs described in subparagraph (2)(ii) of this paragraph need not enter into the taxpayer's computation of the amount of inventoriable costs, regardless of their treatment by the taxpayer in his financial reports. Costs described in subparagraph (2)(iii) of this paragraph must be included in or excluded from the taxpayer's computation of the amount inventoriable costs in accordance with the treatment of such costs by the taxpayer in his financial reports and generally accepted accounting principles. For the treatment of indirect production costs described in subparagraph (2) of this paragraph in the case of a taxpayer who is not using comparable methods of accounting for such costs for tax and financial reporting see paragraph (c)(3) of this section. For contracts entered into after December 31, 1982, notwithstanding this section, taxpayers who use an inventory method of accounting for extended period long-term contracts (as defined in paragraph (b)(3) of §1.451–3) for tax purposes may be required to use the cost allocation rules provided in paragraph (d)(6) of §1.451–3 rather than the cost allocation rules provided in this section. See paragraph (d)(6)(v) of §1.451–3. After a taxpayer has determined which costs must be treated as indirect production costs includible in the computation of the amount of inventoriable costs, such costs must be allocated to a taxpayer's ending inventory in a manner prescribed by paragraph (d) of this section.

(2) *Includibility of certain indirect production costs*—(i) *Indirect production* costs included in inventoriable costs. Indirect production costs which must enter into the computation of the amount of inventoriable costs (regardless of their treatment by a taxpayer in his financial reports) include:

(*a*) Repair expenses,

(*b*) Maintenance,

(*c*) Utilities, such as heat, power and light,

(*d*) Rent,

(*e*) Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan,

(*f*) Indirect materials and supplies,

(*g*) Tools and equipment not capitalized, and

(*h*) Costs of quality control and inspection,

to the extent, and only to the extent, such costs are incident to and necessary for production or manufacturing operations or processes.

(ii) *Costs not included in inventoriable costs*. Costs which are not required to be included for tax purposes in the computation of the amount of inventoriable costs (regardless of their treatment by a taxpayer in his financial reports) include:

(*a*) Marketing expenses,

(*b*) Advertising expenses,

(*c*) Selling expenses,

(*d*) Other distribution expenses,

(*e*) Interest,

(*f*) Research and experimental expenses including engineering and product development expenses,

(*g*) Losses under section 165 and the regulations thereunder,

(*h*) Percentage depletion in excess of cost depletion,

(*i*) Depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports,

(*j*) Income taxes attributable to income received on the sale of inventory,

(*k*) Pension contributions to the extent that they represent past services cost,

(*l*) General and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

(*m*) Salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities taken as a whole rather than to production or manufacturing operations or processes.

Notwithstanding the preceding sentence, if a taxpayer consistently includes in his computation of the amount of inventoriable costs any of the costs described in the preceding sentence, a change in such method of inclusion shall be considered a change in method of accounting within the meaning of sections 446, 481, and paragraph (e)(4) of this section.

(iii) *Indirect production costs includible in inventoriable costs depending upon treatment in taxpayer's financial reports.* In the case of costs listed in this subdivision, the inclusion or exclusion of such costs from the amount of inventoriable costs for purposes of a taxpayer's financial reports shall determine whether such costs must be included in or excluded from the computation of inventoriable costs for tax purposes, but only if such treatment is not inconsistent with generally accepted accounting principles. In the case of costs which are not included in subdivision (i) or (ii) of this subparagraph, nor listed in this subdivision, whether such costs must be included in or excluded from the computation of inventoriable costs for tax purposes depends upon the extent to which such costs are similar to costs included in subdivision (i) or (ii), and if such costs are dissimilar to costs in subdivision (i) or (ii), such costs shall be treated as included in or excludable from the amount of inventoriable costs in accordance with this subdivision. The costs listed in this subdivision are:

(*a*) *Taxes.* Taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes) attributable to assets incident to and necessary for production or manufacturing operations or processes. Thus, for example, the cost of State and local property taxes imposed on a factory or other production facility and any State and local taxes imposed on inventory must be included in or excluded from the computation of the amount of inventoriable costs for tax purposes depending upon their treatment by a taxpayer in his financial reports.

(*b*) *Depreciation and depletion.* Depreciation reported in financial reports and cost depletion on assets incident to and necessary for production or manufacturing operations or processes. In computing cost depletion under this section, the adjusted basis of such assets shall be reduced by cost depletion and not by percentage depletion taken thereon.

(*c*) *Employee benefits.* Pension and profit-sharing contributions representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor incident to and necessary for production or manufacturing operations or processes. These other benefits include workmen's compensation expenses, payments under a wage continuation plan described in section 105(d), amounts of a type which would be includible in the gross income of employees under nonqualified pension, profit-sharing and stock bonus plans, premiums on life and health insurance and miscellaneous benefits provided for employees such as safety, medical treatment, cafeteria, recreational facilities, membership dues, etc., which are otherwise allowable as deductions under chapter 1 of the Code.

(*d*) *Costs attributable to strikes, rework labor, scrap and spoilage.* Costs attributable to rework labor, scrap and spoilage which are incident to and necessary for production or manufacturing operations or processes and costs attributable to strikes incident to production or manufacturing operation or processes.

(*e*) *Factory administrative expenses.* Administrative costs of production (but not including any cost of selling or any return on capital) incident to and necessary for production or manufacturing operations or processes.

(*f*) *Officers' salaries.* Salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes.

(*g*) *Insurance costs.* Insurance costs incident to and necessary for production or manufacturing operations or processes such as insurance on production machinery and equipment. A change in the taxpayer's treatment in his financial reports of costs described in this subdivision which results in a change in treatment of such costs for tax purposes shall constitute a change in method of accounting within the meaning of sections 446 and 481 to which paragraph (e) applies.

(3) *Exception.* Except as provided in paragraph (d)(6) of §1.451–3, in the case of a taxpayer whose method of accounting for production costs in his financial reports is not comparable to his method of accounting for such costs for tax purposes (such as a taxpayer using the prime cost method for purposes of financial reports), the following rules apply:

(i) *Indirect production costs included in inventoriable costs.* Indirect production costs which must enter into the computation of the amount of inventoriable costs (to the extent, and only to the extent, such costs are incident to and necessary for production or manufacturing operations or processes) include:

(*a*) Repair expenses,

(*b*) Maintenance,

(*c*) Utilities, such as heat, power and light,

(*d*) Rent,

(*e*) Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan,

(*f*) Indirect materials and supplies,

(*g*) Tools and equipment not capitalized,

(*h*) Costs of quality control and inspection,

(*i*) Taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes),

(*j*) Depreciation and amortization reported for financial purposes and cost depletion,

(*k*) Administrative costs of production (but not including any cost of selling or any return on capital) incident to and necessary for production or manufacturing operations or processes,

(*l*) Salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes, and

(*m*) Insurance costs incident to and necessary for production or manufacturing operations or processes such as insurance on production machinery and equipment.

(ii) *Costs not included in inventoriable costs.* Costs which are not required to be included in the computation of the amount of inventoriable costs include:

(*a*) Marketing expenses,

(*b*) Advertising expenses,

(*c*) Selling expenses,

(*d*) Other distribution expenses,

(*e*) Interest,

(*f*) Research and experimental expenses including engineering and product development expenses,

(*g*) Losses under section 165 and the regulations thereunder,

(*h*) Percentage depletion in excess of cost depletion,

(*i*) Depreciation reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports,

(*j*) Income taxes attributable to income received on the sale of inventory,

(*k*) Pension and profit-sharing contributions representing either past service costs or representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor. These other benefits include workmen's compensation expenses, payments under a wage continuation plan described in section 105(d), amounts of a type which would be includible in the gross income of employees under nonqualified pension, profit-sharing and stock bonus plans, premiums on life and health insurance and miscellaneous benefits provided for employees such as safety, medical treatment, cafeteria, recreational facilities, membership dues, etc., which are otherwise allowable as deductions under chapter 1 of the Code,

(*l*) Cost attributable to strikes, rework labor, scrap and spoilage,

(*m*) General and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

(*n*) Salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes.

(d) *Allocation methods*—(1) *In general.* Indirect production costs required to be included in the computation of the amount of inventoriable costs pursuant to paragraphs (b) and (c) of this paragraph must be allocated to goods in a taxpayer's ending inventory (determined in accordance with the taxpayer's method of identification) by the use of a method of allocation which fairly apportions such costs among the various items produced. Acceptable methods for allocating indirect production costs to the cost of goods in the ending inventory include the manufacturing burden rate method and the standard cost method. In addition, the practical capacity concept can be used in conjunction with either the manufacturing burden rate or standard cost method.

(2) *Manufacturing burden rate method*—(i) *In general.* Manufacturing burden rates may be developed in accordance with acceptable accounting principles and applied in a reasonable manner. In developing a manufacturing burden rate, the factors described in paragraph (d)(2)(ii) of this section may be taken into account. Furthermore, if the taxpayer chooses, he may allocate different indirect production costs on the basis of different manufacturing burden rates. Thus, for example, the taxpayer may use one burden rate for allocating rent and another burden rate for allocating utilities. The method used by the taxpayer in allocating such costs in his financial reports shall be given great weight in determining whether the taxpayer's method employed for tax purposes fairly allocates indirect production costs to the ending inventory. Any change in a manufacturing burden rate which is merely a periodic adjustment to reflect current operating conditions, such as increases in automation or changes in operation, does not constitute a change in method of accounting under section 446. However, a change in the concept upon which such rates are developed does constitute a change in method of accounting requiring the consent of the Commissioner. The taxpayer shall maintain adequate records and working papers to support all manufacturing burden rate calculations.

(ii) *Development of manufacturing burden rate.* The following factors, among others, may be taken into account in developing manufacturing burden rates:

(*a*) The selection of an appropriate level of activity and period of time upon which to base the calculation of rates which will reflect operating conditions for purposes of the unit costs being determined;

(*b*) The selection of an appropriate statistical base such as direct labor hours, direct labor dollars, or machine hours, or a combination thereof, upon which to apply the overhead rate to determine production costs; and

(*c*) The appropriate budgeting, classification and analysis of expenses (for example, the analysis of fixed and variable costs).

(iii) *Operation of the manufacturing burden rate method.* (*a*) The purpose of the manufacturing burden rate method used in conjunction with the full absorption method of inventory costing is to allocate an appropriate amount of indirect production costs to a taxpayer's goods in ending inventory by the use of predetermined rates intended to approximate the actual amount of indirect production costs incurred. Accordingly, the proper use of the manufacturing burden rate method under this section requires that any net negative or net positive difference between the total predetermined amount of indirect production costs allocated to the goods in ending inventory and the total amount of indirect production costs actually incurred and required to be allocated to such goods (i.e., the under or over-applied burden) must be treated as an adjustment to the taxpayer's ending inventory in the taxable year in which such difference arises. However, if such adjustment is not significant in amount in relation to the taxpayer's total actual indirect production costs for the year then such adjustment need not be allocated to the taxpayer's goods in ending inventory unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative adjustments consistently.

(*b*) Notwithstanding subdivision (*a*), the practical capacity concept may be used to determine the total amount of fixed indirect production costs which must be allocated to goods in ending inventory. See subparagraph (4) of this paragraph.

(3) *Standard cost method*—(i) *In general.* A taxpayer may use the so-called ''standard cost'' method of allocating inventoriable costs to the goods in ending inventory, provided he treats variances in accordance with the procedures prescribed in paragraph (d)(3)(ii) of this section. The method used by the taxpayer in allocating such costs in his financial reports shall be given great weight in determining whether the taxpayer's method employed for tax purposes fairly allocates indirect production costs to the ending inventory. For purposes of this subparagraph, a ''net positive overhead variance'' shall mean the excess of total standard (or estimated) indirect production costs over total actual indirect production costs and a ''net negative overhead variance'' shall mean the excess of total actual indirect production costs over total standard (or estimated) indirect production costs.

(ii) *Treatment of variances.* (*a*) The proper use of the standard cost method pursuant to this subparagraph requires that a taxpayer must reallocate to the goods in ending inventory a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct production cost variances. The taxpayer must apportion such variances among his various items in ending inventory. However, if such variances are not significant in amount in relation to the taxpayer's total actual indirect production costs for the year then such variances need not be allocated to the taxpayer's goods in ending inventory unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative variances consistently.

(*b*) Notwithstanding subdivision (*a*), the practical capacity concept may be used to determine the total amount of fixed indirect production costs which must be allocated to goods in ending inventory. See subparagraph (4) of this paragraph.

(4) *Practical capacity concept*—(i) *In general.* Under the practical capacity concept, the percentage of practical capacity represented by actual production (not greater than 100 percent), as calculated under subdivision (ii) of this subparagraph, is used to determine the total amount of fixed indirect production costs which must be included in the taxpayer's computation of the amount of inventoriable costs. The portion of such costs to be included in the taxpayer's computation of the amount of inventoriable costs is then combined with variable indirect production costs and both are allocated to the goods in ending inventory in accordance with this paragraph. See the example in subdivision (ii)(*d*) of this subparagraph. The difference (if any) between the amount of all fixed indirect production costs and the fixed indirect production costs which are included in the computation of the amount of inventoriable costs under the practical capacity concept is allowable as a deduction for the taxable year in which such difference occurs.

(ii) *Calculation of practical capacity*—(*a*) *In general.* Practical capacity and theoretical capacity (as described in (*c*) of this subdivision) may be computed in terms of tons, pounds, yards, labor hours, machine hours, or any other unit of production appropriate to the cost accounting system used by a particular taxpayer. The determination of practical capacity and theoretical capacity should be modified from time to time to reflect a change in underlying facts and conditions such as increased output due to automation or other changes in plant operation. Such a change does not constitute a change in method of accounting under sections 446 and 481.

(*b*) *Based upon taxpayer's experience.* In selecting an appropriate level of production activity upon which to base the calculation of practical capacity, the taxpayer shall establish the production operating conditions expected during the period for which the costs are being determined, assuming that the utilization of production facilities during operations will be approximately at capacity. This level of production activity is frequently described as practical capacity for the period and is ordinarily based upon the historical experience of the taxpayer. For example, a taxpayer operating on a 5-day, 8-hour basis may have a "normal" production of 100,000 units a year based upon three years of experience.

(*c*) *Based upon theoretical capacity.* Practical capacity may also be established by the use of "theoretical" capacity, adjusted for allowances for estimated inability to achieve maximum production, such as machine breakdown, idle time, and other normal work stoppages. Theoretical capacity is the level of production the manufacturer could reach if all machines and departments were operated continously at peak efficiency.

(*d*) *Example.* The provisions of (*c*) of this subdivision may be illustrated by the following example:

Corporation X operates a stamping plant with a theoretical capacity of 50 units per hour. The plant actually operates 1960 hours per year based on an 8-hour day, 5 day week basis and 15 shutdown days for vacations and holidays. A reasonable allowance for down time (the time allowed for ordinary and necessary repairs and maintenance) is 5 percent of practical capacity before reduction for down time. Assuming no loss of production during starting up, closing down, or employee work breaks, under these facts and circumstances X may properly make a practical capacity computation as follows:

Practical capacity without allowance for down time based on theoretical capacity per hour is (1960 × 50)	98,000
Reduction for down time (98,000 × 5 percent)	4,900
Practical capacity	93,100

The 93,100 unit level of activity (*i.e.*, practical capacity) would, therefore, constitute an appropriate base for calculating the amount of fixed indirect production costs to be included in the computation of the amount of inventoriable costs for the period under review. On this basis if only 76,000 units were produced for the period, the effect would be that approximately 81.6 percent (76,000, the actual number of units produced, divided by 93,100, the maximum number of units producible at practical capacity) of the fixed indirect production costs would be included in the computation of the amount of inventoriable costs during the year. The portion of the fixed indirect production costs not so included in the computation of the amount of inventoriable costs would be deductible in the year in which paid or incurred. Assume further that 7,600 units were on hand at the end of the taxable year and the 7,600 units were in the same proportion to the total units produced. Thus, 10 percent (7,600 units in inventory at the end of the taxable year, divided by 76,000, the actual number of units produced) of the fixed indirect production costs included in the computation of the amount of inventoriable costs (the above-mentioned 81.6 percent) and 10 percent of the variable indirect production costs would be included in the cost of the goods in the ending inventory, in accordance with a method of allocation provided by this paragraph.

(e) *Transition to full absorption method of inventory costing*—(1) *In general*—(i) *Mandatory requirement.* A taxpayer not using the full absorption method of inventory costing, as prescribed by paragraph (a) of this section, must change to that method. Any change to the full absorption method must be made by the taxpayer with respect to all trades or businesses of the taxpayer to which this section applies. A taxpayer not using the full absorption method of inventory costing, as prescribed by paragraph (a) of this section, who makes the special election provided in subdivision (ii) of this subparagraph during the transition period described in subdivision (ii) of this subparagraph need not change to the full absorption method of inventory costing for taxable years prior to the year for which such election is made. In determining whether the taxpayer is changing to a more or less inclusive method of inventory costing, all positive and negative adjustments for all items and all trades or businesses of the taxpayer shall be aggregated. If the net adjustment is positive, paragraph (e)(3) shall apply, and if the net adjustment is negative, paragraph (e)(4) shall apply to the change. The rules otherwise prescribed in sections 446 and 481 and the regulations thereunder shall apply to any taxpayer who fails to make the special election in subdivision (ii) of this subparagraph. The transition rules of this paragraph are available only to those taxpayers who change their method of inventory costing.

(ii) *Special election during two-year-transition period.* If a taxpayer elects to change to the full absorption method of inventory costing during the transition period provided herein, he may elect on Form 3115 to change to such full absorption method of inventory costing and, in so doing, employ the transition procedures and adopt any of the transition methods prescribed in subparagraph (3) of this paragraph. Such election shall be made during the first 180 days of any taxable year beginning on or after September 19, 1973 and before September 19, 1975 (i.e., the ''transition period'') and the change in inventory costing method shall be made for the taxable year in which the election is made. Notwithstanding the preceding sentence if the taxpayer's prior returns have been examined by the Service prior to Sept. 19, 1973, and there is a pending issue involving the taxpayer's method of inventory costing, the taxpayer may request the application of this regulation by agreeing and filing a letter to that effect with the district director, within 90 days after September 19, 1973 to change to the full absorption method for the first taxable year of the taxpayer beginning after Sept. 19, 1973 and subsequently filing Form 3115 within the first 180 days of such taxable year of change.

(iii) *Change initiated by the Commissioner.* A taxpayer who properly makes an election under subdivision (ii) of this subparagraph shall be considered to have made a change in method of accounting not initiated by the taxpayer, notwithstanding the provisions of §1.481–1(c)(5). Thus, any of the taxpayer's ''pre-1954 inventory balances'' with respect to such inventory shall not be taken into account as an adjustment under section 481. For purposes of this paragraph, a ''pre-1954 inventory balance'' is the net amount of the adjustments which would have been required if the taxpayer had made such change in his method of accounting with respect to his inventory in his first taxable year which began after December 31, 1953, and ended after August 16, 1954. See section 481(a)(2) and §1.481–3.

(2) *Procedural rules for change.* If a taxpayer makes an election pursuant to subparagraph (1)(ii) of this paragraph, the Commissioner's consent will be evidenced by a letter of consent to the taxpayer, setting forth the values of inventory, as provided by the taxpayer, determined under the full absorption method of inventory costing, except to the extent that no determination of such values is necessary under subparagraph (3)(ii)(B) of this paragraph (the cut off method), the amount of the adjustments (if any) required to be taken into account by section 481, and the treatment to be accorded to any such adjustments. Such full absorption values shall be subject to verification on examination by the district director. The taxpayer shall preserve at his principal place of business all records, data, and other evidence relating to the full absorption values of inventory.

(3) *Transition methods.* In the case of a taxpayer who properly makes an election under subparagraph (1)(ii) of this paragraph during the transition period—

(i) *10-year adjustment period.* Such taxpayer may elect to take any adjustment required by section 481 with respect to any inventory being revalued under the full absorption method into account ratably over a period designated by the taxpayer at the time of such election, not to exceed the lesser of 10 taxable years commencing with the year of transition or the number of years the taxpayer has been on the inventory method from which he is changing. If the taxpayer dies or ceases to exist in a transaction other than one to which section 381(a) of the Code applies or if the taxpayer's inventory (determined under the full absorption method) on the last day of any taxable year is reduced (by other than a strike or involuntary conversion) by more than an amount equal to 33⅓ percent of the taxpayer's inventory (determined under the full absorption method) as of the beginning of the year of change, the entire amount of the section 481 adjustment not previously taken into account in computing income shall be taken into account in computing income for the taxable year in which such taxpayer so ceases to exist or such taxpayer's inventory is so reduced.

(ii) *Additional rules for LIFO taxpayers.* A taxpayer who uses the LIFO method of inventory identification may either—

(*a*) Employ the special transition rules described in subdivision (i) of this subparagraph. Accordingly, all LIFO layers must be revalued under the full absorption method and the section 481 adjustment must be computed for all items in all layers in inventory, but no pre-1954 inventory balances shall be taken into account as adjustments under section 481; or

(*b*)(*1*) Employ a cut-off method whereby the full absorption method is only applied in costing layers of inventory acquired during all taxable years beginning with the year for which an election is made under subparagraph (e)(1)(ii).

(*2*) In the case of a taxpayer using dollar value LIFO, employ a cut-off method whereby the taxpayer must use, for the year of change, the full absorption method in computing the base year cost and current cost of a dollar value inventory pool for the beginning of such year. The taxpayer shall not be required to recompute his LIFO inventories based on the full absorption method for a taxable year beginning prior to the year of change to the full absorption method. The base cost and layers of increment previously computed shall be retained and treated as if such base cost and layers of increment had been computed under the method authorized by this section. The taxpayer shall use the year of change as the base year in applying the double extension method or other method approved by the Commissioner, instead of the earliest year for which he adopted the LIFO method for any items in the pool.

(4) *Transition to full absorption method of inventory costing from a method more* inclusive of indirect production costs—(i) *Taxpayer has not previously changed to his present method pursuant to subparagraphs (1), (2), and (3) of this paragraph.* If a taxpayer wishes to change to the full absorption method of inventory costing (as prescribed by paragraph (a) of this section) from a method of inventory costing which is more inclusive of indirect production costs and he has not previously changed to his present method by use of the special transition rules provided by subparagraphs (1), (2) and (3) of this paragraph, he may elect on Form 3115 to change to the full absorption method of inventory costing and, in so doing, take into account any resulting section 481 adjustment generally over 10 taxable years commencing with the year of transition. The Commissioner's consent to such election will be evidenced by a letter of consent to the taxpayer setting forth the values of inventory, as provided by the taxpayer determined under the full absorption method of inventory costing, except to the extent that no determination of such values is necessary under subparagraph (3)(ii)(*b*) of this paragraph, the amount of the adjustments (if any) required to be taken into account by section 481, and the treatment to be accorded such adjustments, subject to terms and conditions specified by the Commissioner to prevent distortions of income. Such election must be made within the transition period described in subparagraph (1)(ii) of this paragraph. A change pursuant to this subparagraph shall be a change initiated by the taxpayer as provided by §1.481–1(c)(5). Thus, any of the taxpayers ''pre-1954 inventory balances'' will be taken into account as an adjustment under section 481.

(ii) *Taxpayer has previously changed to his present method pursuant to subparagraph (1), (2), and (3) of this paragraph or would satisfy all the requirements of subdivision (i) of this subparagraph but fails to elect within the transition period.* If a taxpayer wishes to change to the full absorption method of inventory costing (as prescribed by paragraph (a) of this section) from a method of inventory costing which is more inclusive of indirect production costs and he has previously changed to his present method pursuant to subparagraphs (1), (2), and (3) of this paragraph or he would satisfy the requirements of subdivision (i) of this subparagraph but he fails to elect within the transition period, he must secure the consent of the Commissioner prior to making such change.

[T.D. 7285, 38 FR 26185, Sept. 19, 1973, as amended by T.D. 8067, 51 FR 393, Jan. 6, 1986; T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8482, 58 FR 42234, Aug. 9, 1993]

§ 1.472–1 Last-in, first-out inventories.

(a) Any taxpayer permitted or required to take inventories pursuant to the provisions of section 471, and pursuant to the provisions of §§1.471–1 to

1.471–9, inclusive, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 472, this section, and § 1.472–2. Under this last-in, first-out (LIFO) inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being:

(1) Those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof, and

(2) Those acquired during the taxable year.

The LIFO inventory method is not dependent upon the character of the business in which the taxpayer is engaged, or upon the identity or want of identity through commingling of any of the goods on hand, and may be adopted by the taxpayer as of the close of any taxable year.

(b) If the LIFO inventory method is used by a taxpayer who regularly and consistently, in a manner similar to hedging on a futures market, matches purchases with sales, then firm purchases and sales contracts (i.e., those not legally subject to cancellation by either party) entered into at fixed prices on or before the date of the inventory may be included in purchases or sales, as the case may be, for the purpose of determining the cost of goods sold and the resulting profit or loss, provided that this practice is regularly and consistently adhered to by the taxpayer and provided that, in the opinion of the Commissioner, income is clearly reflected thereby.

(c) A manufacturer or processor who has adopted the LIFO inventory method as to a class of goods may elect to have such method apply to the raw materials only (including those included in goods in process and in finished goods) expressed in terms of appropriate units. If such method is adopted, the adjustments are confined to costs of the raw material in the inventory and the cost of the raw material in goods in process and in finished goods produced by such manufacturer or processor and reflected in the inventory. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Assume that the opening inventory had 10 units of raw material, 10 units of goods in process, and 10 units of finished goods, and that the raw material cost was 6 cents a unit, the processing cost 2 cents a unit, and overhead cost 1 cent a unit. For the purposes of this example, it is assumed that the entire amount of goods in process was 50 percent processed.

OPENING INVENTORY

	Raw material	Goods in process	Finished goods
Raw material	$0.60	$0.60	$0.60
Processing cost	....	.10	.20
Overhead	....	.05	.10

In the closing inventory there are 20 units of raw material, 6 units of goods in process, and 8 units of finished goods and the costs were: Raw material 10 cents, processing cost 4 cents, and overhead 1 cent.

CLOSING INVENTORY

[Based on cost and prior to adjustment]

	Raw material	Goods in process	Finished goods
Raw material	$2.00	$0.60	$0.80
Processing costs	....	.12	.32
Overhead	....	.03	.08
Total	2.00	.75	1.20

There were 30 units of raw material in the opening inventory and 34 units in the closing inventory. The adjustment to the closing inventory would be as follows:

CLOSING INVENTORY AS ADJUSTED

	Raw material	Goods in process	Finished goods
Raw material:			
20 at 6 cents	$1.20	....	....
6 at 6 cents	....	$0.36	....
4 at 6 cents	....	....	$0.24
4 at 10 cents [1]	....	....	.40
Processing costs	....	.12	.32
Overhead	....	.03	.08
Total	1.20	.51	1.04

[1] This excess is subject to determination of price under section 472(b)(1) and § 1.472–2. If the excess falls in goods in process, the same adjustment is applicable.

The only adjustment to the closing inventory is the cost of the raw material; the processing costs and overhead cost are not changed.

Example 2. Assume that the opening inventory had 5 units of raw material, 10 units of goods in process, and 20 units of finished goods, with the same prices as in Example 1, and that the closing inventory had 20 units of raw material, 20 units of goods in process, and 10 units of finished goods, with raw material costs as in the closing inventory in Example 1. The adjusted closing inventory would be as follows in so far as the raw material is concerned:

Raw material, 20 at 6 cents	$1.20
Goods in process:	
15 at 6 cents	.90
5 at 10 cents [1]	.50
Finished goods:	
None at 6 cents	0.00
10 at 10 cents [1]	1.00

[1] This excess is subject to determination of price under section 472(b)(1) and § 1.472–2.

The 20 units of raw material in the raw state plus 15 units of raw material in goods in process make up the 35 units of raw material that were contained in the opening inventory.

(d) For the purposes of this section, raw material in the opening inventory must be compared with similar raw material in the closing inventory. There may be several types of raw materials, depending upon the character, quality, or price, and each type of raw material in the opening inventory must be compared with a similar type in the closing inventory.

(e) In the cotton textile industry there may be different raw materials depending upon marked differences in length of staple, in color or grade of the cotton. But where different staple lengths or grades of cotton are being used at different times in the same mill to produce the same class of goods, such differences would not necessarily require the classification into different raw materials.

(f) As to the pork packing industry a live hog is considered as being composed of various raw materials, different cuts of a hog varying markedly in price and use. Generally a hog is processed into approximately 10 primal cuts and several miscellaneous articles. However, due to similarity in price and use, these may be grouped into fewer classifications, each group being classed as one raw material.

(g) When the finished product contains two or more different raw materials as in the case of cotton and rayon mixtures, each raw material is treated separately and adjustments made accordingly.

(h) Upon written notice addressed to the Commissioner of Internal Revenue, Attention T:R, Washington, D.C. 20224 by the taxpayer, a taxpayer who has heretofore adopted the LIFO inventory method in respect of any goods may adopt the method authorized in this section and limit the election to the raw material including raw materials entering into goods in process and in finished goods. If this method is adopted as to any specific goods, it must be used exclusively for such goods for any prior taxable year (not closed by agreement) to which the prior election applies and for all subsequent taxable years, unless permission to change is granted by the Commissioner.

(i) The election may also be limited to that phase in the manufacturing process where a product is produced that is recognized generally as a salable product as, for example, in the textile industry where one phase of the process is the production of yarn. Since yarn is generally recognized as a salable product, the election may be limited to that portion of the process when yarn is produced. In the case of copper and brass processors, the election may be limited to the production of bars, plates, sheets, etc., although these may be further processed into other products.

(j) The election may also apply to any one raw material, when two or more raw materials enter into the composition of the finished product; for example, in the case of cotton and rayon yarn, the taxpayer may elect to inventory the cotton only. However, a taxpayer who has previously made an election to use the LIFO inventory method may not later elect to exclude any raw materials that were covered by such previous election.

(k) If a taxpayer using the retail method of pricing inventories, authorized by § 1.471–8, elects to use in connection therewith the LIFO inventory method authorized by section 472 and this section, the apparent cost of the goods on hand at the end of the year, determined pursuant to § 1.471–8, shall be adjusted to the extent of price changes therein taking place after the close of the preceding taxable year. The amount of any apparent inventory increase or decrease to be eliminated in this adjustment shall be determined by reference to acceptable price indexes established to the satisfaction of the Commissioner. Price indexes prepared by the United States Bureau of Labor Statistics which are applicable to the goods in question will be considered acceptable to the Commissioner. Price indexes which are based upon inadequate records, or which are not subject to complete and detailed audit within the Internal Revenue Service, will not be approved.

(l) If a taxpayer uses consistently the so-called ''dollar-value'' method of pricing inventories, or any other method of computation established to the satisfaction of the Commissioner as reasonably adaptable to the purpose and intent of section 472 and this section, and if such taxpayer elects under section 472 to use the LIFO inventory method authorized by such section, the taxpayer's opening and closing inventories shall be determined under section 472 by the use of the appropriate adaptation. See §1.472–8 for rules relating to the use of the dollar-value method.

[T.D. 6500, 25 FR 11727, Nov. 26, 1960, as amended by T.D. 6539, 26 FR 518, Jan. 20, 1961]

§1.472–2 Requirements incident to adoption and use of LIFO inventory method.

Except as otherwise provided in §1.472–1 with respect to raw material computations, with respect to retail inventory computations, and with respect to other methods of computation established to the satisfaction of the Commissioner as reasonably adapted to the purpose and intent of section 472, and in §1.472–8 with respect to the ''dollar-value'' method, the adoption and use of the LIFO inventory method is subject to the following requirements:

(a) The taxpayer shall file an application to use such method specifying with particularity the goods to which it is to be applied.

(b) The inventory shall be taken at cost regardless of market value.

(c) Goods of the specified type included in the opening inventory of the taxable year for which the method is first used shall be considered as having been acquired at the same time and at a unit cost equal to the actual cost of the aggregate divided by the number of units on hand. The actual cost of the aggregate shall be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the prior taxable year with the exception that restoration shall be made with respect to any writedown to market values resulting from the pricing of former inventories.

(d) Goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with specific invoices and regardless of specific cost accounting records, at costs determined pursuant to the provisions of subparagraph (1) or (2) of this paragraph, dependent upon the character of the transactions in which the taxpayer is engaged:

(1)(i) In the case of a taxpayer engaged in the purchase and sale of merchandise, such as a retail grocer or druggist, or engaged in the initial production of merchandise and its sale without processing, such as a miner selling his ore output without smelting or refining, such costs shall be determined—

(*a*) By reference to the actual cost of the goods most recently purchased or produced;

(*b*) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(*c*) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced, the goods reflected in such inventory increase being considered for the purposes of section 472 as having been acquired all at the same time; or

(*d*) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

(ii) Whichever of the several methods of valuing the inventory increase is adopted by the taxpayer and approved by the Commissioner shall be consistently adhered to in all subsequent taxable years so long as the LIFO inventory method is used by the taxpayer.

(iii) The application of subdivisions (i) and (ii) of this subparagraph may be illustrated by the following examples:

Example 1. Suppose that the taxpayer adopts the LIFO inventory method for the taxable year 1957 with an opening inventory of 10 units at 10 cents per unit, that it makes 1957 purchases of 10 units as follows:

January	1 at	$0.11=	$0.11
April	2 at	.12=	.24
July	3 at	.13=	.39
October	4 at	.14=	.56
Totals	10		1.30

and that it has a 1957 closing inventory of 15 units. This closing inventory, depending upon the taxpayer's method of valuing inventory increases, will be computed as follows:

(*a*) Most recent purchases—

	10 at	$0.10	$1.00
October	4 at	.14	.56
July	1 at	.13	.13
Totals	15		1.69

(*b*) In order of acquisitions—

	10 at	$0.10	$1.00
January	1 at	.11	.11
April	2 at	.12	.24
July	2 at	.13	.26
Totals	15		1.61

or

(*c*) At an annual average—

	10 at	$0.10	$1.00
(130/10)	5 at	.13	.65
Totals	15		1.65

Example 2. Suppose that the taxpayer's closing inventory for 1958, the year following that involved in Example 1 of this subdivision, reflects an inventory decrease for the year, and not an increase; suppose that there is, accordingly, a 1958 closing inventory of 13 units. Inasmuch as the decreased closing inventory will be determined wholly by reference to the 15 units reflected in the opening inventory for the year, and will be taken ''in the order of acquisition'' pursuant to section 472 (b) (1), and inasmuch as the character of the taxpayer's opening inventory for 1958 will be dependent upon its method of valuing its 5-unit inventory increase for 1957, the closing inventory for 1958 will be computed as follows:

(*a*) In case the increase for 1957 was taken by reference to the most recent purchases—

From 1956	10 at	$0.10	$1.00
July 1957	1 at	.13	.13
October 1957	2 at	.14	.28
Totals	13		1.41

or

(*b*) In case the increase for 1957 was taken in the order of acquisition—

From 1956	10 at	$0.10	$1.00
January 1957	51 at	.11	.11
April 1957	2 at	.12	.24
Totals	13		1.35

or

(*c*) In case the increase for 1957 was taken on the basis of an average—

From 1956	10 at	$0.10	$1.00
From 1957	3 at	.13	.39
Totals	13		1.39

(2) In the case of a taxpayer engaged in manufacturing, fabricating, processing, or otherwise producing merchandise, such costs shall be determined:

(i) In the case of raw materials purchased or initially produced by the taxpayer, in the manner elected by the taxpayer under subparagraph (1) of this paragraph to the same extent as if the taxpayer were engaged in purchase and sale transactions; and

(ii) In the case of goods in process, regardless of the stage to which the manufacture, fabricating, or processing may have advanced, and in the case of finished goods, pursuant to any proper method which, in the opinion of the Commissioner, clearly reflects income.

(e) *LIFO conformity requirement*—(1) *In general.* The taxpayer must establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining the income, profit, or loss for the taxable year for which the LIFO inventory method is first used, or for any subsequent taxable year, for credit purposes or for purposes of reports to shareholders, partners, or other proprietors, or to beneficiaries, has not used any inventory method other than that referred to in §1.472–1 or at variance with the requirement referred to in §1.472–2(c). See paragraph (e)(2) of this section for rules relating to the meaning of the term ''taxable year'' as used in this paragraph. The following are not considered at variance with the requirement of this paragraph:

(i) The taxpayer's use of an inventory method other than LIFO for purposes of ascertaining information reported as a supplement to or explanation of the taxpayer's primary presentation of the taxpayer's income, profit, or loss for a taxable year in credit statements or financial reports (including preliminary and unaudited financial reports). See paragraph (e)(3) of this section for rules relating to the reporting of supplemental and explanatory information ascertained by the use of an inventory method other than LIFO.

(ii) The taxpayer's use of an inventory method other than LIFO to ascertain the value of the taxpayer's inventory of goods on hand for purposes of reporting the value of such inventories as assets. See paragraph (e)(4) of this section for rules relating to such disclosures.

(iii) The taxpayer's use of an inventory method other than LIFO for purposes of ascertaining information reported in internal management reports. See paragraph (e)(5) of this section for rules relating to such reports.

(iv) The taxpayer's use of an inventory method other than LIFO for purposes of issuing reports or credit statements covering a period of operations that is less than the whole of a taxable year for which the LIFO method is used for Federal income tax purposes. See paragraph (e)(6) of this section for rules relating to series of interim reports.

(v) The taxpayer's use of the lower of LIFO cost or market method to value LIFO inventories for purposes of financial reports and credit statements. However, except as provided in paragraph (e)(7) of this section, a taxpayer may not use market value in lieu of cost to value inventories for purposes of financial reports or credit statements.

(vi) The taxpayer's use of a costing method or accounting method to ascertain income, profit, or loss for credit purposes or for purposes of financial reports if such costing method or accounting method is neither inconsistent with the inventory method referred to in §1.472–1 nor at variance with the requirement referred to in §1.472–2(c), regardless of whether such costing method or accounting method is used by the taxpayer for Federal income tax purposes. See paragraph (e)(8) of this section for examples of such costing methods and accounting methods.

(vii) For credit purposes or for purposes of financial reports, the taxpayer's treatment of inventories, after such inventories have been acquired in a transaction to which section 351 applies from a transferor that used the LIFO method with respect to such inventories, as if such inventories had the same acquisition dates and costs as in the hands of the transferor.

(viii) For credit purposes or for purposes of financial reports relating to a taxable year, the taxpayer's determination of income, profit, or loss for the taxable year by valuing inventories in accordance with the procedures described in section 472(b) (1) and (3), notwithstanding that such valuation differs from the valuation of inventories for Federal income tax purposes because the taxpayer either—

(A) Adopted such procedures for credit or financial reporting purposes beginning with an accounting period other than the taxable year for which the LIFO method was first used by the taxpayer for Federal income tax purposes, or

(B) With respect to such inventories treated a business combination for credit or financial reporting purposes in a manner different from the treatment of the business combination for Federal income tax purposes.

(2) *One-year periods other than a taxable year.* The rules of this paragraph relating to the determination of income, profit, or loss for a taxable year and credit statements or financial reports that cover a taxable year also apply to the determination of income, profit, or loss for a one-year period other than a taxable year and credit statements or financial reports that cover a one-year period other than a taxable year, but only if the one-year period both begins and ends in a taxable year or years for which the taxpayer uses the LIFO method for Federal income tax purposes. For example, the requirements of paragraph (e)(1) of this section apply to a taxpayer's determination of income for purposes of a credit statement that covers a 52-week fiscal year beginning and ending in a taxable year for which the taxpayer uses the LIFO method for Federal income tax purposes. Similarly, in the case of a calendar year taxpayer, the requirements of paragraph (e)(1) of this section apply to the taxpayer's determination of income for purposes of a credit statement that covers the period October 1, 1981, through September 30, 1982, if the taxpayer uses the LIFO method for Federal income tax purposes in taxable years 1981 and 1982.

However, the Commissioner will waive any violation of the requirements of this paragraph in the case of a credit statement or financial report that covers a one-year period other than a taxable year if the report was issued before January 22, 1981.

(3) *Supplemental and explanatory information*—(i) *Face of the income statement.* Information reported on the face of a taxpayer's financial income statement for a taxable year is not considered a supplement to or explanation of the taxpayer's primary presentation of the taxpayer's income, profit, or loss for the taxable year in credit statements or financial reports. For purposes of paragraph (e)(3) of this section, the face of an income statement does not include notes to the income statement presented on the same page as the income statement, but only if all notes to the financial income statement are presented together.

(ii) *Notes to the income statement.* Information reported in notes to a taxpayer's financial income statement is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by the income statement if all notes to the financial income statement are presented together and if they accompany the income statement in a single report. If notes to an income statement are issued in a report that does not include the income statement, the question of whether the information reported therein is supplemental or explanatory is determined under the rules in paragraph (e)(3)(iv) of this section.

(iii) *Appendices and supplements to the income statement.* Information reported in an appendix or supplement to a taxpayer's financial income statement is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by the income statement if the appendix or supplement accompanies the income statement in a single report and the information reported in the appendix or supplement is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement. If an appendix or supplement to an income statement is issued in a report that does not include the income statement, the question of whether the information reported therein is supplemental or explanatory is determined under the rules in paragraph (e)(3)(iv) of this section. For purposes of paragraph (e)(3)(iii) of this section, an appendix or supplement to an income statement includes written statements, schedules, and reports that are labelled supplements or appendices to the income statement. However, sections of an annual report such as those labelled ''President's Letter'', ''Management's Analysis'', ''Statement of Changes in Financial Position'', ''Summary of Key Figures'', and similar sections are reports described in paragraph (e)(3)(iv) of this section and are not considered ''supplements or appendices to an income statement'' within the meaning of paragraph (e)(3)(iii) of this section, regardless of whether such sections are also labelled as supplements or appendices. For purposes of paragraph (e)(3)(iii) of this section, information is considered to be clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement if the information either—

(A) Is reported in an appendix or supplement that contains a general statement identifying all such supplemental or explanatory information;

(B) Is identified specifically as supplemental or explanatory by a statement immediately preceding or following the disclosure of the information;

(C) Is disclosed in the context of making a comparison to corresponding information disclosed both on the face of the taxpayer's income statement and in the supplement or appendix; or

(D) Is a disclosure of the effect on an item reported on the face of the taxpayer's income statement of having used the LIFO method.

For example, a restatement of cost of goods sold based on an inventory method other than LIFO is considered to be clearly identified as supplemental or explanatory information if the supplement or appendix containing the restatement contains a general statement that all information based on such inventory method is reported in the appendix or supplement as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement.

(iv) *Other reports; in general.* The rules of paragraph (e)(3) (iv), (v), and (vi) of this section apply to the following types of reports: news releases; letters to shareholders, partners, or other proprietors or beneficiaries; oral statements at press conferences, shareholders' meetings or securities analysts' meetings; sections of an annual report such as those labelled "President's Letter", "Management's Analysis", "Statement of Changes in Financial Position", "Summary of Key Figures", and similar sections; and reports other than a taxpayer's income statement or accompanying notes, appendices, or supplements. Information disclosed in such a report is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by an income statement if the supplemental or explanatory information is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement and the specific item of information being explained or supplemented, such as the cost of goods sold, net income, or earnings per share ascertained using the LIFO method, is also reported in the other report.

(v) *Other reports; disclosure of non-LIFO income.* For purposes of paragraph (e)(3)(iv) of this section, supplemental or explanatory information is considered to have been clearly identified as such if it would be considered to have been clearly identified as such under the rules of paragraph (e)(3)(iii) of this section, relating to information reported in supplements or appendices to an income statement. For example, if at a securities analysts' meeting the following question is asked, "What would the reported earnings per share for the year have been if the FIFO method had been used to value inventories?", it would be permissible to respond "Reported earnings per share for the year were $6.00. If the company had used the FIFO method to value inventories this year and had computed earnings based upon the following assumptions, earnings per share would have been $8.20. FIFO earnings are based on the following assumptions:

"(A) The use of the same effective tax rate as used in computing LIFO earnings, and

"(B) All other conditions and assumptions remain the same, including—

"(*1*) The use of the LIFO method for Federal income tax purposes and

"(*2*) The investment of the tax savings resulting from such use of the LIFO method, the income from which is included in both LIFO and FIFO "earnings." "

(vi) *Other reports; disclosure of effect on income.* For purposes of paragraph (e)(3)(iv) of this section, if the only supplement to or explanation of a specific item is the effect on the item of having used LIFO instead of a method other than LIFO to value inventories, it is not necessary to also report the specific item. For example, if at a shareholders' meeting the question is asked, "What was the effect on reported earnings per share of not having used FIFO to value inventories?", it would be permissible to respond "If earnings would have been computed on the basis of the following assumptions, the use of LIFO instead of FIFO to value inventories would have decreased reported earnings per share by $2.20. FIFO earnings are based on the following assumptions:

"(A) The use of the same effective tax rate as used in computing LIFO earnings, and

"(B) All other conditions and assumptions remain the same, including—

"(*1*) The use of the LIFO method for Federal income tax purposes and

"(*2*) The investment of the tax savings resulting from such use of the LIFO method, the income from which is included in both LIFO and FIFO earnings."

(4) *Inventory asset value disclosures.* Under paragraph (e)(1)(ii) of this section, the use of an inventory method other than LIFO to ascertain the value of the taxpayer's inventories for purposes of reporting the value of the inventories as assets is not considered the ascertainment of income, profit, or loss and therefore is not considered at variance with the requirement of paragraph (e)(1) of this section. Therefore, a taxpayer may disclose the value of inventories on a balance sheet using a method other than LIFO to identify the inventories, and such a disclosure will not be considered at variance with the requirement of paragraph (e)(1) of this section. However, the disclosure of income, profit, or loss for a taxable year on a balance sheet issued to creditors, shareholders, partners, other proprietors, or beneficiaries is considered at variance with the requirement of paragraph (e)(1) of this section if such income information is ascertained using an inventory method other than LIFO and such income information is for a taxable year for which the LIFO method is used for Federal income tax purposes. Therefore, a balance sheet that discloses the net worth of a taxpayer, determined as if income had been ascertained using an inventory method other than LIFO, may be at variance with the requirement of paragraph (e)(1) of this section if the disclosure of net worth is made in a manner that also discloses income, profit, or loss for a taxable year.

However, a disclosure of income, profit, or loss using an inventory method other than LIFO is not considered at variance with the requirement of paragraph (e)(1) of this section if the disclosure is made in the form of either a footnote to the balance sheet or a parenthetical disclosure on the face of the balance sheet. In addition, an income disclosure is not considered at variance with the requirement of paragraph (e)(1) of this section if the disclosure is made on the face of a supplemental balance sheet labelled as a supplement to the taxpayer's primary presentation of financial position, but only if, consistent with the rules of paragraph (e)(3) of this section, such a disclosure is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of financial income as reported on the face of the taxpayer's income statement.

(5) *Internal management reports.* [Reserved]

(6) *Series of interim reports.* For purposes of paragraph (e)(1)(iv) of this section, a series of credit statements or financial reports is considered a single statement or report covering a period of operations if the statements or reports in the series are prepared using a single inventory method and can be combined to disclose the income, profit, or loss for the period. However, the Commissioner will waive any violation of the requirement of this paragraph in the case of a series of interim reports issued before February 6, 1978, that cover a taxable year, or a series of interim reports issued before January 22, 1981 that cover a one-year period other than a taxable year.

(7) *Market value.* The Commissioner will waive any violation of the requirement of this paragraph in the case of a taxpayer's use of market value in lieu of cost for a credit statement or financial report issued before January 22, 1981. However, the special rule of this (7) applies only to a taxpayer's use of market value in lieu of cost and does not apply to the use of a method of valuation such as market value in lieu of cost but not more than FIFO cost.

(8) *Use of different methods.* The following are examples of costing methods and accounting methods that are neither inconsistent with the inventory method referred to in §1.472–1 nor at variance with the requirement of §1.472–2(c) and which, under paragraph (e)(1)(vi) of this section, may be used to ascertain income, profit, or loss for credit purposes or for purposes of financial reports regardless of whether such method is also used by the taxpayer for Federal income tax purposes:

(i) Any method relating to the determination of which costs are includible in the computation of the cost of inventory under the full absorption inventory method.

(ii) Any method of establishing pools for inventory under the dollar-value LIFO inventory method.

(iii) Any method of determining the LIFO value of a dollar-value inventory pool, such as the double-extension method, the index method, and the link chain method.

(iv) Any method of determining or selecting a price index to be used with the index or link chain method of valuing inventory pools under the dollar-value LIFO inventory method.

(v) Any method permitted under §1.472–8 for determining the current-year cost of closing inventory for purposes of using the dollar-value LIFO inventory method.

(vi) Any method permitted under §1.472–2(d) for determining the cost of goods in excess of goods on hand at the beginning of the year for purposes of using a LIFO method other than the dollar-value LIFO method.

(vii) Any method relating to the classification of an item as inventory or a capital asset.

(viii) The use of an accounting period other than the period used for Federal income tax purposes.

(ix) The use of cost estimates.

(x) The use of actual cost of cut timber or the cost determined under section 631(a).

(xi) The use of inventory costs unreduced by any adjustment required by the application of section 108 and section 1017, relating to discharge of indebtedness.

(xii) The determination of the time when sales or purchases are accrued.

(xiii) The use of a method to allocate basis in the case of a business combination other than the method used for Federal income tax purposes.

(xiv) The treatment of transfers of inventory between affiliated corporations in a manner different from that required by §1.1502–13.

(9) *Reconciliation of LIFO inventory values.* A taxpayer may be required to reconcile differences between the value of inventories maintained for credit or financial reporting purposes and for Federal income tax purposes in order to show that the taxpayer has satisfied the requirements of this paragraph.

(f) Goods of the specified type on hand as of the close of the taxable year preceding the taxable year for which this inventory method is first used shall be included in the taxpayer's closing inventory for such preceding taxable year at cost determined in the manner prescribed in paragraph (c) of this section.

(g) The LIFO inventory method, once adopted by the taxpayer with the approval of the Commissioner, shall be adhered to in all subsequent taxable years unless—

(1) A change to a different method is approved by the Commissioner; or

(2) The Commissioner determines that the taxpayer, in ascertaining income, profit, or loss for the whole of any taxable year subsequent to his adoption of the LIFO inventory method, for credit purposes or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, has used any inventory method at variance with that referred to in §1.472–1 and requires of the taxpayer a change to a different method for such subsequent taxable year or any taxable year thereafter.

(h) The records and accounts employed by the taxpayer in keeping his books shall be maintained in conformity with the inventory method referred to in §1.472–1; and such supplemental and detailed inventory records shall be maintained as will enable the district director readily to verify the taxpayer's inventory computations as well as his compliance with the requirements of section 472 and §§1.472–1 through 1.472–7.

(i) Where the taxpayer is engaged in more than one trade or business, the Commissioner may require that if the LIFO method of valuing inventories is used with respect to goods in one trade or business the same method shall also be used with respect to similar goods in the other trades or businesses if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

[T.D. 6500, 25 FR 11728, Nov. 26, 1960, as amended by T.D. 6539, 26 FR 518, Jan. 20, 1961; T.D. 7756, 46 FR 6920, Jan. 22, 1981; T.D. 7756, 46 FR 15685, Mar. 9, 1981]

§ 1.472–3 Time and manner of making election.

(a) The LIFO inventory method may be adopted and used only if the taxpayer files with his income tax return for the taxable year as of the close of which the method is first to be used a statement of his election to use such inventory method. The statement shall be made on Form 970 pursuant to the instructions printed with respect thereto and to the requirements of this section, or in such other manner as may be acceptable to the Commissioner. Such statement shall be accompanied by an analysis of all inventories of the taxpayer as of the beginning and as of the end of the taxable year for which the LIFO inventory method is proposed first to be used, and also as of the beginning of the prior taxable year. In the case of a manufacturer, this analysis shall show in detail the manner in which costs are computed with respect to raw materials, goods in process, and finished goods, segregating the products (whether in process or finished goods) into natural groups on the basis of either (1) similarity in factory processes through which they pass, or (2) similarity of raw materials used, or (3) similarity in style, shape, or use of finished products. Each group of products shall be clearly described.

(b) The taxpayer shall submit for the consideration of the Commissioner in connection with the taxpayer's adoption or use of the LIFO inventory method such other detailed information with respect to his business or accounting system as may be at any time requested by the Commissioner.

(c) As a condition to the taxpayer's use of the LIFO inventory method, the Commissioner may require that the method be used with respect to goods other than those specified in the taxpayer's statement of election if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

(d) Whether or not the taxpayer's application for the adoption and use of the LIFO inventory method should be approved, and whether or not such method, once adopted, may be continued, and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns.

[T.D. 6500, 25 FR 11729, Nov. 26, 1960, as amended by T.D. 7295, 38 FR 34203, Dec. 12, 1973]

§ 1.472–4 Adjustments to be made by taxpayer.

A taxpayer may not change to the LIFO method of taking inventories unless, at the time he files his application for the adoption of such method, he agrees to such adjustments incident to the change to or from such method, or incident to the use of such method, in the inventories of prior taxable years or otherwise, as the district director upon the examination of the taxpayer's returns may deem necessary in order that the true income of the taxpayer will be clearly reflected for the years involved.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§ 1.472–5 Revocation of election.

An election made to adopt and use the LIFO inventory method is irrevocable, and the method once adopted shall be used in all subsequent taxable years, unless the use of another method is required by the Commissioner, or authorized by him pursuant to a written application therefor filed as provided in paragraph (e) of § 1.446–1.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§ 1.472–6 Change from LIFO inventory method.

If the taxpayer is granted permission by the Commissioner to discontinue the use of LIFO method of taking inventories, and thereafter to use some other method, or if the taxpayer is required by the Commissioner to discontinue the use of the LIFO method by reason of the taxpayer's failure to conform to the requirements detailed in § 1.472–2, the inventory of the specified goods for the first taxable year affected by the change and for each taxable year thereafter shall be taken—

(a) In conformity with the method used by the taxpayer under section 471 in inventorying goods not included in his LIFO inventory computations; or

(b) If the LIFO inventory method was used by the taxpayer with respect to all of his goods subject to inventory, then in conformity with the inventory method used by the taxpayer prior to his adoption of the LIFO inventory method; or

(c) If the taxpayer had not used inventories prior to his adoption of the

LIFO inventory method and had no goods currently subject to inventory by a method other than the LIFO inventory method, then in conformity with such inventory method as may be selected by the taxpayer and approved by the Commissioner as resulting in a clear reflection of income; or

(d) In any event, in conformity with any inventory method to which the taxpayer may change pursuant to application approved by the Commissioner.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§ 1.472–7 Inventories of acquiring corporations.

For additional rules in the case of certain corporate acquisitions specified in section 381(a), see section 381(c)(5) and the regulations thereunder.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§ 1.472–8 Dollar-value method of pricing LIFO inventories.

(a) *Election to use dollar-value method.* Any taxpayer may elect to determine the cost of his LIFO inventories under the so-called ''dollar-value'' LIFO method, provided such method is used consistently and clearly reflects the income of the taxpayer in accordance with the rules of this section. The dollar-value method of valuing LIFO inventories is a method of determining cost by using ''base-year'' cost expressed in terms of total dollars rather than the quantity and price of specific goods as the unit of measurement. Under such method the goods contained in the inventory are grouped into a pool or pools as described in paragraphs (b) and (c) of this section. The term ''base-year cost'' is the aggregate of the cost (determined as of the beginning of the taxable year for which the LIFO method is first adopted, i.e., the base date) of all items in a pool. The taxable year for which the LIFO method is first adopted with respect to any item in the pool is the ''base year'' for that pool, except as provided in paragraph (g)(3) of this section. Liquidations and increments of items contained in the pool shall be reflected only in terms of a net liquidation or increment for the pool as a whole. Fluctuations may occur in quantities of various items within the pool, new items which properly fall within the pool may be added, and old items may disappear from the pool, all without necessarily effecting a change in the dollar value of the pool as a whole. An increment in the LIFO inventory occurs when the end of the year inventory for any pool expressed in terms of base-year cost is in excess of the beginning of the year inventory for that pool expressed in terms of base-year cost. In determining the inventory value for a pool, the increment, if any, is adjusted for changing unit costs or values by reference to a percentage, relative to base-year-cost, determined for the pool as a whole. See paragraph (e) of this section. See also paragraph (f) of this section for rules relating to the change to the dollar-value LIFO method from another LIFO method.

(b) *Principles for establishing pools of manufacturers and processors*—(1) *Natural business unit pools.* A pool shall consist of all items entering into the entire inventory investment for a natural business unit of a business enterprise, unless the taxpayer elects to use the multiple pooling method provided in subparagraph (3) of this paragraph. Thus, if a business enterprise is composed of only one natural business unit, one pool shall be used for all of its inventories, including raw materials, goods in process, and finished goods. If, however, a business enterprise is actually composed of more than one natural business unit, more than one pool is required. Where similar types of goods are inventoried in two or more natural business units of the taxpayer, the Commissioner may apportion or allocate such goods among the various natural business units, if he determines that such apportionment or allocation is necessary in order to clearly reflect the income of such taxpayer. Where a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, any pooling of the LIFO inventory of such purchased goods for the wholesaling or retailing operations shall be determined in accordance with the rules of paragraph (c) of this section.

(2) *Definition of natural business unit.* (i) Whether an enterprise is composed of more than one natural business unit is a matter of fact to be determined from all the circumstances. The natural business divisions adopted by the taxpayer for internal management purposes, the existence of separate and distinct production facilities and processes, and the maintenance of separate profit and loss records with respect to separate operations are important considerations in determining what is a business unit, unless such divisions, facilities, or accounting records are set up merely because of differences in geographical location. In the case of a manufacturer or processor, a natural business unit ordinarily consists of the entire productive activity of the enterprise within one product line or within two or more related product lines including (to the extent engaged in by the enterprise) the obtaining of materials, the processing of materials, and the selling of manufactured or processed goods. Thus, in the case of a manufacturer or processor, the maintenance and operation of a raw material warehouse does not generally constitute, of itself, a natural business unit. If the taxpayer maintains and operates a supplier unit the production of which is both sold to others and transferred to a different unit of the taxpayer to be used as a component part of another product, the supplier unit will ordinarily constitute a separate and distinct natural business unit. Ordinarily, a processing plant would not in itself be considered a natural business unit if the production of the plant, although saleable at this stage, is not sold to others, but is transferred to another plant of the enterprise, not operated as a separate division, for further processing or incorporation into another product. On the other hand, if the production of a manufacturing or processing plant is transferred to a separate and distinct division of the taxpayer, which constitutes a natural business unit, the supplier unit itself will ordinarily be considered a natural business unit. However, the mere fact that a portion of the production of a manufacturing or processing plant may be sold to others at a certain stage of processing with the remainder of the production being further processed or incorporated into another product will not of itself be determinative that the activities devoted to the production of the portion sold constitute a separate business unit. Where a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, the wholesaling or retailing operations with respect to such purchased goods shall not be considered a part of any manufacturing or processing unit.

(ii) The rules of this subparagraph may be illustrated by the following examples:

Example 1. A corporation manufactures, in one division, automatic clothes washers and driers of both commercial and domestic grade as well as electric ranges, mangles, and dishwashers. The corporation manufactures, in another division, radios and television sets. The manufacturing facilities and processes used in manufacturing the radios and television sets are distinct from those used in manufacturing the automatic clothes washers, etc. Under these circumstances, the enterprise would consist of two business units and two pools would be appropriate, one consisting of all of the LIFO inventories entering into the manufacture of clothes washers and driers, electric ranges, mangles, and dishwashers and the other consisting of all of the LIFO inventories entering into the production of radio and television sets.

Example 2. A taxpayer produces plastics in one of its plants. Substantial amounts of the production are sold as plastics. The remainder of the production is shipped to a second plant of the taxpayer for the production of plastic toys which are sold to customers. The taxpayer operates his plastics plant and toy plant as separate divisions. Because of the different product lines and the separate divisions the taxpayer has two natural business units.

Example 3. A taxpayer is engaged in the manufacture of paper. At one stage of processing, uncoated paper is produced. Substantial amounts of uncoated paper are sold at this stage of processing. The remainder of the uncoated paper is transferred to the taxpayer's finishing mill where coated paper is produced and sold. This taxpayer has only one natural business unit since coated and uncoated paper are within the same product line.

(3) *Multiple pools*—(i) *Principles for establishing multiple pools.* (*a*) A taxpayer may elect to establish multiple pools for inventory items which are not within a natural business unit as to which the taxpayer has adopted the

natural business unit method of pooling as provided in subparagraph (1) of this paragraph. Each such pool shall ordinarily consist of a group of inventory items which are substantially similar. In determining whether such similarity exists, consideration shall be given to all the facts and circumstances. The formulation of detailed rules for selection of pools applicable to all taxpayers is not feasible. Important considerations to be taken into account include, for example, whether there is substantial similarity in the types of raw materials used or in the processing operations applied; whether the raw materials used are readily interchangeable; whether there is similarity in the use of the products; whether the groupings are consistently followed for purposes of internal accounting and management; and whether the groupings follow customary business practice in the taxpayer's industry. The selection of pools in each case must also take into consideration such factors as the nature of the inventory items subject to the dollar-value LIFO method and the significance of such items to the taxpayer's business operations. Where similar types of goods are inventoried in natural business units and multiple pools of the taxpayer, the Commissioner may apportion or allocate such goods among the natural business units and the multiple pools, if he determines that such apportionment or allocation is necessary in order to clearly reflect the income of the taxpayer.

(*b*) Raw materials which are substantially similar shall be pooled together in accordance with the principles of this subparagraph. However, inventories of raw or unprocessed materials of an unlike nature may not be placed into one pool, even though such materials become part of otherwise identical finished products.

(*c*) Finished goods and goods-in-process in the inventory shall be placed into pools classified by major classes or types of goods. The same class or type of finished goods and goods-in-process shall ordinarily be included in the same pool. Where the material content of a class of finished goods and goods-in-process included in a pool has been changed, for example, to conform with current trends in an industry, a separate pool of finished goods and goods-in-process will not ordinarily be required unless the change in material content results in a substantial change in the finished goods.

(*d*) The requirement that pools be established by major types of materials or major classes of goods is not to be construed so as to preclude the establishment of a miscellaneous pool. Since a taxpayer may elect the dollar-value LIFO method with respect to all or any designated goods in his inventory, there may be a number of such inventory items covered in the election. A miscellaneous pool shall consist only of items which are relatively insignificant in dollar value by comparison with other inventory items in the particular trade or business and which are not properly includible as part of another pool.

(ii) *Raw materials content pools.* The dollar-value method of pricing LIFO inventories may be used in conjunction with the raw materials content method authorized in §1.472–1. Raw materials (including the raw material content of finished goods and goods-in-process) which are substantially similar shall be pooled together in accordance with the principles of subdivision (i) of this subparagraph. However, inventories of materials of an unlike nature may not be placed into one pool, even though such materials become part of otherwise identical finished products.

(4) *IPIC method pools.* A manufacturer or processor that elects to use the inventory price index computation method described in paragraph (e)(3) of this section (IPIC method) for a trade or business may elect to establish dollar-value pools for those items accounted for using the IPIC method based on the 2-digit commodity codes (i.e., major commodity groups) in Table 6 (Producer price indexes and percent changes for commodity groupings and individual items, not seasonally adjusted) of the ''PPI Detailed Report'' published monthly by the United States Bureau of Labor Statistics (available from New Orders, Superintendent of Documents, PO Box 371954, Pittsburgh, PA 15250–7954). A taxpayer electing to establish dollar-value pools

under this paragraph (b)(4) may combine IPIC pools that comprise less than 5 percent of the total current-year cost of all dollar-value pools to form a single miscellaneous IPIC pool. A taxpayer electing to establish dollar-value pools under this paragraph (b)(4) may combine a miscellaneous IPIC pool that comprises less than 5 percent of the total current-year cost of all dollar-value pools with the largest IPIC pool. Each of these 5 percent rules is a method of accounting. A taxpayer may not change to, or cease using, either 5 percent rule without obtaining the Commissioner's prior consent. Whether a specific IPIC pool or the miscellaneous IPIC pool satisfies the applicable 5 percent rule must be determined in the year of adoption or year of change (whichever is applicable) and redetermined every third taxable year. Any change in pooling required or permitted as a result of a 5 percent rule is a change in method of accounting. A taxpayer must secure the consent of the Commissioner pursuant to §1.446–1(e) before combining or separating pools and must combine or separate its IPIC pools in accordance with paragraph (g)(2) of this section.

(c) *Principles for establishing pools for wholesalers, retailers, etc*—(1) *In general.* Items of inventory in the hands of wholesalers, retailers, jobbers, and distributors shall be placed into pools by major lines, types, or classes of goods. In determining such groupings, customary business classifications of the particular trade in which the taxpayer is engaged is an important consideration. An example of such customary business classification is the department in the department store. In such case, practices are relatively uniform throughout the trade, and departmental grouping is peculiarly adapted to the customs and needs of the business. However, in appropriate cases, the principles set forth in paragraphs (b) (1) and (2) of this section, relating to pooling by natural business units, may be used, with permission of the Commissioner, by wholesalers, retailers, jobbers, or distributors. Where a wholesaler or retailer is also engaged in the manufacturing or processing of goods, the pooling of the LIFO inventory for the manufacturing or processing operations shall be determined in accordance with the rules of paragraph (b) of this section.

(2) *IPIC method pools.* A retailer that elects to use the inventory price index computation method described in paragraph (e)(3) of this section (IPIC method) for a trade or business may elect to establish dollar-value pools for those items accounted for using the IPIC method based on either the general expenditure categories (i.e., major groups) in Table 3 (Consumer Price Index for all Urban Consumers (CPI-U): U.S. city average, detailed expenditure categories) of the ''CPI Detailed Report'' or the 2-digit commodity codes (i.e., major commodity groups) in Table 6 (Producer price indexes and percent changes for commodity groupings and individual items, not seasonally adjusted) of the ''PPI Detailed Report.'' A wholesaler, jobber, or distributor that elects to use the IPIC method for a trade or business may elect to establish dollar-value pools for any group of goods accounted for using the IPIC method and included within one of the 2-digit commodity codes (i.e., major commodity groups) in Table 6 (Producer price indexes and percent changes for commodity groupings and individual items, not seasonally adjusted) of the ''PPI Detailed Report.'' The ''CPI Detailed Report'' and the ''PPI Detailed Report'' are published monthly by the United States Bureau of Labor Statistics (BLS) (available from New Orders, Superintendent of Documents, P.O. Box 371954, Pittsburgh, PA 15250–7954). A taxpayer electing to establish dollar-value pools under this paragraph (c)(2) may combine IPIC pools that comprise less than 5 percent of the total current-year cost of all dollar-value pools to form a single miscellaneous IPIC pool. A taxpayer electing to establish pools under this paragraph (c)(2) may combine a miscellaneous IPIC pool that comprises less than 5 percent of the total current-year cost of all dollar-value pools with the largest IPIC pool. Each of these 5 percent rules is a method of accounting. Thus, a taxpayer may not change to, or cease using, either 5 percent rule without obtaining the Commissioner's prior consent. Whether

a specific IPIC pool or the miscellaneous IPIC pool satisfies the applicable 5 percent rule must be determined in the year of adoption or year of change (whichever is applicable) and redetermined every third taxable year. Any change in pooling required or permitted under a 5 percent rule is a change in method of accounting. A taxpayer must secure the consent of the Commissioner pursuant to section 1.446–1(e) before combining or separating pools and must combine or separate its IPIC pools in accordance with paragraph (g)(2) of this section.

(d) *Determination of appropriateness of pools.* Whether the number and the composition of the pools used by the taxpayer is appropriate, as well as the propriety of all computations incidental to the use of such pools, will be determined in connection with the examination of the taxpayer's income tax returns. Adequate records must be maintained to support the base-year unit cost as well as the current-year unit cost for all items priced on the dollar-value LIFO inventory method, regardless of the method authorized by paragraph (e) of this section which is used in computing the LIFO value of the dollar-value pool. The pool or pools selected must be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commissioner as provided in paragraph (e) of §1.446–1. However, see paragraph (h) of this section for authorization to change the method of pooling in certain specified cases.

(e) *Methods of computation of the LIFO value of a dollar-value pool*—(1) *Methods authorized.* A taxpayer may ordinarily use only the so-called ''double-extension'' method for computing the base-year and current-year cost of a dollar-value inventory pool. Where the use of the double-extension method is impractical, because of technological changes, the extensive variety of items, or extreme fluctuations in the variety of the items, in a dollar-value pool, the taxpayer may use an index method for computing all or part of the LIFO value of the pool. An index may be computed by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns. The use of any so-called ''link-chain'' method will be approved for taxable years beginning after December 31, 1960, only in those cases where the taxpayer can demonstrate to the satisfaction of the district director that the use of either an index method or the double-extension method would be impractical or unsuitable in view of the nature of the pool. A taxpayer using either an index or link-chain method shall attach to his income tax return for the first taxable year beginning after December 31, 1960, for which the index or link-chain method is used, a statement describing the particular link-chain method or the method used in computing the index. The statement shall be in sufficient detail to facilitate the determination as to whether the method used meets the standards set forth in this subparagraph. In addition, a copy of the statement shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington, D.C. 20224. The taxpayer shall submit such other information as may be requested with respect to such index or link-chain method. Adequate records must be maintained by the taxpayer to support the appropriateness, accuracy, and reliability of an index or link-chain method. A taxpayer may request the Commissioner to approve the appropriateness of an index or link-chain method for the first taxable year beginning after December 31, 1960, for which it is used. Such request must be submitted within 90 days after the beginning of the first taxable year beginning after December 31, 1960, in which the taxpayer desires to use the index or link-chain method, or on or before May 1, 1961, whichever is later. A taxpayer entitled to use the retail method of pricing LIFO inventories authorized by paragraph (k) of §1.472–1 may use retail price indexes prepared by the United States Bureau of Labor Statistics. Any method of computing the LIFO value of a dollar-value pool must be used for the year of adoption and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner in accordance with paragraph (e) of §1.446–1 to use a different method.

(2) *Double-extension method.* (i) Under the double-extension method the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost. The respective extensions at the two costs are then each totaled. The first total gives the amount of the current inventory in terms of base-year cost and the second total gives the amount of such inventory in terms of current-year cost.

(ii) The total current-year cost of items making up a pool may be determined—

(*a*) By reference to the actual cost of the goods most recently purchased or produced;

(*b*) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(*c*) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced; or

(*d*) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

(iii) Under the double-extension method a base-year unit cost must be ascertained for each item entering a pool for the first time subsequent to the beginning of the base year. In such a case, the base-year unit cost of the entering item shall be the current-year cost of that item unless the taxpayer is able to reconstruct or otherwise establish a different cost. If the entering item is a product or raw material not in existence on the base date, its cost may be reconstructed, that is, the taxpayer using reasonable means may determine what the cost of the item would have been had it been in existence in the base year. If the item was in existence on the base date but not stocked by the taxpayer, he may establish, by using available data or records, what the cost of the item would have been to the taxpayer had he stocked the item. If the base-year unit cost of the entering item is either reconstructed or otherwise established to the satisfaction of the Commissioner, such cost may be used as the base-year unit cost in applying the double-extension method. If the taxpayer does not reconstruct or establish to the satisfaction of the Commissioner a base-year unit cost, but does reconstruct or establish to the satisfaction of the Commissioner the cost of the item at some year subsequent to the base year, he may use the earliest cost which he does reconstruct or establish as the base-year unit cost.

(iv) To determine whether there is an increment or liquidation in a pool for a particular taxable year, the end of the year inventory of the pool expressed in terms of base-year cost is compared with the beginning of the year inventory of the pool expressed in terms of base-year cost. When the end of the year inventory of the pool is in excess of the beginning of the year inventory of the pool an increment occurs in the pool for that year. If there is an increment for the taxable year, the ratio of the total current-year cost of the pool to the total base-year cost of the pool must be computed. This ratio when multiplied by the amount of the increment measured in terms of base-year cost gives the LIFO value of such increment. The LIFO value of each such increment is hereinafter referred to in this section as the ''layer of increment'' and must be separately accounted for and a record thereof maintained as a separate layer of the pool, and may not be combined with a layer of increment occurring in a different year. On the other hand, when the end of the year inventory of the pool is less than the beginning of the year inventory of the pool, a liquidation occurs in the pool for that year. Such liquidation is to be reflected by reducing the most recent layer of increment by the excess of the beginning of the year inventory over the end of the year inventory of the pool. However, if the amount of the liquidation exceeds the amount of the most recent layer of increment, the preceding layers of increment in reverse chronological order are to be successively reduced by the amount of such excess until all the excess is absorbed. The base-year inventory is to be reduced by liquidation only to the extent that the aggregate of all liquidation exceeds the aggregate of all layers of increment.

(v) The following examples illustrate inventories under the double-extension the computation of the LIFO value of method.

Example 1. (a) A taxpayer elects, beginning with the calendar year 1961, to compute his inventories by use of the LIFO inventory method under section 472 and further elects to use the dollar-value method in pricing such inventories as provided in paragraph (a) of this section. He creates Pool No. 1 for items A, B, and C. The composition of the inventory for Pool No. 1 at the base date, January 1, 1961, is as follows:

Items	Units	Unit cost	Total cost
A	1,000	$5	$5,000
B	2,000	4	8,000
C	500	2	1,000
Total base-year cost at Jan. 1, 1961	....	....	14,000

(b) The closing inventory of Pool No. 1 at December 31, 1961, contains 3,000 units of A, 1,000 units of B, and 500 units of C. The taxpayer computes the current-year cost of the items making up the pool by reference to the actual cost of goods most recently purchased. The most recent purchases of items A, B, and C are as follows:

Item	Purchase date	Quantity purchased	Unit cost
A	Dec. 15, 1961	3,500	$6.00
B	Dec. 10, 1961	2,000	5.00
C	Nov. 1, 1961	500	2.50

(c) The inventory of Pool No. 1 at December 31, 1961, shown at base-year and current-year cost is as follows:

Item	Quantity	Dec. 31, 1961, inventory at Jan. 1, 1961, base-year cost		Dec. 31, 1961, inventory at current-year cost	
		Unit cost	Amount	Unit cost	Amount
A	3,000	$5.00	$15,000	$6.00	$18,000
B	1,000	4.00	4,000	5.00	5,000
C	500	2.00	1,000	2.50	1,250
Total	....	....	20,000	....	24,250

(d) If the amount of the December 31, 1961, inventory at base-year cost were equal to, or less than, the base-year cost of $14,000 at January 1, 1961, such amount would be the closing LIFO inventory at December 31, 1961. However, since the base-year cost of the closing LIFO inventory at December 31, 1961, amounts to $20,000, and is in excess of the $14,000 base-year cost of the opening inventory for that year, there is a $6,000 increment in Pool No. 1 during the year. This increment must be valued at current-year cost, i.e., the ratio of 24,250/20,000, or 121.25 percent. The LIFO value of the inventory at December 31, 1961, is $21,275, computed as follows:

POOL NO. 1

	Dec. 31, 1961, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1961, inventory at LIFO value
Jan. 1, 1961, base cost	14,000	100.00	$14,000
Dec. 31, 1961, increment	6,000	121.25	7,275
Total	20,000	....	21,275

Example 2. (a) Assume the taxpayer in Example 1 during the year 1962 completely disposes of item C and purchases item D. Assume further that item D is properly includible in Pool No. 1 under the provisions of this section. The closing inventory on December 31, 1962, consists of quantities at current-year unit cost, as follows:

Items	Units	Current-year unit cost Dec. 31, 1962
A	2,000	$6.50
B	1,500	6.00
D	1,000	5.00

(b) The taxpayer establishes that the cost of item D, had he acquired it on January 1, 1961, would have been $2.00 per unit. Such cost shall be used as the base-year unit cost for item D, and the LIFO computations at December 31, 1962, are made as follows:

Item	Quantity	Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost		Dec. 31, 1962, inventory at current-year cost	
		Unit cost	Amount	Unit cost	Amount
A	2,000	$5.00	$10,000	$6.50	$13,000
B	1,500	4.00	6,000	6.00	9,000
D	1,000	2.00	2,000	5.00	5,000
Total	....	....	18,000	....	27,000

(c) Since the closing inventory at base-year cost, $18,000, is less than the 1962 opening inventory at base-year cost, $20,000, a liquidation of $2,000 has occurred during 1962. This liquidation is to be reflected by reducing the most recent layer of increment. The LIFO value of the inventory at December 31, 1962, is $18,850, and is summarized as follows:

POOL NO. 1

	Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1962, inventory at LIFO value
Jan. 1, 1961, base cost	14,000	100.00	$14,000
Dec. 31, 1961, increment	4,000	121.25	4,850
Total	18,000	....	18,850

(3) *Inventory price index computation (IPIC) method*—(i) *In general.* The inventory price index computation method provided by this paragraph (e)(3) (IPIC method) is an elective method of determining the LIFO value of a dollar-value pool using consumer or producer price indexes published by the United States Bureau of Labor Statistics (BLS). A taxpayer using the IPIC method must compute a separate inventory price index (IPI) for each dollar-value pool. This IPI is used to convert the total current-year cost of the items in a dollar-value pool to base-year cost in order to determine whether there is an increment or liquidation in terms of base-year cost and, if there is an increment, to determine the LIFO inventory value of the current year's layer of increment (layer). Using one IPI to compute the base-year cost of a dollar-value pool for the current taxable year and using a different IPI to compute the LIFO inventory value of the current taxable year's layer is not permitted under the IPIC method. The IPIC method will be accepted by the Commissioner as an appropriate method of computing an index, and the use of that index to compute the LIFO value of a dollar-value pool will be accepted as accurate, reliable, and suitable. The appropriateness of a taxpayer's computation of an IPI, which includes all the steps described in paragraph (e)(3)(iii) of this section, will be determined in connection with an examination of the taxpayer's federal income tax return. A taxpayer using the IPIC method may elect to establish dollar-value pools according to the special rules in paragraphs (b)(4) and (c)(2) of this section or the general rules in paragraphs (b) and (c) of this section. Taxpayers eligible to use the IPIC method are described in paragraph (e)(3)(ii) of this section. The manner in which an IPI is computed is described in paragraph (e)(3)(iii) of this section. Rules relating to the adoption of, or change to, the IPIC method are in paragraph (e)(3)(iv) of this section.

(ii) *Eligibility.* Any taxpayer electing to use the dollar-value LIFO method may elect to use the IPIC method. Except as provided in this paragraph (e)(3)(ii) or in other published guidance, a taxpayer that elects to use the IPIC method for a specific trade or business must use that method to account for all items of dollar-value LIFO inventory. A taxpayer that uses the retail price indexes computed by the BLS and published in ''Department Store Inventory Price Indexes'' (available from the BLS by calling (202) 606–6325 and entering document code 2415) may elect to use the IPIC method for items that do not fall within any of the major groups listed in ''Department Store Inventory Price Indexes.''

(iii) *Computation of an inventory price index*—(A) *In general.* The computation of an IPI for a dollar-value pool requires the following four steps, which are described in more detail in this paragraph (e)(3)(iii): First, selection of a BLS table and an appropriate month; second, assignment of items in a dollar-value pool to BLS categories (selected BLS categories); third, computation of category inflation indexes for selected BLS categories; and fourth, computation of the IPI. A taxpayer may compute the IPI for each dollar-value pool using either the double-extension method (double-extension IPIC method) or the link-chain method (link-chain IPIC method), without regard to whether the use of a double-extension method is impractical or unsuitable. The use of either the double-extension IPIC method or the link-chain IPIC method is a method of accounting, and the adopted method must be applied consistently to all dollar-value pools within a trade or business accounted for under the IPIC method. A taxpayer that wants to change from the double-extension IPIC method to the link-chain IPIC method, or vice versa, must secure the consent of the Commissioner under § 1.446–1(e). This change must be made with a new base year as described in paragraph (e)(3)(iv)(B)(1).

(B) *Selection of BLS table and appropriate month*—(*1*) *In general*. Under the IPIC method, an IPI is computed using the consumer or producer price indexes for certain categories (BLS price indexes and BLS categories, respectively) listed in the selected BLS table of the ''CPI Detailed Report'' or the ''PPI Detailed Report'' for the appropriate month.

(*2*) *BLS table selection*. Manufacturers, processors, wholesalers, jobbers, and distributors must select BLS price indexes from Table 6 (Producer price indexes and percent changes for commodity groupings and individual items, not seasonally adjusted) of the ''PPI Detailed Report'', unless the taxpayer can demonstrate that selecting BLS price indexes from another table of the ''PPI Detailed Report'' is more appropriate. Retailers may select BLS price indexes from either Table 3 (Consumer Price Index for all Urban Consumers (CPI-U): U.S. city average, detailed expenditure categories) of the ''CPI Detailed Report'' or from Table 6 (or another more appropriate table) of the ''PPI Detailed Report.'' The selection of a BLS table is a method of accounting and must be used for the taxable year of adoption and all subsequent years, unless the taxpayer obtains the Commissioner's consent under § 1.446–1(e) to change its table selection. A taxpayer that changes its BLS table must establish a new base year in the year of change as described in paragraph (e)(3)(iv)(B) of this section.

(*3*) *Appropriate month*. In the case of a retailer using the retail method, the appropriate month is the last month of the retailer's taxable year. In the case of all other taxpayers, the appropriate month is the month most consistent with the method used to determine the current-year cost of the dollar-value pool under paragraph (e)(2)(ii) of this section and the taxpayer's history of inventory production or purchases during the taxable year. A taxpayer not using the retail method may annually select an appropriate month for each dollar-value pool or make an election on Form 970, ''Application to Use LIFO Inventory Method,'' to use a representative appropriate month (representative month). An election to use a representative month is a method of accounting and the month elected must be used for the taxable year of the election and all subsequent taxable years, unless the taxpayer obtains the Commissioner's consent under § 1.446–1(e) to change or revoke its election.

(*4*) *Examples*. The following examples illustrate the rules of this paragraph (e)(3)(iii)(B)(*3*):

Example 1. Determining an appropriate month. A wholesaler of seasonal goods timely files a Form 970, ''Application to Use LIFO Inventory Method,'' for the taxable year ending December 31, 2001. The taxpayer indicates elections to use the dollar-value LIFO method, to determine the current-year cost using the earliest acquisitions method in accordance with paragraph (e)(2)(ii)(*b*) of this section, and to use the IPIC method under paragraph (e)(3) of this section. Although the taxpayer purchases inventory items regularly throughout the year, the items purchased vary according to the seasons. The seasonal items on hand at December 31, 2001, are purchased between October and December. Thus, based on the taxpayer's use of the earliest acquisitions method of determining current-year cost and its experience with inventory purchases, the appropriate month for the items represented in the ending inventory at December 31, 2001, is October.

Example 2. Electing a representative month. A retailer not using the retail method timely files a Form 970, ''Application to Use LIFO Inventory Method,'' for the taxable year ending December 31, 2001. The taxpayer indicates elections to use the dollar-value LIFO method, the most recent purchases method of determining current-year cost under paragraph (e)(2)(ii)(*a*) of this section, the IPIC method under paragraph (e)(3) of this section, and December as its representative month under paragraph (e)(3)(iii)(B)(*3*) of this section. The items in the taxpayer's ending inventory are purchased fairly uniformly throughout the year, with the first purchases normally occurring in January and the last purchases normally occurring in December. The taxpayer's election to use December as its representative month is permissible because the taxpayer elected to use the most recent purchases method and the taxpayer's last purchases of the taxable year normally occur during December, the last month of the taxpayer's taxable year.

Example 3. Changing representative month. The facts are the same as in *Example 2,* except the taxpayer files a Form 3115, ''Application for Change in Accounting Method,'' requesting permission to change to the earliest acquisitions method of determining current-year cost in accordance with paragraph (e)(2)(ii)(*b*) of this section and to change its representative month from December to January beginning with the taxable year ending December 31, 2003. If the Commissioner consents to the taxpayer's request to change to the earliest acquisitions method, December will no longer be a permissible representative month for this taxpayer because of the absence of a nexus between the earliest acquisitions method, the month of December (the last month of the taxpayer's taxable year), and the taxpayer's experience with inventory purchases during the year. Thus, the Commissioner will permit the taxpayer to change its representative month to January, the first month of the taxpayer's taxable year.

Example 4. Changing representative month. The facts are the same as in *Example 2.* In 2002, the taxpayer changes its annual accounting period to a taxable year ending June 30, which requires the taxpayer to file a return for the short taxable year beginning January 1, 2002, and ending June 30, 2002. As a result, December is no longer a permissible representative month because of the absence of a nexus between the most recent purchases method, the month of December, and the taxpayer's experience with inventory purchases during the year. The taxpayer should file a Form 3115 requesting permission to change its representative month from December to June beginning with the short taxable year ending June 30, 2002. Because the taxpayer's last purchases of the taxable year now will occur in June, the Commissioner will consent to the taxpayer's request to change its representative month to June.

Example 5. Changing representative month. The facts are the same as *in Example 2,* except that the taxpayer elects to use January as its representative month. The taxpayer timely files a Form 3115 requesting permission to change its representative month from January to December beginning with the taxable year ending December 31, 2003. January is not a permissible representative month because of the absence of a nexus between the most recent purchases method, the taxpayer's history of inventory purchases, and the month of January, the first month in the taxpayer's taxable year. Because December is a permissible representative month, the Commissioner will permit the taxpayer to change its representative month to December.

(C) *Assignment of inventory items to BLS categories*—(*1*) *In general.* Except as provided in paragraph (e)(3)(iii)(C)(*2*) of this section, a taxpayer must assign each item in a dollar-value pool to the most-detailed BLS category of the selected BLS table that contains that item. For example, in Table 6 of the ''PPI Detailed Report'' for a given month, the commodity codes for the various BLS categories run from 2 to 8 digits, with the least-detailed BLS categories having a 2-digit code and the most-detailed BLS categories usually (but not always) having an 8-digit code. For purposes of assigning items to the most-detailed BLS category, manufacturers and processors must assign each raw material item to the most-detailed PPI category that includes that raw material and must assign each finished good item to the most-detailed PPI category that includes that finished good. In addition, manufacturers and processors must assign each work-in-process (WIP) item to the most-detailed PPI category that includes the finished good into which the item will be manufactured or processed. For this purpose, *finished good* means a salable item that the taxpayer regularly sells. For example, a gasoline-engine manufacturer that also manufactures the pistons used in those engines and regularly sells some of the pistons (e.g., to retailers of replacement parts) must assign both finished pistons that have not been affixed to an engine block and piston WIP items to the most-detailed PPI category that includes pistons. Finished pistons that have been affixed to an engine block must be assigned to the most-detailed PPI category that includes gasoline engines. In contrast, if sales of these pistons occur infrequently, the taxpayer must assign both finished pistons and piston WIP items to the most-detailed PPI category that includes gasoline engines.

(*2*) *10 percent method.* Instead of assigning each item in a dollar-value pool to the most-detailed BLS categories, as described in paragraph (e)(3)(iii)(C)(*1*) of this section, a taxpayer may elect to use the 10 percent method described in this paragraph (e)(3)(iii)(C)(*2*). Under the 10 percent method, items are assigned to BLS categories using a three-step procedure.

First, when the current-year cost of a specific item is 10 percent or more of the total current-year cost of the dollar-value pool, the taxpayer must assign that item to the most-detailed BLS category that includes that item (10 percent BLS category). Any other item that is includible in that 10 percent BLS category (other than an item that qualifies for its own 10 percent BLS category under the preceding sentence) must be assigned to that 10 percent BLS category. Second, if one or more items have not been assigned to BLS categories in the first step, the taxpayer must investigate successively less-detailed BLS categories and assign the unassigned item(s) to the first BLS category that contains unassigned items whose current-year cost, in the aggregate, is 10 percent or more of the total current-year cost of the dollar-value pool (also, 10 percent BLS categories). This step must be repeated until all the items in the dollar-value pool have been included in an appropriate 10 percent BLS category, the current-year cost of the unassigned items, in the aggregate, is less than 10 percent of the total current-year cost of the dollar-value pool, or the taxpayer determines that a single BLS category is not appropriate for the aggregate of the unassigned items. Third, if items in a dollar-value pool have not been assigned to a 10 percent BLS category because the current-year cost of those items, in the aggregate, is less than 10 percent of the total current-year cost of the dollar-value pool, the taxpayer must assign those items to the most-detailed BLS category that includes all those items (also, a 10 percent category). On the other hand, if items in a dollar-value pool have not been assigned to a 10 percent BLS category because the taxpayer determines that a single BLS category is not appropriate for the aggregate of those items, the taxpayer must assign each of those items to a single miscellaneous BLS category created by the taxpayer (also, a 10 percent category). In no event may a taxpayer assign items in a dollar-value pool to a BLS category that is less detailed than either the major groups of consumer goods described in Table 3 of the monthly "CPI Detailed Report" or the major commodity groups of producer goods described in Table 6 of the monthly "PPI Detailed Report." Principles similar to those described in paragraph (e)(3)(iii)(C)(*1*) apply for purposes of assigning raw material, work-in-process, and finished good items to the most-detailed BLS category under the 10 percent method.

(*3*) *Change in method of accounting.* The 10 percent method of assigning items in a dollar-value pool to BLS categories is a method of accounting. In addition, a taxpayer's selection of a BLS category for a specific item is a method of accounting. However, the assignment of items to different BLS categories solely as a result of the application of the 10 percent method is a change in underlying facts and not a change in method of accounting. Likewise, the selection of a new BLS category for a specific item as a result of a revision to a BLS table is a change in underlying facts and not a change in method of accounting. A taxpayer that wants to change its method of selecting BLS categories (i.e., to or from the 10-percent method) or of selecting a BLS category for a specific item must secure the Commissioner's consent in accordance with §1.446–1(e). A taxpayer that voluntarily changes its method of selecting BLS categories or of selecting a BLS category for a specific item must establish a new base year in the year of change as described in paragraph (e)(3)(iv)(B) of this section.

(D) *Computation of a category inflation index*—(*1*) *In general.* As described in more detail in this paragraph (e)(3)(iii)(D), a category inflation index reflects the inflation that occurs in the BLS price indexes for a selected BLS category (or, if applicable, 10 percent BLS category) during the relevant measurement period.

(*2*) *BLS price indexes.* The BLS price indexes are the cumulative indexes published in the selected BLS table for the appropriate month. A taxpayer may elect to use either preliminary or final BLS price indexes for the appropriate month, provided that the selected BLS price indexes are used consistently. However, a taxpayer that elects to use final BLS price indexes for the appropriate month must use preliminary BLS price indexes for any taxable year for which the taxpayer files its original federal income tax return before the BLS publishes final BLS price indexes for the appropriate month. If a BLS price index for a most-detailed or 10 percent BLS category is not otherwise available for the appropriate or representative month (but not because the BLS categories in the BLS table have been revised), the taxpayer must use the BLS price index for the next most-detailed BLS category that includes the specific item(s) in the most-detailed or 10 percent BLS category. If a BLS price index is not otherwise available for the appropriate or representative month because the BLS categories in the BLS table have been revised, the rules of paragraph (e)(3)(iii)(D)(*4*) of this section apply.

(*3*) *Category inflation index*—(*i*) *In general.* Except as provided in paragraph (e)(3)(iii)(D)(*4*) of this section (concerning compound category inflation indexes) or (e)(3)(iii)(D)(*5*) of this section (concerning category inflation indexes for certain 10 percent BLS categories), a category inflation index for a selected BLS category (or, if applicable, 10 percent BLS category) is computed under the rules of this paragraph (e)(3)(iii)(D)(*3*).

(*ii*) *Double-extension IPIC method.* In the case of a taxpayer using the double-extension IPIC method, the category inflation index for a BLS category is the quotient of the BLS price index for the appropriate or representative month of the current year divided by the BLS price index for the appropriate month of the taxable year preceding the base year (base month). However, if the taxpayer did not have an opening inventory in the year that its election to use the dollar-value LIFO method and double-extension IPIC method became effective, the category inflation index for a BLS category is the quotient of the BLS price index for the appropriate or representative month of the current year divided by the BLS price index for the month immediately preceding the month of the taxpayer's first inventory production or purchase.

(*iii*) *Link-chain IPIC method.* In the case of a taxpayer using the link-chain IPIC method, the category inflation index for a BLS category is the quotient of the BLS price index for the appropriate or representative month of the current year divided by the BLS price index for the appropriate month used for the immediately preceding taxable year. However, if the taxpayer did not have an opening inventory in the year that its election to use the dollar-value LIFO method and link-chain IPIC method became effective, the category inflation index for a BLS category for the year of election is the quotient of the BLS price index for the appropriate or representative month of the current year divided by the BLS price index for the month immediately preceding the month of the taxpayer's first inventory production or purchase.

(*iv*) *Special rules concerning representative months.* A taxpayer electing to use a representative month under paragraph (e)(3)(iii)(B)(*3*) of this section must use an appropriate month, rather than the representative month, to determine category inflation indexes in the circumstances described in this paragraph (e)(3)(iii)(D)(*3*)(*iv*) and in other similar circumstances. For example, in the case of a short taxable year, the category inflation index should reflect the inflation that occurs from the base month (in the case of the double-extension IPIC method), or the appropriate or representative month used for the preceding taxable year (in the case of the link-chain IPIC method), and the appropriate month for the short taxable year. Similarly, if a taxpayer using the link-chain IPIC method is granted consent to change both its method of determining the current-year cost of a dollar-value pool and its representative month, the category inflation index for the year of change should reflect the inflation that occurs between the old representative month used for the preceding taxable year and the new representative month used for the year of change.

(*4*) *Compound category inflation index for revised BLS categories or price indexes*—(*i*) *In general.* Periodically, the BLS revises a BLS table to add one or more new BLS categories, eliminate one or more previously reported BLS categories, or reset the base-year BLS price index of one or more BLS categories. If the BLS has revised the applicable BLS table for a taxable year, a taxpayer must compute the category inflation index for each BLS category for which the taxpayer cannot compute a category inflation index in accordance with paragraph (e)(3)(iii)(D)(*3*) of this section (affected BLS category) using a reasonable method, provided the method is used consistently for all affected BLS categories within a particular taxable year. For example, if the BLS revised the CPI by adding new BLS categories as of January 2001 and eliminating some previously reported BLS categories as of December 2000, January 2002 would be the first month for which it would be possible to compute a category inflation index for a 12-month period using the BLS price indexes for any affected category. The compound category inflation index described in paragraph (e)(3)(iii)(D)(*4*)(*ii*) of this section is a reasonable method of computing the category inflation index for an affected BLS category.

(*ii*) *Computation of compound category inflation index.* When the applicable BLS table is revised as described in paragraph (e)(3)(iii)(D)(*4*)(*i*) of this section, a taxpayer may use the procedure described in this paragraph (e)(3)(iii)(D)(*4*)(*ii*) to compute a compound category inflation index for each affected BLS category represented in the taxpayer's ending inventory. For this purpose, a compound category inflation index is the product of the category inflation index for the ''first portion'' multiplied by the corresponding category inflation index for the ''second portion.'' The category inflation index for the first portion must reflect the inflation that occurs between the end of the base month (in the case of the double-extension IPIC method), or the preceding year's appropriate or representative month (in the case of the link-chain IPIC method), and the end of the last month covered by the unrevised BLS table based on the old BLS category. The corresponding category inflation index for the second portion must reflect the inflation that occurs between the beginning of the first month covered by the revised BLS table based on the new BLS category and the end of the current year's appropriate or representative month. First, using the revised BLS table for the current-year's appropriate or representative month, the taxpayer assigns items in the dollar-value pool using its method of assigning items to BLS categories as described in paragraph (e)(3)(iii)(C) of this section. Second, for each affected BLS category represented in the ending inventory, the taxpayer computes the category inflation index for the second portion using this formula: [A/B], where A equals the BLS price index for the current year's appropriate or representative month and B equals the BLS price index for the last month covered by the unrevised BLS table (as published for the first month of the revised BLS table). Third, using the unrevised BLS table for the base month (in the case of the double extension IPIC method) or the preceding year's appropriate or representative month (in the case of the link-chain IPIC method), the taxpayer assigns each of the items in the dollar-value pool using its method of assigning items to BLS categories. Fourth, for each affected BLS category represented in the ending inventory, the taxpayer computes the category inflation index for the first portion using this formula: [C/D], where C equals the BLS price index for the last month covered by the unrevised BLS table (as published for the last month of the unrevised BLS table) and D equals the BLS price index for the base month (in the case of the double-extension IPIC method) or the preceding year's appropriate or representative month (in the case of the link-chain IPIC method). Fifth, for each affected BLS category represented in the ending inventory, the taxpayer computes the compound category inflation index using this formula: [X*Y], where X equals the category inflation index for the second portion, and Y equals the corresponding category inflation index for the first portion. For the purpose of computing the compound category inflation index for each affected BLS category, the corresponding category inflation index for the first portion is the category inflation index for the unrevised BLS category that includes the specific inventory item(s) included in the revised BLS category. If items included in a single revised BLS category had been included in separate BLS categories before the revision of the BLS table, the corresponding category inflation index for the first portion is the weighted harmonic mean of the category inflation indexes for these unrevised BLS categories. See paragraph (e)(3)(iii)(E)(*1*) of this section for a formula of the weighted harmonic mean. When computing this weighted-average category inflation index, a taxpayer must use the current-year costs (or in the case of a retailer using the retail method, the retail selling prices) in ending inventory as the weights.

(*iii*) *New base year*. A taxpayer may establish a new base year in the year following the taxable year for which the taxpayer computed a compound category inflation index under this paragraph (e)(3)(iii)(D)(*4*) for one or more affected BLS categories in a dollar-value pool. See paragraph (e)(3)(iv)(B) of this section for the procedures and computations incident to establishing a new base year.

(*iv*) *Examples*. The following examples illustrate the rules of this paragraph (e)(3)(iii)(D)(*4*):

Example 1. BLS categories eliminated. (i) A retailer, whose taxable year ends January 31, elected to account for its inventories using the dollar-value LIFO method and double-extension IPIC method (based on the CPI), beginning with the taxable year ending January 31, 1997. The taxpayer does not use the retail method, but elected to use January as its representative month. On January 31, 1999, the taxpayer's only dollar-value pool contains only two items—lemons and peaches. The total current-year cost of these items is as follows: lemons, $40, and peaches, $30.

(ii) The CPI was revised in October of 1998 to eliminate the ''Citrus fruits'' subcategory of ''Other fresh fruits.'' In addition, the base-year BLS price index for ''Other fresh fruits'' was reset to 100.00 as of October 1, 1998. In relevant part, the January 1999 CPI permits the assignment of both lemons and peaches to ''Other fresh fruits.'' The January 1999 BLS price indexes for ''Citrus fruits'' and ''Other fresh fruits'' are 96.6 and 105.6, respectively. In relevant part, the September 1998 CPI permits the assignment of lemons to ''Citrus fruits'' and peaches to ''Other fresh fruits.'' The September 1998 BLS price indexes for ''Citrus fruits'' and ''Other fresh fruits'' are 194.9 and 294.9, respectively, and the January 1997 BLS price indexes for ''Citrus fruits'' and ''Other fresh fruits'' are 190.2 and 290.2, respectively.

(iii) Because the BLS eliminated the category, ''Citrus fruits,'' as of October 1998, it did not publish a BLS price index for that category in the January 1999 CPI. Thus, the taxpayer cannot compute a category inflation index for ''Citrus fruits'' under the normal procedures, but may compute a compound category inflation index for that affected BLS category using the procedures described in paragraph (e)(3)(iii)(D)(*4*)(*ii*) of this section.

(iv) The taxpayer computes a compound category inflation index for the two BLS categories that formerly included lemons and peaches. The taxpayer first assigns lemons and peaches to ''Other fresh fruits,'' the most-detailed index in the January 1999 CPI, and then computes the category inflation index for the second portion as follows:

Item	1999 category	Jan. 1999 index/Sept. 1998 index (as published in Oct. 1998)	Category inflation index
Lemons and Peaches	Other fresh fruits	105.6/100.0	1.0560

(v) The taxpayer assigns the lemons and peaches to the most-detailed BLS categories in the January 1998 CPI as follows: lemons to ''Citrus fruits'' and peaches to ''Other fresh fruits.'' Then, the taxpayer computes the category inflation index for the first portion as follows:

Item	1998 category	Sept. 1998 index (as published in Sept. 1998)/Jan. 1997	Category inflation index
Lemons	Citrus fruits	194.9/190.2	1.0247
Peaches	Other fresh Fruits	294.9/290.2	1.0162

(vi) Because lemons and peaches, which are included together in the revised ''Other fresh fruits'' category, had been included in separate BLS categories before the BLS table was revised, the taxpayer must compute a single corresponding category inflation index for the affected BLS categories for the first portion. This corresponding category inflation index is the weighted harmonic mean of the separate corresponding category inflation indexes for the first portion using the cost of the items in ending inventory as the weights. The taxpayer computes the corresponding category inflation index for ''Other fresh fruits'' for the first portion as follows:

Item	(I) Weight (cost of item)	(II) Category inflation index	(III) Quotient: (I)/(II)
Lemons	$40.00	1.0247	$39.04
Peaches	30.00	1.0162	29.52
Total	70.00		68.56

(IV) Sum of weights	(V) Sum of (weight/category inflation index)	(VI) Weighted harmonic mean of other fresh fruits: (IV)/(V)
$70.00	$68.56	1.0210

(vii) Finally, the taxpayer computes the compound category inflation index for Other fresh fruits as follows:

Item	(I) Category inflation index (second portion)	(II) Category inflation index (first portion)	(III) Compound category inflation index: (I)*(II)
Other fresh fruits	1.0560	1.0210	1.0782

(viii) The taxpayer may establish a new base year for the taxable year ending January 31, 2000.

Example 2. BLS categories separated. (i) The facts are the same as in *Example 1*, except prior to October 1998, both lemons and peaches were assigned to ''Other fresh fruits'' and in the October 1998 CPI, the BLS created a new category, ''Citrus fruits,'' for citrus fruits, such as lemons. Moreover, the BLS reset the base-year BLS price index for ''Other fresh fruits'' to 100.0 as of October 1, 1998. As a result of these changes, the taxpayer may no longer assign lemons to ''Other fresh fruits.''

(ii) Because ''Citrus fruits'' is new as of October 1998, the BLS did not publish a BLS price index for this BLS category in the January 1999 CPI. Thus, because the taxpayer cannot compute a category inflation index for ''Citrus fruits'' under the normal procedures, the taxpayer may compute a compound category inflation index for the affected BLS category using the procedures described in paragraph (e)(3)(iii)(D)(*4*)(*ii*) of this section.

(iii) Based on the January 1999 CPI, the taxpayer assigns lemons to ''Citrus fruits'' and peaches to ''Other fresh fruits.'' Then, the taxpayer computes a compound category inflation index for each of the two BLS categories. The computation of the category inflation index for the second portion is as follows:

Item	1999 category	Jan. 1999 index/Sept. 1998 index (as published in Oct. 1998)	Category inflation index
Lemons	Citrus fruits	96.6/100	0.9660
Peaches	Other fresh fruits	105.6/100	1.0560

(iv) Then, the taxpayer computes the category inflation index for the first portion as follows:

Item	1998 category	Sept. 1998 index (as published in Sept. 1998)/Jan. 1997	Category inflation index
Lemons & Peaches	Other fresh fruits	294.9/290.2	1.0162

(v) Finally, the taxpayer computes the compound category inflation index for ''Citrus fruits'' and ''Other fresh fruits'':

Item	(I) Category inflation index (second portion)	(II) Category inflation index (first portion)	(III) Compound category inflation index: (I)*(II)
Citrus fruits	0.9660	1.0162	0.9816
Other fresh fruits	1.0560	1.0162	1.0731

(vi) The taxpayer may establish a new base year for the taxable year ending January 31, 2000.

(5) *10 percent method. (i) Applicability.* A taxpayer that elects to use the 10 percent method described in paragraph (e)(3)(iii)(C)(*2*) of this section must compute a category inflation index for a less-detailed 10 percent BLS category as provided in this paragraph (e)(3)(iii)(D)(*5*). A less-detailed 10 percent category is a BLS category that—

(*A*) subsumes two or more BLS categories;

(*B*) Does not have a single assigned item whose current-year cost is 10 percent or more of the current-year cost of all the items in the dollar-value pool;

(*C*) Has at least one item in at least one of the subsumed BLS categories; and

(*D*) Has at least one subsumed BLS category that either does not have any assigned items or is a separate 10 percent BLS category.

(*ii*) *Determination of category inflation index.* If the rules of this paragraph (e)(3)(iii)(D)(*5*) apply, the category inflation index for the less-detailed 10 percent BLS category is equal to the weighted arithmetic mean of the category inflation index (or, compound category inflation index, if applicable) for each of the subsumed BLS categories that have been assigned at least one item from the taxpayer's dollar-value pool (excluding any item that is properly assigned to a separate 10 percent BLS category). [Weighted Arithmetic Mean = Sum of (Weight × Category Inflation Index)]/Sum of Weights]. The appropriate weight for each of the most-detailed BLS categories referenced in the preceding sentence is the corresponding BLS weight. Currently, in January of each year, the BLS publishes the BLS weights determined for December of the preceding year. In the case of a taxpayer using the double-extension IPIC method, the BLS weights for December of the taxable year preceding the base year are to be used for all taxable years. In the case of a taxpayer using the link-chain IPIC method, the BLS weights for December of a given calendar year are to be used for taxable years that end during the 12-month period that begins on July 1 of the following calendar year. However, if the BLS weights are not published for all of the most-detailed BLS categories referenced above, the taxpayer may use the current-year cost (or in the case of a retailer using the retail method, the retail selling prices) of all items assigned to a specific most-detailed BLS category as the appropriate weight for that category, but must compute a weighted harmonic mean. See paragraph (e)(3)(iii)(E)(*1*) of this section for a formula of the weighted harmonic mean.

(E) *Computation of Inventory Price Index (IPI)—(1) Double-extension IPIC method.* Under the double-extension IPIC method, the IPI for a dollar-value pool is the weighted harmonic mean of the category inflation indexes (or, if applicable, compound category inflation indexes) determined under paragraph (e)(3)(iii)(D) of this section for each selected BLS category (or, if applicable 10 percent BLS category) represented in the taxpayer's dollar-value pool at the end of the taxable year. The formula for computing the weighted harmonic mean of the category inflation indexes is: [Sum of Weights/Sum of (Weight/Category Inflation Index)]. The weights to be used when computing this weighted harmonic mean are the current-year costs (or, in the case of a retailer using the retail method, the retail selling prices) in each selected BLS category represented in the dollar-value pool at the end of the taxable year.

(*2*) *Link-chain IPIC method*. Under the link-chain IPIC method, the IPI for a dollar-value pool is the product of the weighted harmonic mean of the category inflation indexes (or, if applicable, the compound category inflation indexes) determined under paragraph (e)(3)(iii)(D) of this section for each selected BLS category (or, if applicable, 10 percent BLS category) represented in the taxpayer's dollar-value pool at the end of the taxable year multiplied by the IPI for the immediately preceding taxable year. The formula for computing the weighted harmonic mean of the category inflation indexes is: [Sum of Weights/Sum of (Weight/Category Inflation Index)]. The weights to be used when computing this weighted harmonic mean are the current-year costs (or, in the case of a retailer using the retail method, the retail selling prices) in each selected BLS category represented in the dollar-value pool at the end of the taxable year.

(*3*) *Examples*. The following examples illustrate the rules of this paragraph (e)(3)(iii)(E):

Example 1. Double-extension method. (i) *Introduction*. R is a retail furniture merchant that does not use the retail method. For the taxable year ending December 31, 2000, R used the first-in, first-out method of identifying inventory and valued its inventory at cost. The total cost of R's inventory on December 31, 2000, was $850,000. R elected to use the dollar-value LIFO and double-extension IPIC methods for its taxable year ending December 31, 2001. R does not elect to use the 10 percent method described in paragraph (e)(3)(iii)(C)(*2*) of this section. R determines the current-year cost of the items using the actual cost of the most recently purchased goods. R elected to pool its inventory based on the major groups in Table 6 of the monthly ''PPI Detailed Report'' in accordance with the special IPIC pooling rules of paragraph (b)(4) of this section. All items in R's inventory fall within the 2-digit commodity code in Table 6 of the monthly ''PPI Detailed Report'' for ''furniture and household durables.'' Therefore, R will maintain a single dollar-value pool.

(ii) *Select a BLS table and appropriate month for 2001*. R determines that the appropriate month for 2001 is October. R also determines that the appropriate month for 2000 would have been December if R had used the IPIC method for that year.

(iii) *Assign inventory items to BLS categories for 2001*. For 2001, R assigns all items in the dollar-value pool to the most-detailed BLS categories listed in Table 6 of the October 2001 ''PPI Detailed Report'' that contain those items. The BLS categories and the current-year cost of the items assigned to them are summarized as follows:

Commodity code	Category	Current-year cost
12120101	Living Room Table	$111,924.00
12120211	Dining Room Table	159,578.00
12120216	Dining Room Chairs	98,639.00
12130101	Upholstered Sofas	332,488.00
12130111	Upholstered Chairs	218,751.00
Total		921,380.00

(iv) *Compute category inflation indexes for 2001*. Because R elected to use the double-extension IPIC method and did not elect the 10 percent method, the category inflation indexes are computed in accordance with paragraph (e)(3)(iii)(D)(*3*)(*ii*) of this section (BLS price indexes for October 2001 divided by BLS price indexes for December 2000). R computes the category inflation indexes for 2001 as follows:

Category	(I) Oct. 2001 index	(II) Dec. 2000 index	(III) Category inflation index: (I)/(II)
Living Room Table	172.4	169.2	1.018913
Dining Room Table	171.9	168.1	1.022606
Dining Room Chairs	172.8	169.7	1.018268
Upholstered Sofas	142.2	140.9	1.009226
Upholstered Chairs	134.1	132.5	1.012075

(v) *Compute IPI for 2001.* R must compute the IPI for 2001, which is the weighted harmonic mean of the category inflation indexes for 2001. The formula for the weighted harmonic mean provided in paragraph (e)(3)(iii)(E)(*1*) of this section is [Sum of Weights/Sum of (Weight/Category Inflation Index)]. The IPI for 2001 is computed as follows:

Category	(I) Weight	(II) Category inflation index	(III) Quotient: (I)/(II)
Living Room Table	$111,924.00	1.018913	$109,846.47
Dining Room Table	159,578.00	1.022606	156,050.33
Dining Room Chairs	98,639.00	1.018268	96,869.39
Upholstered Sofas	332,488.00	1.009226	329,448.51
Upholstered Chairs	218,751.00	1.012075	216,141.10
Total	$921,380.00		$908,355.80

(IV) Sum of weights	(V) Sum of (weight/category inflation index)	(VI) Inventory price index: (IV)/(V)
$921,380.00	$908,355.80	1.01433821

(vi) *Determine the LIFO value of the dollar-value pool for 2001.* For 2001, R determines the total base-year cost of its ending inventory by dividing the total current-year cost of the items in the dollar-value pool by the IPI for 2001. The total base-year cost of R's ending inventory is $908,355.80 ($921,380/1.01433821). Comparing the base-year cost of the ending inventory to the base-year cost of the beginning inventory, R determines that the base-year cost of the 2001 increment is $58,355.80 ($908,355.80 - $850,000.00). R multiplies the base-year cost of the 2001 increment by the IPI for 2001 and determines that the LIFO value of the 2001 layer is $59,192.52 ($58,355.80 * 1.01433821). Thus, the LIFO value of R's total inventory at the end of 2001 is $909,192.52 ($850,000.00 (opening inventory) + $59,192.52 (2001 layer)).

(vii) *Select a BLS table and appropriate month for 2002.* For 2002, R must compute a new IPI under the double-extension IPIC method to determine the LIFO value of its dollar-value pool. R determines that the appropriate month for 2002 is November.

(viii) *Assign inventory items to BLS categories for 2002.* For 2002, R assigns all items in the dollar-value pool to the most-detailed BLS categories listed in Table 6 of the November 2002 ''PPI Detailed Report'' that contain those items. The BLS categories and the current-year cost of the items assigned to them are summarized as follows:

Commodity code	Category	Current-year cost
12120103	Living Room Desks	$125,008.00
12120211	Dining Room Table	136,216.00
12120216	Dining Room Chairs	113,569.00
12130101	Upholstered Sofas	343,900.00
12130111	Upholstered Chairs	233,050.00
Total		$951,743.00

(ix) *Compute category inflation indexes for 2002.* Because R uses the double-extension IPIC method and did not elect the 10 percent method, the category inflation indexes are computed in accordance with paragraph (e)(3)(iii)(D)(*3*)(*ii*) of this section (BLS price indexes for November 2002 divided by BLS price indexes for December 2000). R computes the category inflation indexes for 2002 as follows:

Category	(I) Nov. 2002 index	(II) Dec. 2000 index	(III) Category inflation index (I)/(II)
Living Room Desks	172.6	160.3	1.076731
Dining Room Table	174.8	168.1	1.039857
Dining Room Chairs	177.0	169.7	1.043017
Upholstered Sofas	144.9	140.9	1.028389
Upholstered Chairs	136.6	132.5	1.030943

(x) *Compute IPI for 2002.* R must compute the IPI for 2002, which is the weighted harmonic mean [Sum of Weights/Sum of (Weight/Category Inflation Index)] of the category inflation indexes for 2002. The IPI for 2002 is computed as follows:

Category	(I) Weight	(II) Category inflation index	(III) Quotient: (I)/(II)
Living Room Desks	$125,008.00	1.076731	$116,099.56
Dining Room Table	136,216.00	1.039857	130,994.93
Dining Room Chairs	113,569.00	1.043017	108,885.09
Upholstered Sofas	343,900.00	1.028389	334,406.53
Upholstered Chairs	233,050.00	1.030943	226,055.17
Total	951,743.00		916,441.28

(IV) Sum of weights	(V) Category inflation index	(VI) Inventory price index: (IV)/(V)
$951,743.00	$916,441.28	1.03852044

(xi) *Determine the LIFO value of the pool for 2002.* For 2002, R determines the total base-year cost of its ending inventory by dividing the total current-year cost of the items in the dollar-value pool by the IPI for 2002. The total base-year cost of the ending inventory is $916,441.28 ($951,743.00/1.03852044). Comparing the base-year cost of the ending inventory to the base-year cost of the beginning inventory, R determines that the base-year cost of the 2002 increment is $8,085.48 ($916,441.28 − $908,355.80). R multiplies the base-year cost of the 2002 increment by the IPI for 2002 and determines that the LIFO value of the 2002 layer is $8,396.94 ($8,085.48 * 1.03852044). Thus, the LIFO value of R's total inventory at the end of 2002 is $917,589.46 ($850,000.00 (opening inventory) + $59,192.52 (2001 layer) + $8,396.94 (2002 layer)).

Example 2. Link-chain method. (i) *Introduction.* The facts are the same as *Example 1*, except that R uses the link-chain IPIC method. The double-extension IPIC method and the link-chain IPIC method yield the same results for the first taxable year in which the dollar-value LIFO and IPIC methods are used. Therefore, this example illustrates only how R will compute the IPI for, and determine the LIFO value of, its dollar-value pool for 2002.

(ii) *Select a BLS table and appropriate month for 2002.* R determines that the appropriate month for 2002 is November.

(iii) *Assign inventory items to BLS categories for 2002.* For 2002, R assigns all items in the dollar-value pool to the most-detailed BLS categories listed in Table 6 of the November 2002 ''PPI Detailed Report'' that contain those items. The BLS categories and the current-year cost of the items assigned to them are summarized as follows:

Commodity code	Category	Current-year cost
12120103	Living Room Desks	$125,008.00
12120211	Dining Room Table	136,216.00
12120216	Dining Room Chairs	113,569.00
12130101	Upholstered Sofas	343,900.00
12130111	Upholstered Chairs	233,050.00
Total		951,743.00

(iv) *Compute category inflation indexes for 2002.* Because R uses the link-chain IPIC method and did not elect the 10 percent method, the category inflation indexes are computed in accordance with paragraph (e)(3)(iii)(D)(*3*)(*iii*) of this section (BLS price indexes for November 2002 divided by BLS price indexes for October 2001). R computes the category inflation indexes for 2002 as follows:

Category	(I) Nov. 2002 index	(II) Oct. 2001 index	(III) Category inflation index: (I)/(II)
Living Room Desks	172.6	162.0	1.065432
Dining Room Table	174.8	171.9	1.016870
Dining Room Chairs	177.0	172.8	1.024306
Upholstered Sofas	144.9	142.2	1.018987

Category	(I) Nov. 2002 index	(II) Oct. 2001 index	(III) Category inflation index: (I)/(II)
Upholstered Chairs	136.6	134.1	1.018643

(v) *Compute IPI for 2002.* As provided in paragraph (e)(3)(iii)(E)(*2*) of this section, R must compute the IPI for 2002 by multiplying the weighted harmonic mean of the category inflation indexes for 2002 by the IPI for 2001. The IPI for 2002 is computed as follows:

Category	(I) Weight	(II) Category inflation index	(III) Quotient: (I)/(II)
Living Room Desks	$125,008.00	1.065432	$117,330.81
Dining Room Table	136,216.00	1.016870	133,956.16
Dining Room Chairs	113,569.00	1.024306	110,874.09
Upholstered Sofas	343,900.00	1.018987	337,492.04
Upholstered Chairs	233,050.00	1.018643	228,784.77
Total	951,743.00		928,437.87

(IV) Sum of weights	(V) Sum of (weight/category inflation index)	(VI) Weighted harmonic mean of category inflation indexes for 2002: (IV)/(V)	(VII) Inventory price index for 2001	(VIII) Inventory price index for 2002: (VI)*(VII)
$951,743.00	$928,437.87	1.02510144	1.01433821	1.03979956

(vi) *Determine the LIFO value of the pool for 2002.* R determines the total base-year cost of its ending inventory by dividing the total current-year cost of the items in the dollar-value pool by the IPI for 2002. The total base-year cost of the ending inventory is $915,313.91 ($951,743.00 / 1.03979956). Comparing the base-year cost of the ending inventory to the base-year cost of the beginning inventory, R determines that the base-year cost of the 2002 layer is $6,958.11 ($915,313.91–$908,355.80). R multiplies the base-year cost of the 2002 layer by the IPI for 2002 and determines that the LIFO value of the 2002 layer is $7,235.04 ($6,958.11 * 1.03979956). Thus, the LIFO value of R's total inventory at the end of 2002 is $916,427.56 ($850,000.00 (opening inventory) + $59,192.52 (2001 layer) + $7,235.04 (2002 layer)).

(iv) *Adoption or change of method*—(A) *Adoption or change to IPIC method.* The use of an inventory price index computed under the IPIC method is a method of accounting. A taxpayer permitted to adopt the dollar-value LIFO method without first securing the Commissioner's consent also may adopt the IPIC method without first securing the Commissioner's consent. The IPIC method may be adopted and used, however, only if the taxpayer provides the following information on a Form 970, ''Application to Use LIFO Inventory Method,'' or in another manner as may be acceptable to the Commissioner: A complete list of dollar-value pools (including a description of the items in each dollar-value pool); the BLS table (i.e., CPI or PPI) selected for each dollar-value pool; the representative month, if applicable, elected for each dollar-value pool; the BLS categories to which the items in each dollar-value pool will be assigned; the method of assigning items to BLS categories (e.g., the 10 percent method) for each dollar-value pool; and the method of computing the IPI (i.e., double-extension IPIC method or link-chain IPIC method) for each dollar-value pool. In the case of a taxpayer permitted to adopt the IPIC method without requesting the Commissioner's consent, the Form 970 must be attached to the taxpayer's income tax return for the taxable year of adoption. In all other cases, a taxpayer may change to the IPIC method only after securing the Commissioner's consent as provided in §1.446–1(e). In these latter cases, the Form 970 containing the information described in this paragraph (e)(3)(iv)(A) must be attached to a Form 3115, ''Application for Change in Accounting Method,'' filed as required by §1.446–1(e). A taxpayer that simultaneously changes to the dollar-value LIFO and IPIC methods from another LIFO method must apply the rules of paragraph (f)(2) of this section before applying the rules of paragraph (e)(3)(iv)(B)(*1*) of this section. To satisfy the requirements of §1.472–2(h), taxpayers must maintain adequate books and records, including those concerning the use of the IPIC method and necessary computations. Notwithstanding the rules in paragraph (e)(1) of this section, a taxpayer that adopts, or changes to, the link-chain IPIC method is not required to demonstrate that the use of any other method of determining the LIFO value of a dollar-value pool is impractical.

(B) *New base year*—(*1*) *Voluntary change*—(*i*) *In general.* In the case of a taxpayer using a non-IPIC method to determine the LIFO value of inventory, the layers previously determined under that method, if any, and the LIFO values of those layers are retained if the taxpayer voluntarily changes to the IPIC method. Instead of using the earliest taxable year for which the taxpayer adopted the LIFO method for any items in the dollar-value pool, the year of change is used as the new base year for the purpose of determining the amount of increments and liquidations, if any, for the year of change and subsequent taxable years. The base-year cost of the layers in a dollar-value pool at the beginning of the year of change must be restated in terms of new base-year cost using the year of change as the new base year and, if applicable, the indexes for the previously determined layers must be recomputed accordingly. The recomputed indexes will be used to determine the LIFO value of subsequent liquidations. For purposes of computing an IPI under paragraph (e)(3)(iii)(E) of this section, the IPI for the immediately preceding year is 1.00. The new total base-year cost of the items in a dollar-value pool for the purpose of determining future increments and liquidations is equal to the total current-year cost of the items in the dollar-value pool (determined using the taxpayer's method of determining the total current-year cost of the items in the dollar-value pool under paragraph (e)(2)(ii) of this section). A taxpayer must allocate this new total base-year cost to each layer based on the ratio of the old base-year cost of the layer to the old total base-year cost of the dollar-value pool.

(*ii*) *Example.* The following example illustrates the rules of this paragraph (e)(3)(iv)(B)(*1*):

Example. (i) In 1990, X elected to use a dollar-value LIFO method (other than the IPIC method) for its single dollar-value pool. X is granted permission to change to the link-chain IPIC method, beginning with the taxable year ending December 31, 2001. X will continue using a single dollar-value pool. X's beginning inventory as of January 1, 2001, computed using its former inventory method, is as follows:

Layer	(I) Base-year cost	(II) Inflation index	(III) LIFO value: (I) * (II)
Base layer	$135,000	1.00	$135,000
1991 layer	20,000	1.43	28,600
1994 layer	60,000	1.55	93,000
1995 layer	13,000	1.59	20,670
1997 layer	2,000	1.61	3,220
Total	230,000		280,490

(ii) Under X's method of determining the current-year cost of items in a dollar-value pool, the current-year cost of the beginning inventory is $391,000. Thus, X's new base-year cost as of January 1, 2001, is $391,000. X allocates this new base-year cost to each layer based on the ratio of old base-year cost of the layer to the total old base-year cost of the dollar-value pool. To recompute the inflation indexes for each of its layers, X divides the LIFO value of each layer by the new base-year cost attributable to the layer. The new base-year cost, recomputed inflation indexes, and LIFO value of X's layers as of January 1, 2001, are as follows:

Layer	(I) Base-year cost	(II) Inflation index	(III) LIFO value: (I) * (II)
Base layer	$229,500	0.588235	$135,000
1991 layer	34,000	0.841176	28,600
1994 layer	102,000	0.911765	93,000
1995 layer	22,100	0.935294	20,670
1997 layer	3,400	0.947059	3,220
Total	391,000		280,490

(iii) In 2001, the current-year cost of X's ending inventory is $430,139. The weighted harmonic mean of the category inflation indexes applicable to X's ending inventory is 1.075347, and in accordance with paragraph (e)(3)(iv)(B)(*1*)(*i*) of this section, the inflation index for the immediately preceding taxable year is 1.00. Thus, X's IPI for 2001 is 1.075347 (1.00 * 1.075347). The total base-year cost of X's ending inventory is $400,000 ($430,139/1.075347). The base-year cost, IPI, and LIFO value of X's layers as of December 31, 2001, are as follows:

Layer	(I) Base-year cost	(II) Inventory price index	(III) LIFO value: (I) * (II)
Base layer	$229,500	0.588235	$135,000
1991 layer	34,000	0.841176	28,600
1994 layer	102,000	0.911765	93,000
1995 layer	22,100	0.935294	20,670
1997 layer	3,400	0.947059	3,220
2001 layer	9,000	1.075347	9,678
Total	400,000		290,168

(iv) In 2002, the current-year cost of X's ending inventory is $418,000. The weighted harmonic mean of the category inflation indexes applicable to X's ending inventory is 1.02292562, and the IPI for the immediately preceding year is 1.075347. Thus, X's IPI for 2001 is 1.10 (1.075347 * 1.02292562). The total base-year cost of X's ending inventory is $380,000 ($418,000/1.10), which results in a liquidation of $20,000 ($400,000−$380,000) in terms of base-year cost. This liquidation eliminates the 2001 layer ($9,000 base-year cost), the 1997 layer ($3,400 base-year cost), and part of the 1995 layer ($7,600 base-year cost). The base-year cost, indexes, and LIFO value of X's layers as of December 31, 2002, are as follows:

Layer	(I) Base-year cost	(II) Inventory price index	(III) LIFO value: (I) * (II)
Base layer	$229,500	0.588235	$135,000
1991 layer	34,000	0.841176	28,600
1994 layer	102,000	0.911765	93,000
1995 layer	14,500	0.935294	13,562
Total	380,000		270,162

(2) *Involuntary change—(i) In general.* If a taxpayer uses a non-IPIC method to compute the LIFO value of a dollar-value pool, and if the Commissioner determines that the taxpayer's method does not clearly reflect income, the Commissioner may require the taxpayer to change to the IPIC method. If the Commissioner requires a taxpayer to change to the IPIC method, and the taxpayer does not provide sufficient information from its books and records to compute an adjustment under section 481, the Commissioner may implement the change using the simplified transition method described in paragraph (e)(3)(iv)(B)(*2*)(*ii*) of this section.

(*ii*) *Simplified Transition Method.* Under the simplified transition method, the Commissioner will recompute the LIFO value of each dollar-value pool as of the beginning of the year of change using the double-extension IPIC method or the link-chain IPIC method. The adjustment under section 481 is equal to the difference between the recomputed LIFO value and the LIFO value of the pool determined under the taxpayer's former method. The Commissioner will compute an IPI using the double-extension IPIC method or link-chain IPIC method for each taxable year in which the LIFO method was used by the taxpayer based on the assumptions that the ending inventory of the pool in each taxable year was comprised of items that fall into the same BLS categories as the items in the ending inventory of the year of change and that the relative weights of those BLS categories in all prior years were the same as the relative weights of those BLS categories in the ending inventory of the year of change. The base-year cost of the items in a dollar-value pool at the end of a taxable year will be determined by dividing the IPI computed for the taxable year into the current-year cost of the items in that pool determined in accordance with paragraph (e)(2)(ii) of this section. If the comparison of the base-year cost of the beginning and ending inventory produces a current-year increment, the base-year cost of that increment will be multiplied by the IPI computed for that taxable year to determine the LIFO value of that layer.

(*iii*) *Example*. The following example illustrates the rules of this paragraph (e)(3)(iv)(B)(*2*)(*ii*).

Example. (i) Z began using a dollar-value LIFO method other than the IPIC method in the taxable year ending December 31, 1998, and maintains a single dollar-value pool. Z's beginning inventory as of January 1, 2000, computed using its method of accounting, was as follows:

Layer	(I) Base-year cost	(II) Inflation index	(III) LIFO value: (I)*(II)
Base layer	$105,000	1.00	$105,000
1998 layer	3,000	1.40	4,200
Total	108,000		109,200

(ii) Upon examining Z's federal income tax return for the taxable year ending December 31, 2000, the examining agent determines that Z's dollar-value LIFO method does not clearly reflect income. The examining agent chooses to change Z to the double-extension IPIC method for 2000 and implements the change using the simplified transition method as follows. First, the inventory in Z's dollar-value pool at the end of 2000 is assigned to the most-detailed categories in the CPI or PPI, whichever is appropriate. Assume that 80 percent of the current-year cost of Z's inventory as of December 31, 2000, is assigned to Category 1, 10 percent is assigned to Category 2, and 10 percent is assigned to Category 3. Assume further that the current-year cost of the inventory in Z's dollar-value pool at the end of 1998 and 1999 was $133,000 and $145,000, respectively.

(iii) The category inflation indexes for 1998 computed under the double-extension IPIC method are 1.17 for Category 1, 1.26 for Category 2, and 1.19 for Category 3. The weights to be used in computing the IPI for 1998 are $106,400 ($133,000 * 80 percent) for Category 1, $13,300 ($133,000 * 10 percent) for Category 2, and $13,300 ($133,000 * 10 percent) for Category 3. The IPI for 1998 is computed as follows:

Category	(I) Weight	(II) Category inflation index	(III) Quotient: (I)/(II)
1	$106,400	1.17	90,940
2	13,300	1.26	10,556
3	13,300	1.19	11,176
Total	133,000		112,672

(IV) Sum of weights	(V) Sum of (weight/category inflation index)	(VI) Inventory price index: (IV)/(V)
$133,000	$112,672	1.180417

(iv) The base-year cost of the inventory in Z's pool at the end of 1998 is $112,672 ($133,000/1.180417), and the base-year cost of the 1998 increment is $7,672 ($112,672 − $105,000). The LIFO value of the 1998 layer is $9,056 ($7,672 × 1.180417).

(v) The category inflation indexes for 1999 computed under the double-extension IPIC method were 1.21 for Category 1, 1.29 for Category 2 and 1.23 for Category 3. The weights to be used in computing the IPI for 1999 are $116,000 ($145,000 × 80 percent) for Category 1, $14,500 ($145,000 × 10 percent) for Category 2, and $14,500 ($145,000 × 10 percent) for Category 3. The IPI for 1999 is computed as follows:

Category	(I) Weight	(II) Category inflation index	(III) Quotient: (I)/(II)
1	$116,000	1.21	$95,868
2	14,500	1.29	11,240
3	14,500	1.23	11,789
Total	145,000		118,897

(IV) Sum of weights	(V) Sum of (weight/category inflation index)	(VI) Inventory price index: (IV)/(V)
$145,000	$118,897	1.219543

(vi) The base-year cost of the inventory in Z's pool at the end of 1999 is $118,897 ($145,000/1.219543), and the base-year cost of the 1999 layer is $6,225 ($118,897 − $112,672). The LIFO value of the 1999 layer is $7,592 ($6,225 × 1.219543).

(vii) The LIFO value of Z's dollar-value pool at the end of 1999 computed under the double-extension IPIC method is as follows:

Layer	(I) Base-year cost	(II) Inventory price index	(III) LIFO value: (I)*(II)
Base layer	$105,000	1.000000	$105,000
1998 layer	7,672	1.180417	9,056
1999 layer	6,225	1.219542	7,592
Total	118,897		121,648

(viii) The section 481(a) adjustment is equal to the difference between the LIFO value of the inventory at the beginning of 2000 computed under Z's former method of accounting and recomputed by the examining agent under the double-extension IPIC method, or $12,448 ($121,648—$109,200).

(ix) Finally, the examining agent will recompute Z's taxable income for 2000 and succeeding taxable years using the double-extension IPIC method.

(v) *Effective date*—(A) *In general.* The rules of this paragraph (e)(3) and paragraphs (b)(4) and (c)(2) of this section are applicable for taxable years ending on or after December 31, 2001.

(B) *Change in method of accounting.* Any change in a taxpayer's method of accounting necessary to comply with this paragraph (e)(3) or with paragraphs (b)(4) or (c)(2) of this section is a change in method of accounting to which the provisions of section 446 and the regulations thereunder apply. For the first or second taxable year ending on or after December 31, 2001, a taxpayer is granted the consent of the Commissioner to change its method of accounting to a method required or permitted by this paragraph (e)(3) and paragraphs (b)(4) and (c)(2) of this section. A taxpayer that wants to change its method of accounting under this paragraph (e)(3)(v) must follow the automatic consent procedures in Rev. Proc. 2002–9 (2002–3 I.R.B. xxx) (see §601.601(d)(2) of this chapter). However, the scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply, and the five-year limitation on the readoption of the LIFO method under section 10.01(2) of the appendix is waived. In addition, if the taxpayer's method of accounting for its LIFO inventories is an issue under consideration at the time the application is filed with the national office, the audit protection of section 7 of Rev. Proc. 2002–9 does not apply. If a taxpayer changing its method of accounting under this paragraph (e)(3)(v)(B) is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer or counsel for the government, as appropriate, at the same time it files the application with the national office. Any change under this paragraph (e)(3)(v)(B) must be made using a cut-off method and new base year. See paragraph (e)(3)(iv)(B)(*1*) of this section for an example of this computation. Because a change under this paragraph (e)(3)(v)(B) is made using a cut-off method, a section 481(a) adjustment is not permitted. However, a taxpayer changing its method of accounting under this paragraph (e)(3)(v)(B) must comply with the requirements of section 10.06(3) of the APPENDIX of Rev. Proc. 2002–9 (concerning bargain purchases).

(f) *Change to dollar-value method from another method of pricing LIFO inventories*—(1) *Consent required.* Except as provided in § 1.472–3 in the case of a taxpayer electing to use a LIFO inventory method for the first time, or in the case of a taxpayer changing to the dollar-value method and continuing to use the same pools as were used under another LIFO method, a taxpayer using another LIFO method of pricing inventories may not change to the dollar-value method of pricing such inventories unless he first secures the consent of the Commissioner in accordance with paragraph (e) of § 1.446–1.

(2) *Method of converting inventory.* Where the taxpayer changes from one method of pricing LIFO inventories to the dollar-value method, the ending LIFO inventory for the taxable year immediately preceding the year of change shall be converted to the dollar-value LIFO method. This is done to establish the base-year cost for subsequent calculations. Thus, if the taxpayer was previously valuing LIFO inventories on the specific goods method, these separate values shall be combined into appropriate pools. For this purpose, the base year for the pool shall be the earliest taxable year for which the LIFO inventory method had been adopted for any item in that pool. No change will be made in the overall LIFO value of the opening inventory for the year of change as a result of the conversion, and that inventory will merely be restated in the manner used under the dollar-value method. All layers of increment for such inventory must be retained, except that all layers of increment which occurred in the same taxable year must be combined. The following examples illustrate the provisions of this subparagraph:

Example 1. (i) Assume that the taxpayer has used another LIFO method for finished goods since 1954 and has complied with all the requirements prerequisite for a change to the dollar-value method. Items A, B, and C, which have previously been inventoried under the specific goods LIFO method, may properly be included in a single dollar-value LIFO pool. The LIFO inventory value of items A, B, and C at December 31, 1960, is $12,200, computed as follows:

Year	Base quantity and yearly increments	Unit cost	Dec. 31, 1960, inventory at LIFO value
Item A			
1954 (base year)	100	$1	$100
1955	200	2	400
1956	100	4	400
1960	100	6	600
Total	500	....	1,500
Item B			
1954 (base year)	300	6	1,800
1955	100	8	800
1960	50	10	500
Total	450	....	3,100
Item C			
1954 (base year)	1,000	4	4,000
1955	200	6	1,200
1956	300	8	2,400
Total	1,500	....	7,600
LIFO value of items A, B, and C at Dec. 31, 1960	....	....	12,200

There were no increments in the years 1957, 1958, or 1959.

(ii) The computation of the ratio of the total current-year cost to the total base-year cost for the base year and each layer of increment in Pool No. 1 is shown as follows:

Item	1954 base-year unit cost	Year 1954	Increments		
			1955	1956	1960
A					
Base-year cost	$1.00	$100	$200	$100	$100
LIFO value	....	100	400	400	600
B					
Base-year cost	6.00	1,800	600	....	300
LIFO value	....	1,800	800	....	500
C					
Base-year cost	4.00	4,000	800	1,200	....
LIFO value	....	4,000	1,200	2,400	....
Total—Base-year cost	5,900	1,600	1,300	400	
Total—LIFO value	5,900	2,400	2,800	1,100	
Ratio of total current-year cost to total base-year cost (percent)	....	100.00	150.00	215.38	275.00

(iii) On the basis of the foregoing computations, the LIFO inventory of Pool No. 1, at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
1954 base cost	$5,900	100.00	$5,900
1955 increment	1,600	150.00	2,400
1956 increment	1,300	215.38	2,800
1960 increment	400	275.00	1,100
Total	9,200	....	12,200

Example 2. Assume the same facts as in Example 1 and assume further that the base-year cost of Pool No. 1 at December 31, 1961, is $8,350. Since the closing inventory for the taxable year 1961 at base-year cost is less than the opening inventory for that year at base-year cost, a liquidation has occurred during 1961. This liquidation absorbs all of the 1960 layer of increment and part of the 1956 layer of increment. The December 31, 1961, inventory is $10,131, computed as follows:

	Dec. 31, 1961, inventory at base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1961, inventory at LIFO value
1954 base cost	$5,900	100.00	$5,900
1955 increment	1,600	150.00	2,400
1956 increment	850	215.38	1,831
Total	8,350	....	10,131

(g) *Transitional rules*—(1) *Change in method of pooling.* Any method of pooling authorized by this section and used by the taxpayer in computing his LIFO inventories under the dollar-value method shall be treated as a method of accounting. Any method of pooling which is authorized by this section shall be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commissioner as provided in paragraph (e) of §1.446–1. Where the taxpayer changes from one method of pooling to another method of pooling permitted by this section, the ending LIFO inventory for the taxable year preceding the year of change shall be restated under the new method of pooling.

(2) *Manner of combining or separating dollar-value pools.* (i) A taxpayer who has been using the dollar-value LIFO method and who is permitted or required to change his method of pooling, shall combine or separate the LIFO value of his inventory for the base year and each yearly layer of increment in order to conform to the new pool or pools. Each yearly layer of increment in the new pool or pools must be separately accounted for and a record thereof maintained, and any liquidation occurring in the new pool or pools subsequent to the formation thereof shall be treated in the same manner as if the new pool or pools had existed from the date the taxpayer first adopted the LIFO inventory method. The combination or separation of the LIFO value of his inventory for the base year

and each yearly layer of increment shall be made in accordance with the appropriate method set forth in this subparagraph, unless the use of a different method is approved by the Commissioner.

(ii) Where the taxpayer is permitted or required to separate a pool into more than one pool, the separation shall be made in the following manner: First, each item in the former pool shall be placed in an appropriate new pool. Every item in each new pool is then extended at its base-year unit cost and the extensions are totaled. Each total is the amount of inventory for each new pool expressed in terms of base-year cost. Then a ratio of the total base-year cost of each new pool to the base-year cost of the former pool is computed. The resulting ratio is applied to the amount of inventory for the base year and each yearly layer of increment of the former pool to obtain an allocation to each new pool of the base-year inventory of the former pool and subsequent layers of increment thereof. The foregoing may be illustrated by the following example of a change for the taxable year 1961:

Example. (a) Assume that items A, B, C, and D are all grouped together in one pool prior to December 31, 1960. The LIFO inventory value at December 31, 1960, is computed as follows:

	Pool ABCD		
	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Jan. 1, 1956, base cost	$10,000	100	$10,000
Dec. 31, 1956, increment	1,000	110	1,100
Dec. 31, 1958, increment	5,000	120	6,000
Dec. 31, 1960, increment	4,000	125	5,000
Total	20,000	....	22,100

(b) The extension of the quantity of items A, B, C, and D at respective base-year unit costs is as follows:

Item	Quantity	Base-year unit cost	Amount
A	2,000	$2	$4,000
B	1,000	3	3,000
C	1,000	5	5,000
D	4,000	2	8,000
Total	....	....	20,000

(c) Under the provisions of this section the taxpayer separates former Pool ABCD into two pools, Pool AB and Pool CD. The computation of the ratio of total base-year cost for each of the new pools to the base-year cost of the former pool is as follows:

Item	Total base-year cost	Ratio
Pool AB:		
A	$4,000	....
B	3,000	....
	7,000	7,000/20,000
Pool CD:		
C	5,000	....
D	8,000	....
	13,000	13,000/20,000
Total for pool ABCD	20,000	....

(d) The ratio of the base-year cost of new Pools AB and CD to the base-year cost of former Pool ABCD is 7,000/20,000 and 13,000/20,000, respectively. The allocation of the January 1, 1956 base cost and subsequent yearly layers of increment of former Pool ABCD to new Pools AB and CD is as follows:

	Base-year cost to be allocated	Pool	
		AB	CD
Jan. 1, 1956, base cost	$10,000	$3,500	$6,500
Dec. 31, 1956, increment	1,000	350	650
Dec. 31, 1958, increment	5,000	1,750	3,250
Dec. 31, 1960, increment	4,000	1,400	2,600
Total	20,000	7,000	13,000

(e) The LIFO value of new Pools AB and CD at December 31, 1960, as allocated, is as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Pool AB			
Jan. 1, 1956, base cost	$3,500	100	$3,500
Dec. 31, 1956, increment	350	110	385
Dec. 31, 1958, increment	1,750	20	2,100
Dec. 31, 1960, increment	1,400	125	1,750

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Total	7,000	....	7,735
Pool CD			
Jan. 1, 1956, base cost	6,500	100	6,500
Dec. 31, 1956, increment	650	110	715
Dec. 31, 1958, increment	3,250	120	3,900
Dec. 31, 1960, increment	2,600	125	3,250
Total	13,000	....	14,365

(iii) Where the taxpayer is permitted or required to combine two or more pools having the same base year, they shall be combined into one pool in the following manner: The LIFO value of the base-year inventory of each of the former pools is combined to obtain a LIFO value of the base-year inventory for the new pool. Then, any layers of increment in the various pools which occurred in the same taxable year are combined into one total layer of increment for that taxable year. However, layers of increment which occurred in different taxable years may not be combined. In combining the layers of increment a new ratio of current-year cost to base-year cost is computed for each of the combined layers of increment. The foregoing may be illustrated by the following example:

Example. (a) Assume the taxpayer has two pools at December 31, 1960. Under the provisions of this section the taxpayer combines these pools into a single pool as of January 1, 1961. The LIFO inventory value of each pool at December 31, 1960, is shown as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1957, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Pool No. 1			
Jan. 1, 1956, base cost	$10,000	100	$10,000
Dec. 31, 1957, increment	2,000	110	2,200
Dec. 31, 1960, increment	1,000	120	1,200
Total	13,000	....	13,400

	Dec. 31, 1960, inventory at Jan. 1, 1957, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Pool No. 2			
Jan. 1, 1957, base cost	5,000	100	5,000
Dec. 31, 1960, increment	3,000	140	4,200
Total	8,000	....	9,200

(b) The computation of the ratio of the total current-year cost to the total base-year cost for the base year and each yearly layer of increment in the new pool is as follows:

Pool	Base year 1957	Increments	
		Dec. 31, 1957	Dec. 31, 1960
No. 1:			
Base-year cost	$10,000	$2,000	$1,000
LIFO value	10,000	2,200	1,200
No. 2:			
Base-year cost	5,000	....	3,000
LIFO value	5,000	....	4,200
Total, base-year cost	15,000	2,000	4,000
Total, LIFO value	15,000	2,200	5,400
Ratio of total current-year cost to total base-year cost (percent)	100	110	135

(c) On the basis of the foregoing computations, the LIFO inventory of the new pool at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1957, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Jan. 1, 1957, base cost	$15,000	100	$15,000
Dec. 31, 1957, increment	2,000	110	2,200
Dec. 31, 1960, increment	4,000	135	5,400
Total	21,000	....	22,600

(iv) In combining pools having different base years, the principles set forth in subdivision (iii) of this subparagraph are to be applied, except that all base years subsequent to the earliest base year shall be treated as increments, and the base-year costs for all pools having a base year subsequent to the earliest base year of any pool shall be redetermined in terms of the base cost for the earliest base year.

The foregoing may be illustrated by the following example:

Example. (a) Assume that the taxpayer has two pools at December 31, 1960. Under the provisions of this section the taxpayer combines these pools into a single pool as of January 1, 1961. The LIFO inventory value of each pool at December 31, 1960, is shown as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current rent-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Pool No. 1			
Jan. 1, 1956, base cost	$7,000	100	$7,000
Dec. 31, 1956, increment	1,000	105	1,050
Dec. 31, 1957, increment	500	110	550
Dec. 31, 1958, increment	500	110	550
Dec. 31, 1960, increment	1,000	120	1,200
Total	10,000		10,350
Pool No. 2			
Jan. 1, 1958, base cost	3,500	100	3,500
Dec. 31, 1958, increment	1,000	110	1,100
Dec. 31, 1959, increment	500	115	575
Total	5,000		5,175

(b) The next step is to redetermine the 1958 base-year cost for Pool No. 2 in terms of 1956 base-year cost. January 1, 1956 base-year unit cost must be reconstructed or established in accordance with paragraph (e)(2) of this section for each item in Pool No. 2. Such costs are assumed to be $9.00 for item A, $20.00 for item B, and $1.80 for item C. A ratio of the 1958 total base-year cost to the 1956 total base-year cost for Pool No. 2 is computed as follows:

Item	Quantity	Jan. 1, 1956, base-year unit cost	Jan. 1, 1956, base-year cost
A	250	$9.00	$2,250
B	75	20.00	1,500
C	500	1.80	900
Total			4,650
A	250	10.00	2,500
B	75	20.00	1,500
C	500	2.00	1,000
Total			5,000

(c) The ratio of the 1956 total base-year cost to the 1958 total base-year cost for Pool No. 2 is 4,650/5,000 or 93 percent. The January 1, 1958 base cost and each yearly layer of increment at 1958 base-year cost is multiplied by this ratio. Such computation is as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1958, base-year cost	Ratio (percent)	Dec. 31, 1960, inventory restated at Jan. 1, 1956, base-year cost
Jan. 1, 1958, base cost	$3,500	93	$3,255
Dec. 31, 1958, increment	1,000	93	930
Dec. 31, 1959, increment	500	93	465
Total			4,650

(d) The computation of the ratio of the total current-year cost to the total base-year cost for the base year (1956) and each yearly layer of increment in the new pool is as follows:

Pool	Base year 1956	Increments				
		Dec. 31, 1956	Dec. 31, 1957	Dec. 31, 1958	Dec. 31, 1959	Dec. 31, 1960
No. 1:						
Base-year cost	$7,000	$1,000	$500	$500		$1,000
LIFO value	7,000	1,050	550	550		1,200
No. 2:						
Base-year cost as restated			3,255	930	$465	
LIFO value			3,500	1,100	575	
Total, base-year cost	7,000	1,000	3,755	1,430	465	1,000
Total, LIFO value	7,000	1,050	4,050	1,650	575	1,200
Ratio of total current-year cost to total base-year cost (percent)	100.00	105.00	107.86	115.38	133.66	120.00

(*e*) On the basis of the foregoing computation, the LIFO inventory of the new pool at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Jan. 1, 1956, base cost	$7,000	100.00	$7,000
Dec. 31, 1956, increment	1,000	105.00	1,050
Dec. 31, 1957, increment	3,755	107.86	4,050
Dec. 31, 1958, increment	1,430	115.38	1,650
Dec. 31, 1959, increment	465	123.66	575
Dec. 31, 1960, increment	1,000	120.00	1,200
Total	14,650	....	15,525

(3) *Change in methods of computation at the LIFO value of a dollar-value pool.* For the first taxable year beginning after December 31, 1960, the taxpayer must use a method authorized by paragraph (e)(1) of this section in computing the base-year cost and current-year cost of a dollar-value inventory pool for the end of such year. If the taxpayer had previously used any methods other than one authorized by paragraph (e)(1) of this section, he shall not be required to recompute his LIFO inventories for taxable years beginning on or before December 31, 1960, under a method authorized by such paragraph. The base cost and layers of increment previously computed by such other method shall be retained and treated as if such base cost and layers of increment had been computed under a method authorized by paragraph (e)(1) of this section. The taxpayer shall use the year of change as the base year in applying the double-extension method or other method approved by the Commissioner, instead of the earliest year for which he adopted the LIFO method for any items in the pool.

(h) *LIFO inventories received in certain nonrecognition transactions*—(1) *In general.* Except as provided in paragraph (h)(3) of this section, if inventory items accounted for under the LIFO method are received in a transaction described in paragraph (h)(2) of this section, then, for the purpose of determining future increments and liquidations, the transferee must use the year of transfer as the base year and must use its current-year cost (computed under the transferee's method of accounting) of those items as their new base-year cost. If the transferee had opening inventories in the year of transfer, then, for the purpose of determining future increments and liquidations, the transferee must use its current-year cost (computed under the transferee's method of accounting) of those inventories as their new base-year cost. For this purpose, ''opening inventory'' refers to all items owned by the transferee before the transfer for which the transferee uses, or elects to use, the LIFO method. The total new base-year cost of the transferee's inventory as of the beginning of the year of transfer is equal to the new base-year cost of the inventory received from the transferor and the new base-year cost of the transferee's opening inventory. The index (or, the cumulative index in the case of the link-chain method) for the year immediately preceding the year of transfer is 1.00. The base-year cost of any layers in the dollar-value pool, as determined after the transfer, must be recomputed accordingly. See paragraph (e)(3)(iv)(B)(*1*) of this section for an example of this computation.

(2) *Transactions to which this paragraph (h) applies.* The rules in this paragraph (h) apply to a transaction in which—

(i) The transferee determines its basis in the inventories, in whole or in part, by reference to the basis of the inventories in the hands of the transferor;

(ii) The transferor used the dollar-value LIFO method to account for the transferred inventories;

(iii) The transferee uses the dollar-value LIFO method to account for the inventories in the year of the transfer; and

(iv) The transaction is not described in section 381(a).

(3) *Anti-avoidance rule.* The rules in this paragraph (h) do not apply to a transaction entered into with the principal purpose to avail the transferee of a method of accounting that would be unavailable to the transferor (or would

be unavailable to the transferor without securing consent from the Commissioner). In determining the principal purpose of a transfer, consideration will be given to all of the facts and circumstances. However, a transfer is deemed made with the principal purpose to avail the transferee of a method of accounting that would be unavailable to the transferor without securing consent from the Commissioner if the transferor acquired inventory in a bargain purchase within the five taxable years preceding the year of the transfer and used a dollar-value LIFO method to account for that inventory that did not treat the bargain purchase inventory and physically identical inventory acquired at market prices as separate items. Inventory is deemed acquired in a bargain purchase if the actual cost of the inventory (or, if appropriate, the allocated cost of the inventory) was less than or equal to 50 percent of the replacement cost of physically identical inventory. Inventory is not considered acquired in a bargain purchase if the actual cost of the inventory (or, if appropriate, the allocated cost of the inventory) was greater than or equal to 75 percent of the replacement cost of physically identical inventory.

(4) *Effective date*. The rules of this paragraph (h) are applicable for transfers that occur during a taxable year ending on or after December 31, 2001.

[T.D. 6539, 26 FR 518, Jan. 20, 1961, as amended by T.D. 7814, 47 FR 11272, Mar. 16, 1982; T.D. 8976, 67 FR 1082, Jan. 9, 2002; 67 FR 5062, 5148, Feb. 4, 2002]

§ 1.475–0 Table of contents.

This section lists the major captions in §§ 1.475(a)–3, 1.475(a)–4, 1.475(b)–1, 1.475(b)–2, 1.475(b)–4, 1.475(c)–1, 1.475(c)–2, 1.475(d)–1 and 1.475(g)–1.

§ 1.475(b)–1 Scope of exemptions from mark-to-market requirement.

(a) Securities held for investment or not held for sale.
(b) Securities deemed identified as held for investment.
(1) In general.
(2) Relationships.
(i) General rule.
(ii) Attribution.
(iii) Trusts treated as partnerships.
(3) Securities traded on certain established financial markets.
(4) Changes in status.
(i) Onset of prohibition against marking.
(ii) Termination of prohibition against marking.
(iii) Examples.
(c) Securities deemed not held for investment; dealers in notional principal contracts and derivatives.
(d) Special rule for hedges of another member's risk.
(e) Transitional rules.
(1) Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts before January 23, 1997.
(i) In general.
(ii) Control defined.
(iii) Applicability.
(2) Dealers in notional principal contracts and derivatives acquired before January 23, 1997.
(i) General rule.
(ii) Exception for securities not acquired in dealer capacity.
(iii) Applicability.

§ 1.475(b)–2 Exemptions—identification requirements.

(a) Identification of the basis for exemption.
(b) Time for identifying a security with a substituted basis.
(c) Integrated transactions under § 1.1275–6.
(1) Definitions.
(2) Synthetic debt held by a taxpayer as a result of legging in.
(3) Securities held after legging out.

§ 1.475(b)–3 [Reserved]

§ 1.475(b)–4 Exemptions—transitional issues.

(a) Transitional identification.
(1) Certain securities previously identified under section 1236.
(2) Consistency requirement for other securities.
(b) Corrections on or before January 31, 1994.
(1) Purpose.
(2) To conform to § 1.475(b)–1(a).
(i) Added identifications.
(ii) Limitations.
(3) To conform to § 1.475(b)–1(c).
(c) Effect of corrections.

§ 1.475(c)–1 Definitions—dealer in securities.

(a) Dealer-customer relationship.
(1) [Reserved]
(2) Transactions described in section 475(c)(1)(B).
(i) In general.
(ii) Examples.
(3) Related parties.
(i) General rule.
(ii) Special rule for members of a consolidated group.
(iii) The intragroup-customer election.
(A) Effect of election.
(B) Making and revoking the election.
(iv) Examples.
(b) Sellers of nonfinancial goods and services.
(1) Purchases and sales of customer paper.
(2) Definition of customer paper.
(3) Exceptions.
(4) Election not to be governed by the exception for sellers of nonfinancial goods or services.
(i) Method of making the election.
(A) Taxable years ending after December 24, 1996.
(B) Taxable years ending on or before December 24, 1996.
(ii) Continued applicability of an election.
(c) Taxpayers that purchase securities from customers but engage in no more than negligible sales of the securities.
(1) Exemption from dealer status.
(i) General rule.
(ii) Election to be treated as a dealer.
(2) Negligible sales.
(3) Special rules for members of a consolidated group.
(i) Intragroup-customer election in effect.
(ii) Intragroup-customer election not in effect.
(4) Special rules.
(5) Example.
(d) Issuance of life insurance products.

§ 1.475(c)–2 Definitions—security.

(a) Items that are not securities.
(b) Synthetic debt that § 1.1275–6(b) treats the taxpayer as holding.
(c) Negative value REMIC residuals acquired before January 4, 1995.
(1) Description.
(2) Special rules applicable to negative value REMIC residuals acquired before January 4, 1995.

§ 1.475(d)–1 Character of gain or loss.

(a) Securities never held in connection with the taxpayer's activities as a dealer in securities.
(b) Ordinary treatment for notional principal contracts and derivatives held by dealers in notional principal contracts and derivatives.

§ 1.475(g)–1 Effective dates.

[T.D. 8700, 61 FR 67719, Dec. 24, 1996, as amended by T.D. 9328, 72 FR 32177, June 12, 2007]

§§ 1.475(a)–1—1.475(a)–2 [Reserved]

§ 1.475(a)–3 Acquisition by a dealer of a security with a substituted basis.

(a) *Scope.* This section applies if—

(1) A dealer in securities acquires a security that is subject to section 475(a) and the dealer's basis in the security is determined, in whole or in part, by reference to the basis of that security in the hands of the person from whom the security was acquired; or

(2) A dealer in securities acquires a security that is subject to section 475(a) and the dealer's basis in the security is determined, in whole or in part, by reference to other property held at any time by the dealer.

(b) *Rules.* If this section applies to a security—

(1) Section 475(a) applies only to changes in value of the security occurring after the acquisition; and

(2) Any built-in gain or loss with respect to the security (based on the difference between the fair market value of the security on the date the dealer acquired it and its basis to the dealer on that date) is taken into account at the time, and has the character, provided by the sections of the Internal Revenue Code that would apply to the built-in gain or loss if section 475(a) did not apply to the security.

[T.D. 8700, 61 FR 67720, Dec. 24, 1996]

§ 1.475(a)–4 Valuation safe harbor.

(a) *Overview*—(1) *Purpose.* This section sets forth a safe harbor that, under certain circumstances, permits taxpayers to elect to use the values of positions reported on certain financial statements as the fair market values of those positions for purposes of section 475. This safe harbor is based on the principle that, if a mark-to-market method used for financial reporting is sufficiently consistent with the requirements of section 475 and if the financial statement employing that method has certain indicia of reliability, then the values used on that financial statement may be used for purposes of section 475. If other provisions of the Internal Revenue Code or regulations require adjustments to fair market value, use of the safe harbor does not eliminate the need for those adjustments. See paragraph (e) of this section.

(2) *Dealer business model.* The safe harbor is based on the business model for a derivatives dealer. Under this model, the dealer seeks to capture and profit from bid-ask spreads in the marketplace by entering into substantially offsetting positions with customers that will remain on the derivatives dealer's books over their terms. Because the positions in the aggregate tend to offset each other, the dealer has achieved a predictable net cash flow (for example, a synthetic annuity) that reflects the captured bid-ask spread. This net cash flow is generally impervious to market fluctuations in the values on which the component derivatives are based. Section 475 requires current recognition of the present value of the net cash flow attributable to the capture of these spreads.

(3) *Summary of paragraphs.* Paragraph (b) of this section sets forth the safe harbor. To determine who may use the safe harbor, paragraph (c) of this section defines the term ''eligible taxpayer.'' Paragraph (d) of this section sets forth the basic requirements for determining whether the method used for financial reporting is sufficiently consistent with the requirements of section 475. Paragraph (e) of this section describes adjustments to the financial statement values that may be required for purposes of applying this safe harbor. Paragraph (f) of this section describes the procedure for making the safe harbor election and the conditions under which the election may be revoked. Paragraph (g) of this section provides that the Commissioner will issue a revenue procedure that lists the types of securities and commodities that are eligible positions for purposes of the safe harbor. Using rules for determining priorities among financial statements, paragraph (h) of this section defines the term ''applicable financial statement'' and so describes the financial statement, if any,

whose values may be used in the safe harbor. In some cases, as required by paragraph (j) of this section, the safe harbor is available only if the taxpayer's operations make significant business use of financial statement values. Paragraph (k) of this section sets forth requirements for record retention and record production. Paragraph (m) of this section provides that the Commissioner may use fair market values that clearly reflect income, but which differ from values used on the applicable financial statement, if an electing taxpayer fails to comply with the recordkeeping and record production requirements of paragraph (k) of this section.

(b) *Safe harbor*—(1) *General rule.* Subject to any adjustment required by paragraph (e) of this section, if an eligible taxpayer uses an eligible method for the valuation of an eligible position on its applicable financial statement and the eligible taxpayer is subject to the election described in paragraph (f) of this section, the value that the eligible taxpayer assigns to that eligible position on its applicable financial statement is the fair market value of the eligible position for purposes of section 475 and must be used for purposes of section 475, even if that value is not the fair market value of the position for any other purpose of the internal revenue laws. Notwithstanding the rule set forth in this paragraph, the Commissioner may, in certain circumstances, use fair market values that clearly reflect income but differ from the values used on the applicable financial statement. See paragraph (m) of this section.

(2) *Example. Use of eligible and non-eligible methods.* X uses eligible methods on its applicable financial statement for some, but not all, securities and commodities that are eligible positions. When X elects into the safe harbor, the election applies to all eligible positions for which X has an eligible method. Therefore, once the election is in effect, the financial statement values for eligible positions for which X has an eligible method are the fair market values of those eligible positions for purposes of section 475. Since X, however, does not have an eligible method for all eligible positions, those eligible positions for which X does not have an eligible method remain subject to the fair market value requirements of section 475 as set out in case law and otherwise.

(3) *Scope of the safe harbor.* The safe harbor may be used only to determine values for eligible positions that are properly marked to market under section 475. It does not determine whether any positions may or may not be subject to mark-to-market accounting under section 475.

(c) *Eligible taxpayer.* An eligible taxpayer is—

(1) A dealer in securities, as defined in section 475(c)(1); or

(2) A dealer in commodities, as defined in section 475(e), that is subject to an election under section 475(e).

(d) *Eligible method*—(1) *Sufficient consistency.* An eligible method is a mark-to-market method that is sufficiently consistent with the requirements of a mark-to-market method under section 475. To be sufficiently consistent with the requirements of a mark-to-market method under section 475, the eligible method must satisfy all of the requirements of paragraph (d)(2) and paragraph (d)(3) of this section.

(2) *General requirements.* The method—

(i) *Frequency.* Must require a valuation of the eligible position no less frequently than annually, including a valuation as of the last business day of the taxable year;

(ii) *Recognition at the mark.* Must recognize into income on the income statement for each taxable year mark-to-market gain or loss based upon the valuation or valuations described in paragraph (d)(2)(i) of this section;

(iii) *Recognition on disposition.* Must require, on disposition of the eligible position, recognition into income (on the income statement for the taxable year of disposition) as if a year-end mark occurred immediately before such disposition; and

(iv) *Fair value standard.* Must require use of a valuation standard that arrives at fair value in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP).

(3) *Limitations*—(i) *Bid-ask method*—(A) *General rule.* Except for eligible positions that are traded on a qualified

board or exchange, as defined in section 1256(g)(7), or eligible positions that the Commissioner designates in a revenue procedure or other published guidance, the valuation standard used must not, other than on a *de minimis* portion of a taxpayer's positions, permit values at or near the bid or ask value. Consequently, the valuation method described in §1.471–4(a)(1) fails to satisfy this paragraph (d)(3)(i)(A).

(B) *Safe harbor.* The restriction in paragraph (d)(3)(i)(A) of this section is satisfied if the method consistently produces values that are closer to the mid-market values than they are to the bid or ask values.

(ii) *Valuations based on present values of projected cash flows.* If the method of valuation consists of projecting cash flows from an eligible position or positions and determining the present value of those cash flows, the method must not take into account any cash flows attributable to a period or time on or before the valuation date. In addition, adjustment of the gain or loss recognized on the mark may be required with respect to payments that will be made after the valuation date to the extent that portions of the payments have been recognized for tax purposes before the valuation and appropriate adjustment has not been made for purposes of determining financial statement value.

(iii) *Accounting for costs and risks.* Valuations may account for appropriate costs and risks, but no cost or risk may be accounted for more than once, either directly or indirectly. Further, no valuation adjustment for any cost or risk may be made for purposes of this safe harbor if that valuation adjustment is not also permitted by, and taken for, U.S. GAAP purposes on the taxpayer's applicable financial statement. If appropriate, the costs and risks that may be accounted for include, but are not limited to, credit risk (appropriately adjusted for any credit enhancement), future administrative costs, and model risk. An adjustment for credit risk is implicit in computing the present value of cash flows using a discount rate greater than a risk-free rate. Accordingly, a determination of whether any further downward adjustment to value for credit risk is warranted, or whether an upward adjustment is required, must take that implicit adjustment into consideration.

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

Example 1. (i) X, a calendar year taxpayer, is a dealer in securities within the meaning of section 475(c)(1). X generally maintains a balanced portfolio of interest rate swaps and other interest rate derivatives, capturing bid-ask spreads and keeping its market exposure within desired limits (using, if necessary, additional derivatives for this purpose). X uses a mark-to-market method on a statement that it is required to file with the United States Securities and Exchange Commission and that satisfies paragraph (d)(2) of this section with respect to both the contracts with customers and the additional derivatives. When determining the amount of any gain or loss realized on a sale, exchange, or termination of a position, X makes a proper adjustment for amounts taken into account respecting payments or receipts. X and all of its counterparties on the derivatives have the same general credit quality as each other.

(ii) Under X's valuation method, as of each valuation date, X determines a mid-market probability distribution of future cash flows under the derivatives and computes the present values of these cash flows. In computing these present values, X uses an industry standard yield curve that is appropriate for obligations by persons with this same general credit quality. In addition, based on information that includes its own knowledge about the counterparties, X adjusts some of these present values either upward or downward to reflect X's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from the general credit quality used in the yield curve to present value the derivatives.

(iii) X's methodology does not violate the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once.

(iv) *Applicability date.* This *Example 1* applies to valuations of securities on or after July 6, 2011.

Example 2. (i) The facts are the same as in *Example 1*, except that X uses a better credit quality in determining the yield curve to discount the payments to be received under the derivatives. Based on information that includes its own knowledge about the counterparties, X adjusts these present values to reflect X's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from this better credit quality obligation.

(ii) X's methodology does not violate the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once.

(iii) *Applicability date.* This *Example 2* applies to valuations of securities on or after July 6, 2011.

Example 3. (i) The facts are the same as in *Example 1*, except that, after computing present values using the discount rates that are appropriate for obligors with the same general credit quality, and based on information that includes X's own knowledge about the counterparties, X adjusts some of these present values either upward or downward to reflect X's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from a better credit quality.

(ii) X's methodology violates the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once. By using the same general credit quality discount rate, X's method takes into account the difference between risk-free obligations and obligations with that lower credit quality. By adjusting values for the difference between a higher credit quality and that lower credit quality, X takes into account risks that it had already accounted for through the discount rates that it used. The same result would occur if X judged some of its counterparties' obligations to be of a higher credit quality but X failed to adjust the values of those obligations to reflect the difference between a higher credit quality and the lower credit quality.

(iii) *Applicability date.* This *Example 3* applies to valuations of securities on or after July 6, 2011.

Example 4. (i) The facts are the same as in *Example 1*, except that X determines the mid-market value for each derivative and then subtracts the corresponding part of the bid-ask spread.

(ii) X's methodology violates the rule in paragraph (d)(3)(i) of this section that forbids valuing positions at or near the bid or ask value.

Example 5. (i) The facts are the same as in *Example 1*, and, in addition, X's adjustments for all risks and costs, including credit risk, future administrative costs and model risk, may occasionally cause the adjusted value of an eligible position to be at or near the bid value or ask value.

(ii) X's methodology does not violate the rule in paragraph (d)(3)(i)(A) of this section that forbids valuing eligible positions at or near the bid or ask value.

(e) *Compliance with other rules.* Notwithstanding any other provisions of this section, the fair market values for purposes of the safe harbor must be consistent with section 482, or rules that adopt section 482 principles, when applicable. For example, if a notional principal contract is subject to section 482 or section 482 principles, the values of future cash flows taken into account in determining the value of the contract for purposes of section 475 must be consistent with section 482.

(f) *Election*—(1) *Making the election.* Unless the Commissioner prescribes otherwise, an eligible taxpayer elects under this section by filing with the Commissioner a statement declaring that the taxpayer makes the safe harbor election in this section for all eligible positions for which it has an eligible method. In addition to any other information that the Commissioner may require, the statement must describe the taxpayer's applicable financial statement for the first taxable year for which the election is effective and must state that the taxpayer agrees to provide upon the request of the Commissioner all information, records, and schedules in the manner required by paragraph (k) of this section. The statement must be attached to a timely filed Federal income tax return (including extensions) for the taxable year for which the election is first effective.

(2) *Duration of the election.* Once made, the election continues in effect for all subsequent taxable years unless revoked.

(3) *Revocation*—(i) *By the taxpayer.* An eligible taxpayer that is subject to an election under this section may revoke the election only with the consent of the Commissioner.

(ii) *By the Commissioner.* The Commissioner, after consideration of the relevant facts and circumstances, may revoke an election under this section, effective beginning with the first open year for which the election is effective or with any subsequent year, if—

(A) The taxpayer fails to comply with paragraph (k) of this section (concerning record retention and production) and the taxpayer does not show reasonable cause for this failure;

(B) The taxpayer ceases to have an applicable financial statement or ceases to use an eligible method; or

(C) For any other reason, no more than a de minimis number of eligible positions, or no more than a de minimis fraction of the taxpayer's eligible positions, are covered by the safe harbor in paragraph (b) of this section.

(4) *Re-election.* If an election is revoked, either by the Commissioner or by the taxpayer, the taxpayer (or any successor in interest of the taxpayer) may not make the election without the consent of the Commissioner for any taxable year that begins before the date that is six years after the first day of the earliest taxable year affected by the revocation.

(g) *Eligible positions.* For any taxpayer, an eligible position is any security or commodity that the Commissioner in a revenue procedure or other published guidance designates as an eligible position with respect to that taxpayer for purposes of this safe harbor.

(h) *Applicable financial statement*—(1) *Definition.* An eligible taxpayer's applicable financial statement for a taxable year is the taxpayer's primary financial statement for that year if that primary financial statement is described in paragraph (h)(2)(i) of this section (concerning statements required to be filed with the SEC) or if that primary financial statement both meets the requirements of paragraph (j) of this section (concerning significant business use) and is described in either paragraph (h)(2)(ii) or (iii) of this section. Otherwise, or if the taxpayer does not have a primary financial statement for the taxable year, the taxpayer does not have an applicable financial statement for the taxable year.

(2) *Primary financial statement.* For any taxable year, an eligible taxpayer's primary financial statement is the financial statement, if any, described in one or more of paragraphs (h)(2)(i), (ii), and (iii) of this section. If more than one financial statement of the taxpayer for the year is so described, the primary financial statement is the one first described in paragraphs (h)(2)(i), (ii), and (iii) of this section. A taxpayer has only one primary financial statement for any taxable year.

(i) *Statement required to be filed with the Securities and Exchange Commission (SEC).* A financial statement that is prepared in accordance with U.S. GAAP and that is required to be filed with the SEC, such as the 10–K or the Annual Statement to Shareholders.

(ii) *Statement filed with a Federal agency other than the Internal Revenue Service.* A financial statement that is prepared in accordance with U.S. GAAP and that is required to be provided to the Federal government or any of its agencies other than the Internal Revenue Service (IRS).

(iii) Certified audited financial statement. A certified audited financial statement that is prepared in accordance with U.S. GAAP; that is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment in the eligible taxpayer, or provided for other substantial non-tax purposes; and that the taxpayer reasonably anticipates will be directly relied on for the purposes for which it was given or provided.

(3) *Example. Primary financial statement.* X prepares financial statement FS1, which is required to be filed with a Federal government agency other than the SEC or the IRS. FS1 is thus described in paragraph (h)(2)(ii) of this section. X also prepares financial statement FS2, which is a certified audited financial statement that is given to creditors and that X reasonably anticipates will be relied on for purposes of making lending decisions. FS2 is thus described in paragraph (h)(2)(iii) of this section. Because FS1, which is described in paragraph (h)(2)(ii) of this section, is described before FS2, which is described in paragraph (h)(2)(iii) of this section, FS1 is X's primary financial statement.

(4) *Financial statements of equal priority.* If the rules of paragraph (h)(2) of this section cause two or more financial statements to be of equal priority, then the statement that results in the highest aggregate valuation of eligible positions being marked to market under section 475 is the primary financial statement.

(5) *Consolidated groups.* If the taxpayer is a member of an affiliated group that files a consolidated return,

the primary financial statement of the taxpayer is the primary financial statement, if any, of the common parent (within the meaning of section 1504(a)(1)) of the consolidated group.

(6) *Supplement or amendment to a financial statement.* A financial statement includes any supplement or amendment to the financial statement.

(7) *Certified audited financial statement.* For purposes of this paragraph (h), a financial statement is a certified audited financial statement if it is certified by an independent certified public accountant from a Registered Public Accounting firm, as defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002, Public Law 107–204, 116 Stat. 746 (July 30, 2002), 15 U.S.C. §7201(a)(12), and rules promulgated under that Act, and is—

(i) Certified to be fairly presented (a ''clean'' opinion);

(ii) Certified to be fairly presented subject to a concern about a contingency, other than a contingency relating to the value of eligible positions (a qualified ''subject to'' opinion); or

(iii) Certified to be fairly presented except for a method of accounting with which the Certified Public Accountant disagrees and which is not a method used to determine the value of an eligible position held by the eligible taxpayer (a qualified ''except for'' opinion).

(i) [Reserved]

(j) *Significant business use*—(1) *In general.* A financial statement is described in this paragraph (j) if—

(i) The financial statement contains values for eligible positions;

(ii) The eligible taxpayer makes significant use of financial statement values in most of the significant management functions of its business; and

(iii) That use is related to the management of all or substantially all of the eligible taxpayer's business.

(2) *Financial statement value.* For purposes of this paragraph (j), the term *financial statement value* means—

(i) A value that is taken from the financial statement; or

(ii) A value that is produced by a process that is in all respects identical to the process that produces the values that appear on the financial statement but that is not taken from the statement because either—

(A) The value was determined as of a date for which the financial statement does not value eligible positions; or

(B) The value is used in the management of the business before the financial statement has been prepared.

(3) *Management functions of a business.* For purposes of this paragraph (j), the term *management functions of a business* refers to the financial and commercial oversight of the business. Oversight includes, but is not limited to, senior management review of business-unit profitability, market risk measurement or management, credit risk measurement or management, internal allocation of capital, and compensation of personnel. Management functions of a business do not include either tax accounting or reporting the results of operations to persons other than directors or employees.

(4) *Significant use.* If an eligible taxpayer uses financial statement values for some significant management functions and uses values that are not financial statement values for other significant management functions, then the determination of whether the taxpayer has made significant use of the financial statement values is made on the basis of all the facts and circumstances. This determination must particularly take into account whether the taxpayer's reliance on the financial statement values exposes the taxpayer to material adverse economic consequences if the values are incorrect.

(k) *Retention and production of records*—(1) *In general.* In addition to all records that section 6001 otherwise requires to be retained, an eligible taxpayer subject to the election provided by this section must keep, and timely provide to the Commissioner upon request, records and books of account that are sufficient to establish that the financial statement to which the income tax return conforms is the taxpayer's applicable financial statement, that the method used on that statement is an eligible method, and that the values used for eligible positions for purposes of section 475 are the values used in the applicable financial statement. This obligation extends to all records and books that are required to be maintained for any period for financial or regulatory reporting purposes, even if these records or books may not otherwise be specifically covered by section 6001. All records and books described in this paragraph (k) must be maintained for the period described in paragraph (k)(4) of this section, even if a lesser period of retention applies for financial statement or regulatory purposes.

(2) *Specific requirements*—(i) *Verification and reconciliation.* Unless the Commissioner otherwise provides—

(A) *In general.* An eligible taxpayer must provide books and records to verify the appropriate use of the safe harbor and reconciliation schedules between the applicable financial statement for the taxable year and the Federal income tax return for that year. The required verification materials and reconciliation schedules include all supporting schedules, exhibits, computer programs, and any other information used in producing the values and schedules, including the documentation of rules and procedures governing determination of the values. The required reconciliation schedules must also include a detailed explanation of any adjustments necessitated by the imperfect overlap between the eligible positions that the taxpayer marks to market under section 475 and the eligible positions for which the applicable financial statement uses an eligible method. In the time and manner provided by the Commissioner, a corporate taxpayer subject to this paragraph (k) must reconcile the net income amount reported on its applicable financial statement to the amount reported on the applicable forms and schedules on its Federal income tax return (such as the Schedule M–1, ''Net Income(Loss) Reconciliation for Corporations With Total Assets of $10 Million or More''; Schedule M–3, ''Net Income(Loss) Reconciliation for Corporations With Total Assets of $10 Million or More''; and Form 1120F, ''U.S. Income Tax Return of a Foreign Corporation''). Eligible taxpayers that are not otherwise required to file a Schedule M–1 or Schedule M–3 must reconcile net income using substitute schedules similar to Schedule M–1 and Schedule M–3, and these substitute schedules must be attached to the return.

(B) *Values on books and records with supporting schedules.* The books and records must state the value used for each eligible position separately from the value used for any other eligible position. However, an eligible taxpayer may make adjustments to values on a pooled basis, if the taxpayer demonstrates that it can compute gain or loss attributable to the sale or other disposition of an individual eligible position.

(C) *Consolidation schedules.* An eligible taxpayer must provide a schedule showing the consolidation and de-consolidation that is used in preparing the applicable financial statement, along with exhibits and subordinate schedules. This schedule must provide information that addresses the differences for consolidation and de-consolidation between the applicable financial statement and the Federal income tax return.

(ii) *Instructions provided by the Commissioner.* The Commissioner may provide an alternative time or manner in which an eligible taxpayer subject to this paragraph (k) must establish that the same values used for eligible positions on the applicable financial statement are also the values used for purposes of section 475 on the Federal income tax return.

(3) *Time for producing records.* All documents described in this paragraph (k) must be produced within 30 days of a request by the Commissioner, unless the Commissioner grants a written extension. Generally, the Commissioner will exercise his discretion to excuse a minor or inadvertent failure to provide requested documents if the taxpayer shows reasonable cause for the failure, has made a good faith effort to comply with the requirement to produce records, and promptly remedies the failure. For failures to maintain, or timely produce, records, see paragraph (f)(3)(ii) of this section (allowing the Commissioner to revoke the election), and see paragraph (m) of this section (allowing the Commissioner, but not the taxpayer, to use for eligible positions that otherwise might be subject to the safe harbor fair market values that clearly reflect income but that are

different from the values used on the applicable financial statement).

(4) *Retention period for records.* All materials required by this paragraph (k) and section 6001 must be retained as long as their contents may become material in the administration of any internal revenue law.

(5) *Agreements with the Commissioner.* The Commissioner and an eligible taxpayer may enter into a written agreement that establishes, for purposes of this paragraph (k), which records must be maintained, how they must be maintained, and for how long they must be maintained.

(l) [Reserved]

(m) *Use of different values.* If, with respect to the records that relate to certain eligible positions for a taxable year, the taxpayer fails to satisfy paragraph (k) of this section (concerning record retention and record production), then, for those eligible positions for that year, the Commissioner may use values that the Commissioner determines to be fair market values that are appropriate to clearly reflect income, even if the values so determined are different from the values reported for those positions on the applicable financial statement. See also paragraph (f)(3)(ii) of this section (concerning revocation of the election by the Commissioner when a taxpayer does not produce required records and fails to demonstrate reasonable cause for the failure).

[T.D. 9328, 72 FR 32177, June 12, 2007, as amended by T.D. 9533, 76 FR 39281, July 6, 2011; T.D. 9637, 78 FR 54760, Sept. 6, 2013]

§ 1.475(b)–1 Scope of exemptions from mark-to-market requirement.

(a) *Securities held for investment or not held for sale.* Except as otherwise provided by this section and subject to the identification requirements of section 475(b)(2), a security is held for investment (within the meaning of section 475(b)(1)(A)) or not held for sale (within the meaning of section 475(b)(1)(B)) if it is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(b) *Securities deemed identified as held for investment*—(1) *In general.* The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(i) Except as provided in paragraph (b)(3) of this section, stock in a corporation, or a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, to which the taxpayer has a relationship specified in paragraph (b)(2) of this section; or

(ii) A contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract (see sections 72, 817, and 7702).

(2) *Relationships*—(i) *General rule.* The relationships specified in this paragraph (b)(2) are—

(A) Those described in section 267(b)(2), (3), (10), (11), or (12); or

(B) Those described in section 707(b)(1)(A) or (B).

(ii) *Attribution.* The relationships described in paragraph (b)(2)(i) of this section are determined taking into account sections 267(c) and 707(b)(3), as appropriate.

(iii) *Trusts treated as partnerships.* For purposes of this paragraph (b)(2), the phrase partnership or trust is substituted for the word *partnership* in sections 707(b) (1) and (3), and a reference to beneficial ownership interest is added to each reference to capital interest or profits interest in those sections.

(3) *Securities traded on certain established financial markets.* Paragraph (b)(1)(i) of this section does not apply to a security if—

(i) The security is actively traded within the meaning of §1.1092(d)–1(a) taking into account only established financial markets identified in §1.1092(d)–1(b)(1) (i) or (ii) (describing national securities exchanges and interdealer quotation systems);

(ii) Less than 15 percent of all of the outstanding shares or interests in the same class are held by the taxpayer and all persons having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section; and

(iii) If the security was acquired (e.g., on original issue) from a person having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section, then, after the time the security was acquired—

(A) At least one full business day has passed; and

(B) There has been significant trading involving persons not having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section.

(4) *Changes in status*—(i) *Onset of prohibition against marking.* (A) Once paragraph (b)(1) of this section begins to apply to the security and for so long as it continues to apply, section 475(a) does not apply to the security in the hands of the taxpayer.

(B) If a security has not been timely identified under section 475(b)(2) and, after the last day on which such an identification would have been timely, paragraph (b)(1) of this section begins to apply to the security, then the dealer must recognize gain or loss on the security as if it were sold for its fair market value as of the close of business of the last day before paragraph (b)(1) of this section begins to apply to the security, and gain or loss is taken into account at that time.

(ii) *Termination of prohibition against marking.* If a taxpayer did not timely identify a security under section 475(b)(2), and paragraph (b)(1) of this section applies to the security on the last day on which such an identification would have been timely but thereafter ceases to apply—

(A) An identification of the security under section 475(b)(2) is timely if made on or before the close of the day paragraph (b)(1) of this section ceases to apply; and

(B) Unless the taxpayer timely identifies the security under section 475(b)(2) (taking into account the additional time for identification that is provided by paragraph (b)(4)(ii)(A) of this section), section 475(a) applies to changes in value of the security after the cessation in the same manner as under section 475(b)(3).

(iii) *Examples.* These examples illustrate this paragraph (b)(4):

Example 1. Onset of prohibition against marking. (A) *Facts.* Corporation *H* owns 75 percent of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). On December 1, 1995, *D* acquired less than half of the stock in corporation *X*. *D* did not identify the stock for purposes of section 475(b)(2). On July 17, 1996, *H* acquired from other persons 70 percent of the stock of *X*. As a result, *D* and *X* became related within the meaning of paragraph (b)(2)(i) of this section. The stock of *X* is not described in paragraph (b)(3) of this section (concerning some securities traded on certain established financial markets).

(B) *Holding.* Under paragraph (b)(4)(i) of this section, *D* recognizes gain or loss on its *X* stock as if the stock were sold for its fair market value at the close of business on July 16, 1996, and the gain or loss is taken into account at that time. As with any application of section 475(a), proper adjustment is made in the amount of any gain or loss subsequently realized. After July 16, 1996, section 475(a) does not apply to D's *X* stock while paragraph (b)(1)(i) of this section (concerning the relationship between *X* and *D*) continues to apply.

Example 2. Termination of prohibition against marking; retained securities identified as held for investment. (A) *Facts.* On July 1, 1996, corporation *H* owned 60 percent of the stock of corporation *Y* and all of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). Thus, *D* and *Y* are related within the meaning of paragraph (b)(2)(i) of this section. Also on July 1, 1996, *D* acquired, as an investment, 10 percent of the stock of *Y*. The stock of *Y* is not described in paragraph (b)(3) of this section (concerning some securities traded on certain established financial markets). When *D* acquired its shares of *Y* stock, it did not identify them for purposes of section 475(b)(2). On December 24, 1996, *D* identified its shares of *Y* stock as held for investment under section 475(b)(2). On December 30, 1996, *H* sold all of its shares of stock in *Y* to an unrelated party. As a result, *D* and *Y* ceased to be related within the meaning of paragraph (b)(2)(i) of this section.

(B) *Holding.* Under paragraph (b)(4)(ii)(A) of this section, identification of the *Y* shares is timely if done on or before the close of December 30, 1996. Because *D* timely identified its *Y* shares under section 475(b)(2), it continues after December 30, 1996, to refrain from marking to market its *Y* stock.

Example 3. Termination of prohibition against marking; retained securities not identified as held for investment. (A) *Facts.* The facts are the same as in *Example 2* above, except that *D* did not identify its stock in *Y* for purposes of section 475(b)(2) on or before December 30, 1996. Thus, *D* did not timely identify these securities under section 475(b)(2) (taking into account the additional time for identification provided in paragraph (b)(4)(ii)(A) of this section).

(B) *Holding.* Under paragraph (b)(4)(ii)(B) of this section, section 475(a) applies to changes in value of *D*'s *Y* stock after December 30, 1996, in the same manner as under section 475(b)(3).

Thus, any appreciation or depreciation that occurred while the securities were prohibited from being marked to market is suspended. Further, section 475(a) applies only to those changes occurring after December 30, 1996.

Example 4. Acquisition of actively traded stock from related party. (A) *Facts.* Corporation *P* is the parent of a consolidated group whose taxable year is the calendar year, and corporation *M*, a member of that group, is a dealer in securities within the meaning of section 475(c)(1). Corporation *M* regularly acts as a market maker with respect to common and preferred stock of corporation *P*. Corporation *P* has outstanding 2,000,000 shares of series *X* preferred stock, which are traded on a national securities exchange. During the business day on December 29, 1997, corporation *P* sold 100,000 shares of series *X* preferred stock to corporation *M* for $100 per share. Subsequently, also on December 29, 1997, persons not related to corporation *M* engaged in significant trading of the series *X* preferred stock. At the close of business on December 30, 1997, the fair market value of series *X* stock was $99 per share. At the close of business on December 31, 1997, the fair market value of series *X* stock was $98.50 per share. Corporation *M* sold the series *X* stock on the exchange on January 2, 1998. At all relevant times, corporation *M* and all persons related to *M* owned less than 15% of the outstanding series *X* preferred stock.

(B) *Holding.* The 100,000 shares of series *X* preferred stock held by corporation *M* are not subject to mark-to-market treatment under section 475(a) on December 29, 1997, because at that time the stock was held for less than one full business day and is therefore treated as properly identified as held for investment. At the close of business on December 30, 1997, that prohibition on marking ceases to apply, and section 475(b)(3) begins to apply. The built-in loss is suspended, and subsequent appreciation and depreciation are subject to section 475(a). Accordingly, when corporation *M* marks the series *X* stock to market at the close of business on December 31, 1997, under section 475(a) it recognizes and takes into account a loss of $.50 per share. Under section 475(b)(3), when corporation *M* sells the series *X* stock on January 2, 1998, it takes into account the suspended loss, that is, the difference between the $100 per share it paid corporation *P* for that stock and the $99-per-share fair market value when section 475(b)(1) ceased to be applied to the stock. No deduction, however, is allowed for that loss. (See §1.1502–13(f)(6), under which no deduction is allowed to a member of a consolidated group for a loss with respect to a share of stock of the parent of that consolidated group, if the member does not take the gain or loss into account pursuant to section 475(a).)

(c) *Securities deemed not held for investment; dealers in notional principal contracts and derivatives.* (1) Except as otherwise determined by the Commissioner in a revenue ruling, revenue procedure, or letter ruling, section 475(b)(1)(A) (exempting from mark-to-market accounting certain securities that are held for investment) does not apply to a security if—

(i) The security is described in section 475(c)(2) (D) or (E) (describing certain notional principal contracts and derivative securities); and

(ii) The taxpayer is a dealer in such securities.

(2) See §1.475(d)–1(b) for a rule concerning the character of gain or loss on securities described in this paragraph (c).

(d) *Special rule for hedges of another member's risk.* A taxpayer may identify under section 475(b)(1)(C) (exempting certain hedges from mark-to-market accounting) a security that hedges a position of another member of the taxpayer's consolidated group if the security meets the following requirements—

(1) The security is a hedging transaction within the meaning of §1.1221–2(b);

(2) The security is timely identified as a hedging transaction under §1.1221–2(f) (including identification of the hedged item); and

(3) The security hedges a position that is not marked to market under section 475(a).

(e) *Transitional rules*—(1) *Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts before January 23, 1997*—(i) *In general.* The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(A) Stock in a corporation that the taxpayer controls (within the meaning of paragraph (e)(1)(ii) of this section); or

(B) A partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust that the taxpayer controls (within the meaning of paragraph (e)(1)(ii) of this section).

(ii) *Control defined.* Control means the ownership, directly or indirectly through persons described in section 267(b) (taking into account section 267(c)), of—

(A) 50 percent or more of the total combined voting power of all classes of stock entitled to vote; or

(B) 50 percent or more of the capital interest, the profits interest, or the beneficial ownership interest in the widely held or publicly traded partnership or trust.

(iii) *Applicability.* The rules of this paragraph (e)(1) apply only before January 23, 1997.

(2) *Dealers in notional principal contracts and derivatives acquired before January 23, 1997*—(i) *General rule.* Section 475(b)(1)(A) (exempting certain securities from mark-to-market accounting) does not apply to a security if—

(A) The security is described in section 475(c)(2) (D) or (E) (describing certain notional principal contracts and derivative securities); and

(B) The taxpayer is a dealer in such securities.

(ii) *Exception for securities not acquired in dealer capacity.* This paragraph (e)(2) does not apply if the taxpayer establishes unambiguously that the security was not acquired in the taxpayer's capacity as a dealer in such securities.

(iii) *Applicability.* The rules of paragraph (e)(2) apply only to securities acquired before January 23, 1997.

[T.D. 8700, 61 FR 67720, Dec. 24, 1996, as amended by T.D. 8985, 67 FR 12865, Mar. 20, 2002]

§ 1.475(b)–2 Exemptions—identification requirements.

(a) *Identification of the basis for exemption.* An identification of a security as exempt from mark to market does not satisfy section 475(b)(2) if it fails to state whether the security is described in—

(1) Either of the first two subparagraphs of section 475(b)(1) (identifying a security as held for investment or not held for sale); or

(2) The third subparagraph thereof (identifying a security as a hedge).

(b) *Time for identifying a security with a substituted basis.* For purposes of determining the timeliness of an identification under section 475(b)(2), the date that a dealer acquires a security is not affected by whether the dealer's basis in the security is determined, in whole or in part, either by reference to the basis of the security in the hands of the person from whom the security was acquired or by reference to other property held at any time by the dealer. See § 1.475(a)–3 for rules governing how the dealer accounts for such a security if this identification is not made.

(c) *Integrated transactions under § 1.1275–6*—(1) *Definitions.* The following terms are used in this paragraph (c) with the meanings that are given to them by § 1.1275–6: integrated transaction, legging into, legging out, qualifying debt instrument, § 1.1275–6 hedge, and synthetic debt instrument.

(2) *Synthetic debt held by a taxpayer as a result of legging in.* If a taxpayer is treated as the holder of a synthetic debt instrument as the result of legging into an integrated transaction, then, for purposes of the timeliness of an identification under section 475(b)(2), the synthetic debt instrument is treated as having the same acquisition date as the qualifying debt instrument. A pre-leg-in identification of the qualifying debt instrument under section 475(b)(2) applies to the integrated transaction as well.

(3) *Securities held after legging out.* If a taxpayer legs out of an integrated transaction, then, for purposes of the timeliness of an identification under section 475(b)(2), the qualifying debt instrument, or the § 1.1275–6 hedge, that remains in the taxpayer's hands is generally treated as having been acquired, originated, or entered into, as the case may be, immediately after the leg-out. If any loss or deduction determined under § 1.1275–6(d)(2)(ii)(B) is disallowed by § 1.1275–6(d)(2)(ii)(D) (which disallows deductions when a taxpayer legs out of an integrated transaction within 30 days of legging in), then, for purposes of this section and section 475(b)(2), the qualifying debt instrument that remains in the taxpayer's hands is treated as having been acquired on the same date that the synthetic debt instrument was treated as having been acquired.

[T.D. 8700, 61 FR 67722, Dec. 24, 1996]

§ 1.475(b)–3 [Reserved]

§ 1.475(b)–4 Exemptions—transitional issues.

(a) *Transitional identification*—(1) *Certain securities previously identified under section 1236*. If, as of the close of the last taxable year ending before December 31, 1993, a security was identified under section 1236 as a security held for investment, the security is treated as being identified as held for investment for purposes of section 475(b).

(2) *Consistency requirement for other securities*. In the case of a security (including a security described in section 475(c)(2)(F)) that is not described in paragraph (a)(1) of this section and that was held by the taxpayer as of the close of the last taxable year ending before December 31, 1993, the security is treated as having been properly identified under section 475(b)(2) or 475(c)(2)(F)(iii) if the information contained in the dealer's books and records as of the close of that year supports the identification. If there is any ambiguity in those records, the taxpayer must, no later than January 31, 1994, place in its records a statement resolving this ambiguity and indicating unambiguously which securities are to be treated as properly identified. Any information that supports treating a security as having been properly identified under section 475(b)(2) or (c)(2)(F)(iii) must be applied consistently from one security to another.

(b) *Corrections on or before January 31, 1994*—(1) *Purpose*. This paragraph (b) allows a taxpayer to add or remove certain identifications covered by §1.475(b)–1.

(2) *To conform to §1.475(b)–1(a)*—(i) *Added identifications*. To the extent permitted by paragraph (b)(2)(ii) of this section, a taxpayer may identify as being described in section 475(b)(1) (A) or (B)—

(A) A security that was held for immediate sale but was not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business (for example, a trading security); or

(B) An evidence of indebtedness that was not held for sale to customers in the ordinary course of the taxpayer's trade or business and that the taxpayer intended to hold for less than one year.

(ii) *Limitations*. An identification described in paragraph (b)(2)(i) of this section is permitted only if—

(A) Prior to December 28, 1993, the taxpayer did not identify as being described in section 475(b)(1) (A) or (B) any of the securities described in paragraph (b)(2)(i) of this section;

(B) The taxpayer identifies every security described in paragraph (b)(2)(i) of this section for which a timely identification of the security under section 475(b)(2) cannot be made after the date on which the taxpayer makes these added identifications; and

(C) The identification is made on or before January 31, 1994.

(3) *To conform to §1.475(b)–1(c)*. On or before January 31, 1994, a taxpayer described in §1.475(b)–1(e)(2)(i)(B) may remove an identification under section 475(b)(1)(A) of a security described in §1.475(b)–1(e)(2)(i)(A).

(c) *Effect of corrections*. An identification added under paragraph (a)(2) or (b)(2) of this section is timely for purposes of section 475(b)(2) or (c)(2)(F)(iii). An identification removed under paragraph (a)(2) or (b)(3) of this section does not subject the taxpayer to the provisions of section 475(d)(2).

[T.D. 8700, 61 FR 67722, Dec. 24, 1996]

§ 1.475(c)–1 Definitions—dealer in securities.

(a) *Dealer-customer relationship*. Whether a taxpayer is transacting business with customers is determined on the basis of all of the facts and circumstances.

(1) [Reserved]

(2) *Transactions described in section 475(c)(1)(B)*—(i) *In general*. For purposes of section 475(c)(1)(B), the term *dealer in securities* includes, but is not limited to, a taxpayer that, in the ordinary course of the taxpayer's trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B).

(ii) *Examples*. The following examples illustrate the rules of this paragraph (a)(2). In the following examples, B is a bank and is not a member of a consolidated group:

Example 1. B regularly offers to enter into interest rate swaps with other persons in the ordinary course of its trade or business. B is willing to enter into interest rate swaps under which it either pays a fixed interest rate and receives a floating rate or pays a floating rate and receives a fixed rate. B is a dealer in securities under section 475(c)(1)(B), and the counterparties are its customers.

Example 2. B, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of positions in a foreign currency with other banks in the interbank market. B's activities in the foreign currency make it a dealer in securities under section 475(c)(1)(B), and the other banks in the interbank market are its customers.

Example 3. B engages in frequent transactions in a foreign currency in the interbank market. Unlike the facts in *Example 2,* however, B does not regularly hold itself out as being willing and able to enter into either side of positions in the foreign currency, and all of B's transactions are driven by its internal need to adjust its position in the currency. No other circumstances are present to suggest that B is a dealer in securities for purposes of section 475(c)(1)(B). B's activity in the foreign currency does not qualify it as a dealer in securities for purposes of section 475(c)(1)(B), and its transactions in the interbank market are not transactions with customers.

(3) *Related parties*—(i) *General rule.* Except as provided in paragraph (a)(3)(ii) of this section (concerning transactions between members of a consolidated group, as defined in §1.1502–1(h)), a taxpayer's transactions with related persons may be transactions with customers for purposes of section 475. For example, if a taxpayer, in the ordinary course of the taxpayer's trade or business, regularly holds itself out to its foreign subsidiaries or other related persons as being willing and able to enter into either side of transactions enumerated in section 475(c)(1)(B), the taxpayer is a dealer in securities within the meaning of section 475(c)(1), even if it engages in no other transactions with customers.

(ii) *Special rule for members of a consolidated group.* Solely for purposes of paragraph (c)(1) of section 475 (concerning the definition of dealer in securities) and except as provided in paragraph (a)(3)(iii) of this section, a taxpayer's transactions with other members of its consolidated group are not with customers. Accordingly, notwithstanding paragraph (a)(2) of this section, the fact that a taxpayer regularly holds itself out to other members of its consolidated group as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) does not cause the taxpayer to be a dealer in securities within the meaning of section 475(c)(1)(B).

(iii) *The intragroup-customer election*—(A) *Effect of election.* If a consolidated group makes the intragroup-customer election, paragraph (a)(3)(ii) of this section (special rule for members of a consolidated group) does not apply to the members of the group. Thus, a member of a group that has made this election may be a dealer in securities within the meaning of section 475(c)(1) even if its only customer transactions are with other members of its consolidated group.

(B) *Making and revoking the election.* Unless the Commissioner otherwise prescribes, the intragroup-customer election is made by filing a statement that says, ''[Insert name and employer identification number of common parent] hereby makes the Intragroup-Customer Election (as described in §1.475(c)–1(a)(3)(iii) of the income tax regulations) for the taxable year ending [describe the last day of the year] and for subsequent taxable years.'' The statement must be signed by the common parent and attached to the timely filed federal income tax return for the consolidated group for that taxable year. The election applies for that year and continues in effect for subsequent years until revoked. The election may be revoked only with the consent of the Commissioner.

(iv) *Examples.* The following examples illustrate this paragraph (a)(3):

GENERAL FACTS. HC, a hedging center, provides interest rate hedges to all of the members of its affiliated group (as defined in section 1504(a)(1)). Because of the efficiencies created by having a centralized risk manager, group policy prohibits members other than *HC* from entering into derivative interest rate positions with outside parties. *HC* regularly holds itself out as being willing and able to, and in fact does, enter into either side of interest rate swaps with its fellow members. *HC* periodically computes its aggregate position and hedges the net risk with an unrelated party. *HC* does not otherwise enter into interest rate positions with persons that are not members of the affiliated group. *HC* attempts to operate at cost, and the terms of its swaps do not factor in any risk of default by the affiliate. Thus, *HC*'s affiliates receive somewhat more favorable terms then they would receive from an unrelated swaps dealer (a fact that may subject *HC* and its fellow members to reallocation of income under section 482). No other circumstances are present to suggest that *HC* is a dealer in securities for purposes of section 475(c)(1)(B).

Example 1. General rule for related persons. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has not elected under section 1501 to file a consolidated return. Under paragraph (a)(3)(i) of this section, *HC*'s transactions with its affiliates can be transactions with customers for purposes of section 475(c)(1). Thus, under paragraph (a)(2)(i) of this section, *HC* is a dealer in securities within the meaning of section 475(c)(1)(B), and the members of the group with which it does business are its customers.

Example 2. Special rule for members of a consolidated group. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has elected to file consolidated returns and has not made the intragroup-customer election. Under paragraph (a)(3)(ii) of this section, *HC*'s interest rate swap transactions with the members of its consolidated group are not transactions with customers for purposes of determining whether *HC* is a dealer in securities within the meaning of section 475(c)(1). Further, the fact that *HC* regularly holds itself out to members of its consolidated group as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) does not cause *HC* to be a dealer in securities within the meaning of section 475(c)(1)(B). Because no other circumstances are present to suggest that *HC* is a dealer in securities for purposes of section 475(c)(1)(B), *HC* is not a dealer in securities.

Example 3. Intragroup-customer election. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has elected to file a consolidated return but has also made the intragroup-customer election under paragraph (a)(3)(iii) of this section. Thus, the analysis and result are the same as in *Example 1.*

(b) *Sellers of nonfinancial goods and services*—(1) *Purchases and sales of customer paper.* Except as provided in paragraph (b)(3) of this section, if a taxpayer would not be a dealer in securities within the meaning of section 475(c)(1) but for its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper with respect to either the taxpayer or a corporation that is a member of the same consolidated group (as defined in §1.1502–1(h)) as the taxpayer, then for purposes of section 475 the taxpayer is not a dealer in securities.

(2) *Definition of customer paper.* A debt instrument is customer paper with respect to a person at a point in time if—

(i) The person's principal activity is selling nonfinancial goods or providing nonfinancial services;

(ii) The debt instrument was issued by a purchaser of the goods or services at the time of the purchase of those goods or services in order to finance the purchase; and

(iii) At all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a corporation that is a member of the same consolidated group as that person.

(3) *Exceptions.* Paragraph (b)(1) of this section does not apply if—

(i) For purposes of section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory;

(ii) The taxpayer is subject to an election under paragraph (b)(4) of this section; or

(iii) The taxpayer is not described in paragraph (b)(2)(i) of this section and one or more debt instruments that are customer paper with respect to a corporation that is a member of the same consolidated group as the taxpayer are accounted for by the taxpayer, or by a corporation that is a member of the same consolidated group as the taxpayer, in a manner that allows recognition of unrealized gains or losses or deductions for additions to a reserve for bad debts.

(4) *Election not to be governed by the exception for sellers of nonfinancial goods or services*—(i) *Method of making the election.* Unless the Commissioner otherwise prescribes, an election under this paragraph (b)(4) must be made in the manner, and at the time, prescribed in this paragraph (b)(4)(i). The taxpayer must file with the Internal Revenue Service a statement that says, ''[Insert name and taxpayer identification number of the taxpayer] hereby elects not to be governed by §1.475(c)–1(b)(1) of the income tax regulations for the taxable year ending [describe

the last day of the year] and for subsequent taxable years.''

(A) *Taxable years ending after December 24, 1996.* If the first taxable year subject to an election under this paragraph (b)(4) ends after December 24, 1996, the statement must be attached to a timely filed federal income tax return for that taxable year.

(B) *Taxable years ending on or before December 24, 1996.* If the first taxable year subject to an election under this paragraph (b)(4) ends on or before December 24, 1996 and the election changes the taxpayer's taxable income for any taxable year the federal income tax return for which was filed before February 24, 1997, the statement must be attached to an amended return for the earliest such year that is so affected, and that amended return (and an amended return for any other such year that is so affected) must be filed not later than June 23, 1997. If the first taxable year subject to an election under this paragraph (b)(4) ends on or before December 24, 1996 but the taxpayer is not described in the preceding sentence, the statement must be attached to the first federal income tax return that is for a taxable year subject to the election and that is filed on or after February 24, 1997.

(ii) *Continued applicability of an election.* An election under this paragraph (b)(4) continues in effect for subsequent taxable years until revoked. The election may be revoked only with the consent of the Commissioner.

(c) *Taxpayers that purchase securities from customers but engage in no more than negligible sales of the securities*—(1) *Exemption from dealer status*—(i) *General rule.* A taxpayer that regularly purchases securities from customers in the ordinary course of a trade or business (including regularly making loans to customers in the ordinary course of a trade or business of making loans) but engages in no more than negligible sales of the securities so acquired is not a dealer in securities within the meaning of section 475(c)(1) unless the taxpayer elects to be so treated or, for purposes of section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory.

(ii) *Election to be treated as a dealer.* A taxpayer described in paragraph (c)(1)(i) of this section elects to be treated as a dealer in securities by filing a federal income tax return reflecting the application of section 475(a) in computing its taxable income.

(2) *Negligible sales.* Solely for purposes of paragraph (c)(1) of this section, a taxpayer engages in negligible sales of debt instruments that it regularly purchases from customers in the ordinary course of its business if, and only if, during the taxable year, either—

(i) The taxpayer sells all or part of fewer than 60 debt instruments, regardless how acquired; or

(ii) The total adjusted basis of the debt instruments (or parts of debt instruments), regardless how acquired, that the taxpayer sells is less than 5 percent of the total basis, immediately after acquisition, of the debt instruments that it acquires in that year.

(3) *Special rules for members of a consolidated group*—(i) *Intragroup-customer election in effect.* If a taxpayer is a member of a consolidated group that has made the intragroup-customer election (described in paragraph (a)(3)(iii) of this section), the negligible sales test in paragraph (c)(2) of this section takes into account all of the taxpayer's sales of debt instruments to other group members.

(ii) *Intragroup-customer election not in effect.* If a taxpayer is a member of a consolidated group that has not made the intragroup-customer election (described in paragraph (a)(3)(iii) of this section), the taxpayer satisfies the negligible sales test in paragraph (c)(2) of this section if either—

(A) The test is satisfied by the taxpayer, taking into account sales of debt instruments to other group members (as in paragraph (c)(3)(i) of this section); or

(B) The test is satisfied by the group, treating the members of the group as if they were divisions of a single corporation.

(4) *Special rules.* Whether sales of securities are negligible is determined without regard to—

(i) Sales of securities that are necessitated by exceptional circumstances and that are not undertaken as recurring business activities;

(ii) Sales of debt instruments that decline in quality while in the taxpayer's hands and that are sold pursuant to an established policy of the taxpayer to dispose of debt instruments below a certain quality; or

(iii) Acquisitions and sales of debt instruments that are qualitatively different from all debt instruments that the taxpayer purchases from customers in the ordinary course of its business.

(5) *Example*. The following example illustrates paragraph (c)(4)(iii) of this section:

Example. I, an insurance company, regularly makes policy loans to its customers but does not sell them. *I*, however, actively trades Treasury securities. No other circumstances are present to suggest that *I* is a dealer in securities for purposes of section 475(c)(1). Since the Treasuries are qualitatively different from the policy loans that *I* originates, under paragraph (c)(4)(iii) of this section, *I* disregards the purchases and sales of Treasuries in applying the negligible sales test in paragraph (c)(2) of this section.

(d) *Issuance of life insurance products*. A life insurance company that is not otherwise a dealer in securities within the meaning of section 475(c)(1) does not become a dealer in securities solely because it regularly issues life insurance products to its customers in the ordinary course of a trade or business. For purposes of the preceding sentence, the term *life insurance product* means a contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract. See sections 72, 817, and 7702.

[T.D. 8700, 61 FR 67723, Dec. 24, 1996]

§ 1.475(c)–2 Definitions—security.

(a) *Items that are not securities*. The following items are not securities within the meaning of section 475(c)(2) with respect to a taxpayer and, therefore, are not subject to section 475—

(1) A security (determined without regard to this paragraph (a)) if section 1032 prevents the taxpayer from recognizing gain or loss with respect to that security;

(2) A debt instrument issued by the taxpayer (including a synthetic debt instrument, within the meaning of §1.1275–6(b)(4), that §1.1275–6(b) treats the taxpayer as having issued); or

(3) A REMIC residual interest, or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect, if the residual interest or the interest or arrangement is acquired on or after January 4, 1995.

(b) *Synthetic debt that §1.1275–6(b) treats the taxpayer as holding*. If §1.1275–6 treats a taxpayer as the holder of a synthetic debt instrument (within the meaning of §1.1275–6(b)(4)), the synthetic debt instrument is a security held by the taxpayer within the meaning of section 475(c)(2)(C).

(c) *Negative value REMIC residuals acquired before January 4, 1995*. A REMIC residual interest that is described in paragraph (c)(1) of this section or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect is not a security within the meaning of section 475(c)(2).

(1) *Description*. A residual interest in a REMIC is described in this paragraph (c)(1) if, on the date the taxpayer acquires the residual interest, the present value of the anticipated tax liabilities associated with holding the interest exceeds the sum of—

(i) The present value of the expected future distributions on the interest; and

(ii) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

(2) *Special rules applicable to negative value REMIC residuals acquired before January 4, 1995*. Solely for purposes of this paragraph (c)—

(i) If a transferee taxpayer acquires a residual interest with a basis determined by reference to the transferor's basis, then the transferee is deemed to acquire the interest on the date the transferor acquired it (or is deemed to acquire it under this paragraph (c)(2)(i)).

(ii) Anticipated tax liabilities, expected future distributions, and anticipated tax savings are determined under the rules in §1.860E–2(a)(3) and without regard to the operation of section 475.

(iii) Present values are determined under the rules in §1.860E–2(a)(4).

[T.D. 8700, 61 FR 67725, Dec. 24, 1996]

§ 1.475(d)–1 Character of gain or loss.

(a) *Securities never held in connection with the taxpayer's activities as a dealer* *in securities.* If a security is never held in connection with the taxpayer's activities as a dealer in securities, section 475(d)(3)(A) does not affect the character of gain or loss from the security, even if the taxpayer fails to identify the security under section 475(b)(2).

(b) *Ordinary treatment for notional principal contracts and derivatives held by dealers in notional principal contracts and derivatives.* Section 475(d)(3)(B)(ii) (concerning the character of gain or loss with respect to a security held by a person other than in connection with its activities as a dealer in securities) does not apply to a security if §1.475(b)–1(c) and the absence of a determination by the Commissioner prevent section 475(b)(1)(A) from applying to the security.

[T.D. 8700, 61 FR 67725, Dec. 24, 1996]

§ 1.475(g)–1 Effective dates.

(a)–(b) [Reserved]

(c) Section 1.475(a)–3 (concerning acquisition by a dealer of a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(d) Section 1.475(a)–4 (concerning a safe harbor to use applicable financial statement values for purposes of section 475) applies to taxable years ending on or after June 12, 2007.

(e) Except as provided elsewhere in this paragraph (d), §1.475(b)–1 (concerning the scope of exemptions from the mark-to-market requirement) applies to taxable years ending on or after December 31, 1993.

(1) Section 1.475(b)–1(b) applies as follows:

(i) Section 1.475(b)–1(b)(1)(i) (concerning equity interests issued by a related person) applies beginning June 19, 1996. If, on June 18, 1996, a security is subject to mark-to-market accounting and, on June 19, 1996, §1.475(b)–1(b)(1) begins to apply to the security solely because of the effective dates in this paragraph (d) (rather than because of a change in facts), then the rules of §1.475(b)–1(b)(4)(i)(A) (concerning the prohibition against marking) apply, but §1.475(b)–1(b)(4)(i)(B) (imposing a mark-to-market on the day before the onset of the prohibition) does not apply.

(ii) Section 1.475(b)–1(b)(2) (concerning relevant relationships for purposes of determining whether equity interests in related persons are prohibited from being marked to market) applies beginning June 19, 1996.

(iii) Section 1.475(b)–1(b)(3) (concerning certain actively traded securities) applies beginning June 19, 1996, to securities held on or after that date, except for securities described in §1.475(b)–1(e)(1)(i) (concerning equity interests issued by controlled entities). If a security is described in §1.475(b)–1(e)(1)(i), §1.475(b)–1(b)(3) applies only on or after January 23, 1997 if the security is held on or after that date. If §1.475(b)–1(b)(1) ceases to apply to a security by virtue of the operation of this paragraph (d)(1)(iii), the rules of §1.475(b)–1(b)(4)(ii) apply to the cessation.

(iv) Except to the extent provided in paragraph (d)(1) of this section, §1.475(b)–1(b)(4) (concerning changes in status) applies beginning June 19, 1996.

(2) Section 1.475(b)–1(c) (concerning securities deemed not held for investment by dealers in notional principal contracts and derivatives) applies to securities acquired on or after January 23, 1997.

(3) Section 1.475(b)–1(d) (concerning the special rule for hedges of another member's risk) is effective for securities acquired, originated, or entered into on or after January 23, 1997.

(f) Section 1.475(b)–2 (concerning identification of securities that are exempt from mark-to-market treatment) applies as follows:

(1) Section 1.475(b)–2(a) (concerning the general rules for identification of basis for exemption from mark to market treatment) applies to identifications made on or after July 1, 1997.

(2) Section 1.475(b)–2(b) (concerning time for identifying a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(3) Section 1.475(b)–2(c) (concerning identification in the context of integrated transactions under §1.1275–6) applies on and after August 13, 1996 (the effective date of §1.1275–6).

(g) [Reserved]

(h) Section 1.475(b)–4 (concerning transitional issues relating to exemptions) applies to taxable years ending on or after December 31, 1993.

(i) Section 1.475(c)–1 applies as follows:

(1) Except as otherwise provided in this paragraph (h)(1), §1.475(c)–1(a) (concerning the dealer-customer relationship) applies to taxable years beginning on or after January 1, 1995.

(i) [Reserved]

(ii) Section 1.475(c)–1(a)(2)(ii) (illustrating rules concerning the dealer-customer relationship) applies to taxable years beginning on or after June 20, 1996.

(iii)(A) Section 1.475(c)–1(a)(3) applies to taxable years beginning on or after June 20, 1996, except for transactions between members of the same consolidated group.

(B) For transactions between members of the same consolidated group, paragraph §1.475(c)–1(a)(3) applies to taxable years beginning on or after December 24, 1996.

(2) Section 1.475(c)–1(b) (concerning sellers of nonfinancial goods and services) applies to taxable years ending on or after December 31, 1993.

(3) Except as otherwise provided in this paragraph (h)(3), section 1.475(c)–1(c) (concerning taxpayers that purchase securities but engage in no more than negligible sales of the securities) applies to taxable years ending on or after December 31, 1993.

(i) Section 1.475(c)–1(c)(3) (special rules for members of a consolidated group) is effective for taxable years beginning on or after December 24, 1996.

(ii) A taxpayer may rely on the rules set out in §1.475(c)–1T(b) (as contained in 26 CFR part 1 revised April 1, 1996) for taxable years beginning before January 23, 1997, provided the taxpayer applies that paragraph reasonably and consistently.

(4) Section 1.475(c)–1(d) (concerning the issuance of life insurance products) applies to taxable years beginning on or after January 1, 1995.

(j) Section 1.475(c)–2 (concerning the definition of security) applies to taxable years ending on or after December 31, 1993. By its terms, however, §1.475(c)–2(a)(3) applies only to residual interests or to interests or arrangements that are acquired on or after January 4, 1995; and the integrated transactions that are referred to in §§1.475(c)–2(a)(2) and 1.475(c)–2(b) exist only after August 13, 1996 (the effective date of §1.1275–6).

(k) Section 1.475(d)–1 (concerning the character of gain or loss) applies to taxable years ending on or after December 31, 1993.

[T.D. 8700, 61 FR 67725, Dec. 24, 1996. Redesignated and amended by T.D. 9328, 72 FR 32181, June 12, 2007]

ADJUSTMENTS

§1.481–1 Adjustments in general.

(a)(1) Section 481 prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a method of accounting different from that under which the taxable income was previously computed. A change in method of accounting to which section 481 applies includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. For rules relating to changes in methods of accounting, see section 446(e) and paragraph (e) of §1.446–1. In computing taxable income for the taxable year of the change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted. The ''year of the change'' is the taxable year for which the taxable income of the taxpayer is computed under a method of accounting different from that used for the preceding taxable year.

(2) Unless the adjustments are attributable to a change in method of accounting initiated by the taxpayer, no part of the adjustments required by subparagraph (1) of this paragraph shall be based on amounts which were taken into account in computing income (or which should have been taken into account had the new method of accounting been used) for taxable years beginning before January 1, 1954, or ending before August 17, 1954 (hereinafter referred to as pre-1954 years).

(b) The adjustments specified in section 481(a) and this section shall take into account inventories, accounts receivable, accounts payable, and any other item determined to be necessary in order to prevent amounts from being duplicated or omitted.

(c)(1) The term ''adjustments'', as used in section 481, has reference to the net amount of the adjustments required by section 481(a) and paragraph (b) of this section. In the case of a change in the over-all method of accounting, such as from the cash receipts and disbursements method to an accrual method, the term ''net amount of the adjustments'' means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in various accounts, such as inventory, accounts receivable, and accounts payable, at the beginning of the taxable year of the change in method of accounting. With respect to the portion of the adjustments attributable to pre-1954 years, it is immaterial that the same items or class of items with respect to which adjustments would have to be made (for the first taxable year to which section 481 applies) do not exist at the time the actual change in method of accounting occurs. For purposes of section 481, only the net dollar balance is to be taken into account. In the case of a change in the treatment of a single material item, the amount of the adjustment shall be determined with reference only to the net dollar balances in that particular account.

(2) If a change in method of accounting is voluntary (i.e., initiated by the taxpayer), the entire amount of the adjustments required by section 481(a) is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income. See, however, §§ 1.446–1(e)(3) and 1.481–4 which provide that the Commissioner may prescribe the taxable year or years in which the adjustments are taken into account.

(3) If the change in method of accounting is involuntary (i.e., not initiated by the taxpayer), then only the amount of the adjustments required by section 481(a) that is attributable to taxable years beginning after December 31, 1953, and ending after August 16, 1954, (hereinafter referred to as post-1953 years) is taken into account. This amount is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income. See, however, §§ 1.446–1(e)(3) and 1.481–4 which provide that the Commissioner may prescribe the taxable year or years in which the adjustments are taken into account. See also § 1.481–3 for rules relating to adjustments attributable to pre-1954 years.

(4) For any adjustments attributable to post-1953 years that are taken into account entirely in the year of change and that increase taxable income by more than $3,000, the limitations on tax provided in section 481(b) (1) or (2) apply. See § 1.481–2 for rules relating to the limitations on tax provided by sections 481(b) (1) and (2).

(5) A change in the method of accounting initiated by the taxpayer includes not only a change which he originates by securing the consent of the Commissioner, but also a change from one method of accounting to another made without the advance approval of the Commissioner. A change in the taxpayer's method of accounting required as a result of an examination of the taxpayer's income tax return will not be considered as initiated by the taxpayer. On the other hand, a taxpayer who, on his own initiative, changes his method of accounting in order to conform to the requirements of any Federal income tax regulation or ruling shall not, merely because of such fact, be considered to have made an involuntary change.

(d) Any adjustments required under section 481(a) that are taken into account during a taxable year must be properly taken into account for purposes of computing gross income, adjusted gross income, or taxable income in determining the amount of any item of gain, loss, deduction, or credit that depends on gross income, adjusted gross income, or taxable income.

[T.D. 6500, 25 FR 11731, Nov. 26, 1960, as amended by T.D. 8608, 60 FR 40078, Aug. 7, 1995]

§ 1.481–2 Limitation on tax.

(a) *Three-year allocation.* Section 481(b)(1) provides a limitation on the tax under chapter 1 of the Internal Revenue Code for the taxable year of change that is attributable to the adjustments required under section 481(a) and § 1.481–1 if the entire amount of the adjustments is taken into account in the year of change. If such adjustments increase the taxpayer's taxable income for the taxable year of the change by more than $3,000, then the tax for such taxable year that is attributable to the adjustments shall not exceed the lesser of the tax attributable to taking such adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and § 1.481–1, or the aggregate of the increases in tax that would result if the adjustments were included ratably in the taxable year of the change and the two preceding taxable years. For the purpose of computing the limitation on tax under section 481(b)(1), the adjustments shall be allocated ratably to the taxable year of the change and the two preceding taxable years, whether or not the adjustments are in fact attributable in whole or in part to such years. The limitation on the tax provided in this paragraph shall be applicable only if the taxpayer used the method of accounting from which the change was made in computing taxable income for the two taxable years preceding the taxable year of the change.

(b) *Allocation under new method of accounting.* Section 481(b)(2) provides a second alternative limitation on the tax for the taxable year of change under chapter 1 of the Internal Revenue Code that is attributable to the adjustments required under section 481(a) and § 1.481–1 where such adjustments increase taxable income for the taxable year of change by more than $3,000. If the taxpayer establishes from his books of account and other records what his taxable income would have been under the new method of accounting for one or more consecutive taxable years immediately preceding the taxable year of the change, and if the taxpayer in computing taxable income for such years used the method of accounting from which the change was made, then the tax attributable to the adjustments shall not exceed the smallest of the following amounts:

(1) The tax attributable to taking the adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and § 1.481–1;

(2) The tax attributable to such adjustments computed under the 3-year allocation provided in section 481(b)(1), if applicable; or

(3) The net increase in the taxes under chapter 1 (or under corresponding provisions of prior revenue laws) which would result from allocating that portion of the adjustments to the one or more consecutive preceding taxable years to which properly allocable under the new method of accounting and from allocating the balance thereof to the taxable year of the change.

(c) *Rules for computation of tax.* (1) The first step in determining whether either of the limitations described in section 481(b) (1) or (2) applies is to compute the increase in tax for the taxable year of the change that is attributable to the increase in taxable income for such year resulting solely from the adjustments required under section 481(a) and § 1.481–1. This increase in tax is the excess of the tax for the taxable year computed by taking into account such adjustments under section 481(a) over the tax computed for such year without taking the adjustments into account.

(2) The next step is to compute under section 481(b)(1) the tax attributable to the adjustments referred to in paragraph (c)(1) of this section for the taxable year of the change and the two preceding taxable years as if an amount equal to one-third of the net amount of such adjustments had been received or accrued in each of such taxable years. The increase in tax attributable to the adjustments for each such taxable year is the excess of the tax for such year computed with the allocation of one-third of the net adjustments to such taxable year over the tax computed without the allocation of any part of the adjustments to such year. For the purpose of computing the aggregate increase in taxes for such taxable years, there shall be taken into account the increase or decrease in tax

for any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(1) but which is affected by a net operating loss under section 172 or by a capital loss carryback or carryover under section 1212, determined with reference to taxable years with respect to which adjustments under section 481(b)(1) are allocated.

(3) In the event that the taxpayer satisfies the conditions set forth in section 481(b)(2), the next step is to determine the amount of the net increase in tax attributable to the adjustments referred to in paragraph (c)(1) of this section for:

(i) The taxable year of the change,

(ii) The consecutive taxable year or years immediately preceding the taxable year of the change for which the taxpayer can establish his taxable income under the new method of accounting, and

(iii) Any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(2), but which is affected by a net operating loss or by a capital loss carryback or carryover determined with reference to taxable years with respect to which such adjustments are allocated.

The net increase in tax for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph shall be computed as if the amount of the adjustments for the prior taxable years to which properly allocable in accordance with section 481(b)(2) had been received or accrued, or paid or incurred, as the case may be, in such prior years and the balance of the adjustments in the taxable year of the change. The amount of tax attributable to such adjustments for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph is the aggregate of the differences (increases and decreases) between the tax for each such year computed by taking into account the allocable portion of the adjustments in computing taxable income and the tax computed without taking into account any portion of the adjustments in computing taxable income. Generally, where there is an increase in taxable income for a preceding consecutive taxable year established under the new method of accounting, computed without regard to adjustments attributable to any preceding taxable year, the amount of the adjustments to be allocated to each such year shall be an amount equal to such increase. However, where the amount of the adjustments to be allocated to a prior taxable year is less than the increase in taxable income for such year established under the new method of accounting, the amount of the increase in such taxable income for purposes of determining the increase in tax under section 481(b)(2) for such year shall be considered to be the amount so allocated. For example, if the amount of the adjustments required by section 481(a) for 1958 (the taxable year of the change) is $60,000, and the increase in taxable income is determined by the taxpayer to be $40,000, $5,000, and $35,000, computed under the new method of accounting, for the taxable years 1957, 1956, and 1955, respectively, then the amount of the adjustments to be allocated to 1955 will be the balance of the adjustments, or $15,000.

(4) The tax for the taxable year of the change shall be the tax for such year, computed without taking any of the adjustments referred to in paragraph (c)(1) of this section into account, increased by the smallest of the following amounts—

(i) The amount of tax for the taxable year of the change attributable solely to taking into account the entire amount of the adjustments required by section 481(a) and § 1.481–1;

(ii) The sum of the increases in tax liability for the taxable year of the change and the two immediately preceding taxable years that would have resulted solely from taking into account one-third of the amount of such adjustments required for each of such years as though such amounts had been properly attributable to such years (computed in accordance with paragraph (c)(2) of this section); or

(iii) The net increase in tax attributable to allocating such adjustments under the new method of accounting (computed in accordance with paragraph (c)(3) of this section).

(5)(i) In the case of a change in method of accounting by a partnership, the adjustments required by section 481 shall be made with respect to the taxable income of the partnership but the limitations on tax under section 481(b) shall apply to the individual partners. Each partner shall take into account his distributive share of the partnership items, as so adjusted, for the taxable year of the change. Section 481(b) applies to a partner whose taxable income is so increased by more than $3,000 as a result of such adjustments to the partnership taxable income. It is not necessary for the partner to have been a member of the partnership for the two taxable years immediately preceding the taxable year of the change of the partnership's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a partner may apply section 481(b)(2) even though he was not a member of the partnership for all the taxable years affected by the computation thereunder.

(ii) In the case of a change in method of accounting by an electing small business corporation under subchapter S, chapter 1 of the Code, the adjustments required by section 481 shall be made with respect to the taxable income of such electing corporation in the year of the change, but the limitations on tax under section 481(b) shall apply to the individual shareholders. Section 481(b) applies to a shareholder of an electing small business corporation whose taxable income is so increased by more than $3,000 as a result of such adjustments to such corporation's taxable income. It is not necessary for the shareholder to have been a member of the electing small business corporation, or for such corporation to have been an electing small business corporation, for the two taxable years immediately preceding the taxable year of the change of the corporation's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a shareholder may apply section 481(b)(2), even though he was not a shareholder, or the corporation was not an electing small business corporation, for all the taxable years affected by the computation thereunder.

(6) For the purpose of the successive computations of the limitations on tax under section 481(b) (1) or (2), if the treatment of any item under the provisions of the Internal Revenue Code of 1986 (or corresponding provisions of prior internal revenue laws) depends upon the amount of gross income, adjusted gross income, or taxable income (for example, medical expenses, charitable contributions, or credits against the tax), such item shall be determined for the purpose of each such computation by taking into account the proper portion of the amount of any adjustments required to be taken into account under section 481 in each such computation.

(7) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning section 1314(a) for such year.

(8) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to tax on self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(d) *Examples.* The application of section 481(b) (1) and (2) may be illustrated by the following examples. Although the examples in this paragraph are based upon adjustments required in the case of a change in the over-all method of accounting, the principles illustrated would be equally applicable to adjustments required in the case of a change in method of accounting for a particular material item, provided the treatment of such adjustments is not specifically subject to some other provision of the Internal Revenue Code of 1986.

Example 1. An unmarried individual taxpayer using the cash receipts and disbursements method of accounting for the calendar year is required by the Commissioner to change to an accrual method effective with the year 1958. As of January 1, 1958, he had an opening inventory of $11,000. On December 31, 1958, he had a closing inventory of $12,500. Merchandise purchases during the year amounted to $22,500, and net sales were $32,000. Total deductible business expenses were $5,000. There were no receivables or payables at January 1, 1958. The computation of taxable income for 1958, assuming no other adjustments, using the new method of accounting follows:

Net sales	....	$32,000
Opening inventory	$11,000	
Purchases	22,500	
Total	33,500	
Less closing inventory	12,500	
Cost of goods sold	....	21,000
Gross profit	....	11,000
Business expenses	....	5,000
Business income	....	6,000
Personal exemption and itemized deductions	....	1,600
Taxable income	....	4,400

Under the cash receipts and disbursements method of accounting, only $9,000 of the $11,000 opening inventory had been included in the cost of goods sold and claimed as a deduction for the taxable years 1954 through 1957; the remaining $2,000 had been so accounted for in pre-1954 years. In order to prevent the same item from reducing taxable income twice, an adjustment of $9,000 must be made to the taxable income of 1958 under the provisions of section 481(a) and § 1.481–1. Since the change in method of accounting was not initiated by the taxpayer, the $2,000 of opening inventory which had been included in cost of goods sold in pre-1954 years is not taken into account. Taxable income for 1958 is accordingly increased by $9,000 under section 481(a) to $13,400. Assuming that the tax on $13,400 is $4,002 and that the tax on $4,400 (income without the adjustment) is $944, the increase in tax attributable to the adjustment, if taken into account for the taxable year of the change, would be the difference between the two, or $3,058. Since the adjustment required by section 481(a) and § 1.481–1 ($9,000) increases taxable income by more than $3,000, the increase in tax for the taxable year 1958 attributable to the adjustment of $9,000 (i.e., $3,058) may be limited under the provisions of section 481(b) (1) or (2). See examples (2) and (3).

Example 2. Assume that the taxpayer in Example 1 used the cash receipts and disbursements method of accounting in computing taxable income for the years 1956 and 1957 and that the taxable income for these years determined under such method was $4,000 and $6,000, respectively. The section 481(b)(1) limitation on tax with a pro rata three-year allocation of the $9,000 adjustment is computed as follows:

Taxable year	Taxable income before adjustment	Taxable income with adjustment	Assume total tax	Assumed tax before adjustment	Increase in tax attributable to adjustment
1956	$4,000	$7,000	$1,660	$840	$820
1957	6,000	9,000	2,300	1,360	940
1958	4,400	7,400	1,780	944	836
Total	....	....	....	....	2,596

Since this increase in tax of $2,596 is less than the increase in tax attributable to the inclusion of the entire adjustment in the income for the taxable year of the change ($3,058), the limitation provided by section 481(b)(1) applies, and the total tax for 1958, the taxable year of the change, if section 481(b)(2) does not apply, is determined as follows:

Tax without any portion of adjustment	$944
Increase in tax attributable to adjustment computed under section 481(b)(1)	2,596
Total tax for taxable year of the change	3,540

Example 3. (i) Assume the same facts as in Example 1 and, in addition, assume that the taxpayer used the cash receipts and disbursements method of accounting in computing taxable income for the years 1953 through 1957; that he established his taxable income under the new method for the taxable years 1953, 1954, and 1957, but did not have sufficient records to establish his taxable income under such method for the taxable years 1955 and 1956. The original taxable income and taxable income as redetermined are as follows:

Taxable year	Taxable income: Determined under cash receipts and disbursements method	Taxable income: Established under new method	Increase or (decrease) in taxable income
1953	$5,000	$7,000	$2,000
1954	6,000	7,000	1,000
1955	5,500	(1)	....
1956	4,000	(1)	....
1957	6,000	10,000	4,000

[1] Undetermined.

As in examples (1) and (2), the total adjustment under section 481(a) is $9,000. Of the $9,000 adjustment, $4,000 may be allocated to 1957, which is the only year consecutively preceding the taxable year of the change for which the taxpayer was able to establish his income under the new method. Since the income cannot be established under the new method for 1956 and 1955, no allocation may be made to 1954 or 1953, even though the taxpayer has established his income for those years under the new method of accounting. The balance of $5,000 ($9,000 minus $4,000) must be allocated to 1958.

(ii) The limitation provided by section 481(b)(2) is computed as follows: The tax for 1957, based on taxable income of $6,000, is assumed to be $1,360. Under the new method, based on taxable income of $10,000, the tax for 1957 is assumed to be $2,640, the increase attributable to $4,000 of the $9,000 section 481(a) adjustment being $1,280, ($2,640 minus $1,360). The tax for 1958, computed on the basis of taxable income of $4,400 (determined under the new method), is assumed to be $944. The tax computed for 1958 on taxable income of $9,400 ($4,400 plus the $5,000 adjustment allocated to 1958) is assumed to be $2,436, leaving a difference of $1,492 ($2,436 minus $944) attributable to the inclusion in 1958 of the portion of the total adjustment to be taken into account which could not be properly allocated to the taxable year or years consecutively preceding 1958.

(iii) The tax attributable to the adjustment is determined by selecting the smallest of the three following amounts:

Increase in tax attributable to adjustment computed under section 481(b)(2) ($1,280 + $1,492)	$2,772
Increase in tax attributable to adjustment computed under section 481(b)(1) (Example 2)	2,596
Increase in tax if the entire adjustment is taken into account in the taxable year of the change (Example 1)	3,058

The final tax for 1958 is then $3,540 computed as follows:

Tax before inclusion of any adjustment	$944
Increase in tax attributable to adjustments (smallest of $2,772, $2,596 or $3,058)	2,596
Total tax for 1958 (limited in accordance with section 481(b)(1))	3,540

Example 4. Assume that X Corporation has maintained its books of account and filed its income tax returns using the cash receipts and disbursements method of accounting for the years 1953 through 1957. The corporation secures permission to change to an accrual method of accounting for the calendar year 1958. The following tabulation presents the data with respect to the taxpayer's income for the years involved:

Year	Taxable income under the cash receipts and disbursements method		Taxable income established under accrual method	Increase or (decrease) attributable to change	Changes in taxable income due to changes in net loss carryback
	Before application of net operating loss carryback	After application of net operating loss carryback			
1953	$2,000	0	(1)		$2,000
1954	4,000	$1,000	(1)		3,000
1955	(5,000)		$1,000	$6,000	
1956	80,000	80,000	77,000	(3,000)	
1957	90,000	90,000	96,000	6,000	
1958			100,000		

[1] Not established.

As indicated above, taxable income for 1953 and 1954, as determined under the cash receipts and disbursements method of accounting, was $2,000 and $4,000, respectively, and after application of the net operating loss carryback from 1955, the taxable income was reduced to zero in 1953 and to $1,000 in 1954. The taxpayer was unable to establish taxable income for these years under an accrual method of accounting; however, under section 481(b)(3)(A), increases or decreases in the tax for taxable years to which no adjustment is allocated must, nevertheless, be taken into account to the extent the tax for such years would be affected by a net operating loss determined with reference to taxable years to which adjustments are allocated. The total amount of the adjustments required under section 481(a) and attributable to the taxable years 1953 through 1957 in this example is assumed to be $10,000. The redetermination of taxable income established by the taxpayer for the taxable years 1955, 1956, and 1957 appears under the heading "Taxable income established under accrual method" in the above tabulation. The tabulation assumes that the taxpayer has been able to recompute the income for those years so as to establish a net adjustment of $9,000, which leaves a balance of $1,000 unaccounted for. In accordance with the requirements of section 481(b)(2), the $1,000 amount is allocated to 1958, the taxable year of the change. The following computations are necessary in order to determine the tax attributable to the adjustments under section 481(a):

INCREASE IN TAX ATTRIBUTABLE TO INCLUSION IN 1958 OF THE ENTIRE $10,000 ADJUSTMENT

Tax on income of 1958 increased by entire amount of adjustment ($100,000 + $10,000)	$51,700

INCREASE IN TAX ATTRIBUTABLE TO INCLUSION IN 1958 OF THE ENTIRE $10,000 ADJUSTMENT—Continued

Tax on income of 1958 without adjustment ($100,000)	46,500
Increase in tax attributable to inclusion of entire adjustment in year of the change	5,200

Increase in tax attributed to adjustment computed under section 481(b)(1)

Year	Amount of adjustment	Tax before adjustment	Tax after adjustment	Increase in tax liability attributable to adjustment
1958	$3,334	$46,500	$48,234	$1,734
1957	3,333	41,300	43,033	1,733
1956	3,333	36,100	37,833	1,733
Increase in tax attributable to adjustment computed under section 481(b)(1)				5,200

Increase in tax attributed to adjustment computed under section 481(b)(2)

Year	Amount of adjustment	Tax before adjustment	Tax after adjustment	Increase in tax liability attributable to adjustment
1953	[1] $2,000	0	[1] $600	$600
1954	[1] 3,000	$300	[1] 1,200	900
1955	6,000	0	300	300
1956	(3,000)	36,100	34,540	(1,560)
1957	96,000	41,300	44,420	3,120
1958	[2] 1,000	46,500	[2] 47,020	520
Increase in tax attributable to the adjustment computed under section 481(b)(2)				3,880

[1] Attributable to recomputations of net operating loss carrybacks determined with reference to net operating loss in 1955.
[2] Attributable to the inclusion of $1,000 in the year of the change which represents the portion of the $10,000 adjustment not allocated to taxable years prior to the year of the change for which taxable income is established under the new method.

Since the limitation under section 481(b)(2) ($3,880) on the amount of tax attributable to the adjustments is applicable, the final tax for the taxable year of the change is computed by adding such amount to the tax for that year computed without the inclusion of any amount attributable to the adjustments, that is, $46,500 plus $3,880, or $50,380.

[T.D. 6500, 25 FR 11732, Nov. 26, 1960, as amended by T.D. 6490, 25 FR 8374, Sept. 1, 1960; T.D. 7301, 39 FR 963, Jan. 4, 1974; T.D. 8608, 60 FR 40078, Aug. 7, 1995]

§ 1.481–3 Adjustments attributable to pre-1954 years where change was not initiated by taxpayer.

If the adjustments required by section 481(a) and § 1.481–1 are attributable to a change in method of accounting which was not initiated by the taxpayer, no portion of any adjustments which is attributable to pre-1954 years shall be taken into account in computing taxable income. For example, if the total adjustments in the case of a change in method of accounting which is not initiated by the taxpayer amount to $10,000, of which $4,000 is attributable to pre-1954 years, only $6,000 of the $10,000 total adjustments is required to be taken into account under section 481 in computing taxable income. The portion of the adjustments which is attributable to pre-1954 years is the net amount of the adjustments which would have been required if the taxpayer had changed his method of accounting in his first taxable year which began after December 31, 1953, and ended after August 16, 1954.

[T.D. 6500, 25 FR 11735, Nov. 26, 1960, as amended by T.D. 8608, 60 FR 40079, Aug. 7, 1995]

§ 1.481–4 Adjustments taken into account with consent.

(a) In addition to the terms and conditions prescribed by the Commissioner under § 1.446–1(e)(3) for effecting a change in method of accounting, including the taxable year or years in which the amount of the adjustments required by section 481(a) is to be taken into account, or the methods of allocation described in section 481(b), a taxpayer may request approval of an alternative method of allocating the amount of the adjustments under section 481. See section 481(c). Requests for approval of an alternative method of allocation shall set forth in detail the facts and circumstances upon which the taxpayer bases its request. Permission will be granted only if the taxpayer and the Commissioner agree to the terms and conditions under which the allocation is to be effected. See §1.446–1(e) for the rules regarding how to secure the Commissioner's consent to a change in method of accounting.

(b) An agreement to the terms and conditions of a change in method of accounting under §1.446–1(e)(3), including the taxable year or years prescribed by the Commissioner under that section (or an alternative method described in paragraph (a) of this section) for taking the amount of the adjustments under section 481(a) into account, shall be in writing and shall be signed by the Commissioner and the taxpayer. It shall set forth the items to be adjusted, the amount of the adjustments, the taxable year or years for which the adjustments are to be taken into account, and the amount of the adjustments allocable to each year. The agreement shall be binding on the parties except upon a showing of fraud, malfeasance, or misrepresentation of material fact.

[T.D. 8608, 60 FR 40079, Aug. 7, 1995]

§ 1.481–5 Effective dates.

Sections 1.481–1, 1.481–2, 1.481–3, and 1.481–4 are effective for Consent Agreements signed on or after December 27, 1994. For Consent Agreements signed before December 27, 1994, see §§1.481–1, 1.481–2, 1.481–3, 1.481–4, and 1.481–5 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

[T.D. 8608, 60 FR 40079, Aug. 7, 1995]

§ 1.482–0 Outline of regulations under section 482.

This section contains major captions for §§1.482–1 through 1.482–9.

§1.482–1 Allocation of income and deductions among taxpayers.

(a) In general.
(1) Purpose and scope.
(2) Authority to make allocations.
(3) Taxpayer's use of section 482.
(b) Arm's length standard.
(1) In general.
(2) Arm's length methods.
(i) Methods.
(ii) Selection of category of method applicable to transaction.
(iii) Coordination of methods applicable to certain intangible development arrangements.
(c) Best method rule.
(1) In general.
(2) Determining the best method.
(i) Comparability.
(ii) Data and assumptions.
(A) Completeness and accuracy of data.
(B) Reliability of assumptions.
(C) Sensitivity of results to deficiencies in data and assumptions.
(iii) Confirmation of results by another method.
(d) Comparability.
(1) In general.
(2) Standard of comparability.
(3) Factors for determining comparability.
(i) Functional analysis.
(ii) Contractual terms.
(A) In general.
(B) Identifying contractual terms.
(*1*) Written agreement.
(*2*) No written agreement.
(C) Examples.
(iii) Risk.
(A) In general.
(B) Identification of party that bears risk.
(C) Examples.
(iv) Economic conditions.
(v) Property or services.
(4) Special circumstances.
(i) Market share strategy.
(ii) Different geographic markets.
(A) In general.
(B) Example.
(C) Location savings.
(D) Example.
(iii) Transactions ordinarily not accepted as comparables.
(A) In general.
(B) Examples.
(e) Arm's length range.
(1) In general.
(2) Determination of arm's length range.
(i) Single method.
(ii) Selection of comparables.
(iii) Comparables included in arm's length range.
(A) In general.
(B) Adjustment of range to increase reliability.
(C) Interquartile range.
(3) Adjustment if taxpayer's results are outside arm's length range.
(4) Arm's length range not prerequisite to allocation.
(5) Examples.
(f) Scope of review.
(1) In general.
(i) Intent to evade or avoid tax not a prerequisite.

(ii) Realization of income not a prerequisite.
(A) In general.
(B) Example.
(iii) Nonrecognition provisions may not bar allocation.
(A) In general.
(B) Example.
(iv) Consolidated returns.
(2) Rules relating to determination of true taxable income.
(i) [Reserved]
(ii) Allocation based on taxpayer's actual transactions.
(A) In general.
(B) [Reserved]
(iii) Multiple year data.
(A) In general.
(B) Circumstances warranting consideration of multiple year data.
(C) Comparable effect over comparable period.
(D) Applications of methods using multiple year averages.
(E) Examples.
(iv) Product lines and statistical techniques.
(v) Allocations apply to results, not methods.
(A) In general.
(B) Example.
(g) Collateral adjustments with respect to allocations under section 482.
(1) In general.
(2) Correlative allocations.
(i) In general.
(ii) Manner of carrying out correlative allocation.
(iii) Events triggering correlative allocation.
(iv) Examples.
(3) Adjustments to conform accounts to reflect section 482 allocations.
(i) In general.
(ii) Example.
(4) Setoffs.
(i) In general.
(ii) Requirements.
(iii) Examples.
(h) Special rules.
(1) Small taxpayer safe harbor. [Reserved]
(2) Effect of foreign legal restrictions.
(i) In general.
(ii) Applicable legal restrictions.
(iii) Requirement for electing the deferred income method of accounting.
(iv) Deferred income method of accounting.
(v) Examples.
(3) Coordination with section 936.
(i) Cost sharing under section 936.
(ii) Use of terms.
(i) Definitions.
(j) Effective/applicability date.

§ 1.482–2 Determination of taxable income in specific situations.

(a) Loans or advances.
(1) Interest on bona fide indebtedness.
(i) In general.
(ii) Application of paragraph (a) of this section.
(A) Interest on bona fide indebtedness.
(B) Alleged indebtedness.
(iii) Period for which interest shall be charged.
(A) General rule.
(B) Exception for certain intercompany transactions in the ordinary course of business.
(C) Exception for trade or business of debtor member located outside the United States.
(D) Exception for regular trade practice of creditor member or others in creditor's industry.
(E) Exception for property purchased for resale in a foreign country.
(*1*) General rule.
(*2*) Interest-free period.
(*3*) Average collection period.
(*4*) Illustration.
(iv) Payment; book entries.
(2) Arm's length interest rate.
(i) In general.
(ii) Funds obtained at situs of borrower.
(iii) Safe haven interest rates for certain loans and advances made after May 8, 1986.
(A) Applicability.
(*1*) General rule.
(*2*) Grandfather rule for existing loans.
(B) Safe haven interest rate based on applicable Federal rate.
(C) Applicable Federal rate.
(D) Lender in business of making loans.
(E) Foreign currency loans.
(3) Coordination with interest adjustments required under certain other Internal Revenue Code sections.
(4) Examples.
(b) Rendering of services.
(c) Use of tangible property.
(1) General rule.
(2) Arm's length charge.
(i) In general.
(ii) Safe haven rental charge.
(iii) Subleases.
(d) Transfer of property.
(e) Cost sharing arrangement.
(f) Effective/applicability Date.
(1) In general.
(2) Election to apply paragraph (b) to earlier taxable years.

§ 1.482–3 Methods to determine taxable income in connection with a transfer of tangible property.

(a) In general.
(b) Comparable uncontrolled price method.
(1) In general.
(2) Comparability and reliability considerations.
(i) In general.
(ii) Comparability.
(A) In general.

(B) Adjustments for differences between controlled and uncontrolled transactions.
(iii) Data and assumptions.
(3) Arm's length range.
(4) Examples.
(5) Indirect evidence of comparable uncontrolled transactions.
(i) In general.
(ii) Limitations.
(iii) Examples.
(c) Resale price method.
(1) In general.
(2) Determination of arm's length price.
(i) In general.
(ii) Applicable resale price.
(iii) Appropriate gross profit.
(iv) Arm's length range.
(3) Comparability and reliability considerations.
(i) In general.
(ii) Comparability.
(A) Functional comparability.
(B) Other comparability factors.
(C) Adjustments for differences between controlled and uncontrolled transactions.
(D) Sales agent.
(iii) Data and assumptions.
(A) In general.
(B) Consistency in accounting.
(4) Examples.
(d) Cost plus method.
(1) In general.
(2) Determination of arm's length price.
(i) In general.
(ii) Appropriate gross profit.
(iii) Arm's length range.
(3) Comparability and reliability considerations.
(i) In general.
(ii) Comparability.
(A) Functional comparability.
(B) Other comparability factors.
(C) Adjustments for differences between controlled and uncontrolled transactions.
(D) Purchasing agent.
(iii) Data and assumptions.
(A) In general.
(B) Consistency in accounting.
(4) Examples.
(e) Unspecified methods.
(1) In general.
(2) Example.
(f) Coordination with intangible property rules.

§ 1.482–4 Methods to determine taxable income in connection with a transfer of intangible property.

(a) In general.
(b) Definition of intangible.
(c) Comparable uncontrolled transaction method.
(1) In general.
(2) Comparability and reliability considerations.
(i) In general.
(ii) Reliability.
(iii) Comparability.
(A) In general.
(B) Factors to be considered in determining comparability.
(*1*) Comparable intangible property.
(*2*) Comparable circumstances.
(iv) Data and assumptions.
(3) Arm's length range.
(4) Examples.
(d) Unspecified methods.
(1) In general.
(2) Example.
(e) Coordination with tangible property rules.
(f) Special rules for transfers of intangible property.
(1) Form of consideration.
(2) Periodic adjustments.
(i) General rule.
(ii) Exceptions.
(A) Transactions involving the same intangible.
(B) Transactions involving comparable intangible.
(C) Methods other than comparable uncontrolled transaction.
(D) Extraordinary events.
(E) Five-year period.
(iii) Examples.
(3) Ownership of intangible property.
(i) Identification of owner.
(A) In general.
(B) Cost sharing arrangements.
(ii) Examples.
(4) Contribution to the value of intangible property owned by another.
(i) In general.
(ii) Examples.
(5) Consideration not artificially limited.
(6) Lump sum payments
(i) In general.
(ii) Exceptions.
(iii) Example.
(g) Coordination with rules governing cost sharing arrangements.
(h) Effective/applicability date.
(1) In general.
(2) Election to apply regulation to earlier taxable years.

§ 1.482–5 Comparable profits method.

(a) In general.
(b) Determination of arm's length result.
(1) In general.
(2) Tested party.
(i) In general.
(ii) Adjustments for tested party.
(3) Arm's length range.
(4) Profit level indicators.
(i) Rate of return on capital employed.
(ii) Financial ratios.
(iii) Other profit level indicators.
(c) Comparability and reliability considerations.
(1) In general.
(2) Comparability.
(i) In general.

(ii) Functional, risk and resource comparability.
(iii) Other comparability factors.
(iv) Adjustments for differences between tested party and the uncontrolled taxpayers.
(3) Data and assumptions.
(i) In general.
(ii) Consistency in accounting.
(iii) Allocations between the relevant business activity and other activities.
(d) Definitions.
(e) Examples.

§ 1.482–6 Profit split method.

(a) In general.
(b) Appropriate share of profits and losses.
(c) Application.
(1) In general.
(2) Comparable profit split.
(i) In general.
(ii) Comparability and reliability considerations.
(A) In general.
(B) Comparability.
(*1*) In general.
(*2*) Adjustments for differences between the controlled and uncontrolled taxpayers.
(C) Data and assumptions.
(D) Other factors affecting reliability.
(3) Residual profit split.
(i) In general.
(A) Allocate income to routine contributions.
(B) Allocate residual profit.
(*1*) Nonroutine contributions generally.
(*2*) Nonroutine contributions of intangible property.
(ii) Comparability and reliability considerations.
(A) In general.
(B) Comparability.
(C) Data and assumptions.
(D) Other factors affecting reliability
(d) Effective/applicability date.
(iii) Example.

§ 1.482–7 Methods to determine taxable income in connection with a cost sharing arrangement.

(a) In general.
(1) RAB share method for cost sharing transactions (CSTs).
(2) Methods for platform contribution transactions (PCTs).
(3) Methods for other controlled transactions.
(i) Contribution to a CSA by a controlled taxpayer that is not a controlled participant.
(ii) Transfer of interest in a cost shared intangible.
(iii) Other controlled transactions in connection with a CSA.
(iv) Controlled transactions in the absence of a CSA.
(4) Coordination with the arm's length standard.
(b) Cost sharing arrangement.
(1) Substantive requirements.
(i) CSTs.
(ii) PCTs.
(iii) Divisional interests.
(iv) Examples.
(2) Administrative requirements.
(3) Date of a PCT.
(4) Divisional interests.
(i) In general.
(ii) Territorial based divisional interests.
(iii) Field of use based divisional interests.
(iv) Other divisional bases.
(v) Examples.
(5) Treatment of certain arrangements as CSAs.
(i) Situation in which Commissioner must treat arrangement as a CSA.
(ii) Situation in which Commissioner may treat arrangement as a CSA.
(iii) Examples.
(6) Entity classification of CSAs.
(c) Platform contributions.
(1) In general.
(2) Terms of platform contributions.
(i) Presumed to be exclusive.
(ii) Rebuttal of Exclusivity.
(iii) Proration of PCT Payments to the extent allocable to other business activities.
(A) In general.
(B) Determining the proration of PCT Payments.
(3) Categorization of the PCT.
(4) Certain make-or-sell rights excluded.
(i) In general.
(ii) Examples.
(5) Examples.
(d) Intangible development costs.
(1) Determining whether costs are IDCs.
(i) Definition and scope of the IDA.
(ii) Reasonably anticipated cost shared intangible.
(iii) Costs included in IDCs.
(iv) Examples.
(2) Allocation of costs.
(3) Stock-based compensation.
(i) In general.
(ii) Identification of stock-based compensation with the IDA.
(iii) Measurement and timing of stock-based compensation IDC.
(A) In general.
(*1*) Transfers to which section 421 applies.
(*2*) Deductions of foreign controlled participants.
(*3*) Modification of stock option.
(*4*) Expiration or termination of CSA.
(B) Election with respect to options on publicly traded stock.
(*1*) In general.
(*2*) Publicly traded stock.
(*3*) Generally accepted accounting principles.
(*4*) Time and manner of making the election.
(C) Consistency.
(4) IDC share.
(5) Examples.

(e) Reasonably anticipated benefits share.
(1) Definition.
(i) In general.
(ii) Reliability.
(iii) Examples.
(2) Measure of benefits.
(i) In general.
(ii) Indirect bases for measuring anticipated benefits.
(A) Units used, produced, or sold.
(B) Sales.
(C) Operating profit.
(D) Other bases for measuring anticipated benefits.
(E) Examples.
(iii) Projections used to estimate benefits.
(A) In general.
(B) Examples.
(f) Changes in participation under a CSA.
(1) In general.
(2) Controlled transfer of interests.
(3) Capability variation.
(4) Arm's length consideration for a change in participation.
(5) Examples.
(g) Supplemental guidance on methods applicable to PCTs.
(1) In general.
(2) Best method analysis applicable for evaluation of a PCT pursuant to a CSA.
(i) In general.
(ii) Consistency with upfront contractual terms and risk allocation—the investor model.
(A) In general.
(B) Example.
(iii) Consistency of evaluation with realistic alternatives.
(A) In general.
(B) Examples.
(iv) Aggregation of transactions.
(v) Discount rate.
(A) In general.
(B) Considerations in best method analysis of discount rate.
(*1*) Discount rate variation between realistic alternatives.
(*2*) [Reserved]
(*3*) Discount rate variation between forms of payment.
(*4*) Post-tax rate.
(C) Example.
(vi) Financial projections.
(vii) Accounting principles.
(A) In general.
(B) Examples.
(viii) Valuations of subsequent PCTs.
(A) Date of subsequent PCT.
(B) Best method analysis for subsequent PCT.
(ix) Arm's length range.
(A) In general.
(B) Methods based on two or more input parameters.
(C) Variable input parameters.
(D) Determination of arm's length PCT Payment.
(*1*) No variable input parameters.
(*2*) One variable input parameter.
(*3*) More than one variable input parameter.
(E) Adjustments.
(x) Valuation undertaken on a pre-tax basis.
(3) Comparable uncontrolled transaction method.
(4) Income method.
(i) In general.
(A) Equating cost sharing and licensing alternatives.
(B) Cost sharing alternative.
(C) Licensing alternative.
(D) Only one controlled participant with nonroutine platform contributions.
(E) Income method payment forms.
(F) Discount rates appropriate to cost sharing and licensing alternatives.
(G) The effect of taxation on determining the arm's length amount.
(ii) Evaluation of PCT Payor's cost sharing alternative.
(iii) Evaluation of PCT Payor's licensing alternative.
(A) Evaluation based on CUT.
(B) Evaluation based on CPM.
(iv) Lump sum payment form.
(v) [Reserved]
(vi) Best method analysis considerations.
(A) Coordination with §1.482–1(c).
(B) Assumptions Concerning Tax Rates.
(C) Coordination with §1.482–4(c)(2).
(D) Coordination with §1.482–5(c).
(E) Certain Circumstances Concerning PCT Payor.
(F) Discount rates.
(*1*) Reflection of similar risk profiles of cost sharing alternative and licensing alternative.
(*2*) [Reserved]
(vii) Routine platform and operating contributions.
(viii) Examples.
(5) Acquisition Price Method.
(i) In general.
(ii) Determination of arm's length charge.
(iii) Adjusted acquisition price.
(iv) Best method analysis considerations.
(v) Example.
(6) Market capitalization method.
(i) In general.
(ii) Determination of arm's length charge.
(iii) Average market capitalization.
(iv) Adjusted average market capitalization.
(v) Best method analysis considerations.
(vi) Examples.
(7) Residual profit split method.
(i) In general.
(ii) Appropriate share of profits and losses.
(iii) Profit split.
(A) In general.
(B) Determine nonroutine residual divisional profit or loss.

(C) Allocate nonroutine residual divisional profit or loss.
(*1*) In general.
(*2*) Relative value determination.
(*3*) Determination of PCT Payments.
(*4*) Routine platform and operating contributions.
(iv) Best method analysis considerations.
(A) In general.
(B) Comparability.
(C) Data and assumptions.
(D) Other factors affecting reliability.
(v) Examples.
(8) Unspecified methods.
(h) Form of payment rules.
(1) CST Payments.
(2) PCT Payments.
(i) In general.
(ii) No PCT Payor stock.
(iii) Specified form of payment.
(A) In general.
(B) Contingent payments.
(C) Examples.
(iv) Conversion from fixed to contingent form of payment.
(3) Coordination of best method rule and form of payment.
(i) Allocations by the Commissioner in connection with a CSA.
(1) In general.
(2) CST allocations.
(i) In general.
(ii) Adjustments to improve the reliability of projections used to estimate RAB shares.
(A) Unreliable projections.
(B) Foreign-to-foreign adjustments.
(C) Correlative adjustments to PCTs.
(D) Examples.
(iii) Timing of CST allocations.
(3) PCT allocations.
(4) Allocations regarding changes in participation under a CSA.
(5) Allocations when CSTs are consistently and materially disproportionate to RAB shares.
(6) Periodic adjustments.
(i) In general.
(ii) PRRR.
(iii) AERR.
(A) In general.
(B) PVTP.
(C) PVI.
(iv) ADR.
(A) In general.
(B) Publicly traded companies.
(C) Publicly traded.
(D) PCT Payor WACC.
(E) Generally accepted accounting principles.
(v) Determination of periodic adjustments.
(A) In general.
(B) Adjusted RPSM as of Determination Date.
(vi) Exceptions to periodic adjustments.
(A) Controlled participants establish periodic adjustment not warranted.
(*1*) Transactions involving the same platform contribution as in the Trigger PCT.
(*2*) Results not reasonably anticipated.
(*3*) Reduced AERR does not cause Periodic Trigger.
(*4*) Increased AERR does not cause Periodic Trigger.
(B) Circumstances in which Periodic Trigger deemed not to occur.
(*1*) 10-year period.
(*2*) 5-year period.
(vii) Examples.
(j) Definitions and special rules.
(1) Definitions.
(i) In general.
(ii) Examples.
(2) Special rules.
(i) Consolidated group.
(ii) Trade or business.
(iii) Partnership.
(3) Character.
(i) CST Payments.
(ii) PCT Payments.
(iii) Examples.
(k) CSA administrative requirements.
(1) CSA contractual requirements.
(i) In general.
(ii) Contractual provisions.
(iii) Meaning of contemporaneous.
(A) In general.
(B) Example.
(iv) Interpretation of contractual provisions.
(A) In general.
(B) Examples.
(2) CSA documentation requirements.
(i) In general.
(ii) Additional CSA documentation requirements.
(iii) Coordination rules and production of documents.
(A) Coordination with penalty regulations.
(B) Production of documentation.
(3) CSA accounting requirements.
(i) In general.
(ii) Reliance on financial accounting.
(4) CSA reporting requirements.
(i) CSA Statement.
(ii) Content of CSA Statement.
(iii) Time for filing CSA Statement.
(A) 90-day rule.
(B) Annual return requirement.
(*1*) In general.
(*2*) Special filing rule for annual return requirement.
(iv) Examples.
(l) Effective/applicability date.
(m) Transition rule.
(1) In general.
(2) Transitional modification of applicable provisions.
(3) Special rule for certain periodic adjustments.

§ 1.482–8 Examples of the best method rule.

(a) Introduction.
(b) Examples.

(c) Effective/applicability date.

§ 1.482–9 Methods to determine taxable income in connection with a controlled services transaction.

(a) In general.
(b) Services cost method.
(1) In general.
(2) Eligibility for the services cost method.
(3) Covered services.
(i) Specified covered services.
(ii) Low margin covered services.
(4) Excluded activities.
(5) Not services that contribute significantly to fundamental risks of business success or failure.
(6) Adequate books and records.
(7) Shared services arrangement.
(i) In general.
(ii) Requirements for shared services arrangement.
(A) Eligibility.
(B) Allocation.
(C) Documentation.
(iii) Definitions and special rules.
(A) Participant.
(B) Aggregation.
(C) Coordination with cost sharing arrangements.
(8) Examples.
(c) Comparable uncontrolled services price method.
(1) In general.
(2) Comparability and reliability considerations.
(i) In general.
(ii) Comparability.
(A) In general.
(B) Adjustments for differences between controlled and uncontrolled transactions.
(iii) Data and assumptions.
(3) Arm's length range.
(4) Examples.
(5) Indirect evidence of the price of a comparable uncontrolled services transaction.
(i) In general.
(ii) Example.
(d) Gross services margin method.
(1) In general.
(2) Determination of arm's length price.
(i) In general.
(ii) Relevant uncontrolled transaction.
(iii) Applicable uncontrolled price.
(iv) Appropriate gross services profit.
(v) Arm's length range.
(3) Comparability and reliability considerations.
(i) In general.
(ii) Comparability.
(A) Functional comparability.
(B) Other comparability factors.
(C) Adjustments for differences between controlled and uncontrolled transactions.
(D) Buy-sell distributor.
(iii) Data and assumptions.
(A) In general.
(B) Consistency in accounting.
(4) Examples.
(e) Cost of services plus method.
(1) In general.
(2) Determination of arm's length price.
(i) In general.
(ii) Appropriate gross services profit.
(iii) Comparable transactional costs.
(iv) Arm's length range.
(3) Comparability and reliability considerations.
(i) In general.
(ii) Comparability.
(A) Functional comparability.
(B) Other comparability factors.
(C) Adjustments for differences between the controlled and uncontrolled transactions.
(iii) Data and assumptions.
(A) In general.
(B) Consistency in accounting.
(4) Examples.
(f) Comparable profits method.
(1) In general.
(2) Determination of arm's length result.
(i) Tested party.
(ii) Profit level indicators.
(iii) Comparability and reliability considerations—Data and assumptions—Consistency in accounting.
(3) Examples.
(g) Profit split method.
(1) In general.
(2) Examples.
(h) Unspecified methods.
(i) Contingent-payment contractual terms for services.
(1) Contingent-payment contractual terms recognized in general.
(2) Contingent-payment arrangement.
(i) General requirements.
(A) Written contract.
(B) Specified contingency.
(C) Basis for payment.
(ii) Economic substance and conduct.
(3) Commissioner's authority to impute contingent-payment terms.
(4) Evaluation of arm's length charge.
(5) Examples.
(j) Total services costs.
(k) Allocation of costs.
(1) In general.
(2) Appropriate method of allocation and apportionment.
(i) Reasonable method standard.
(ii) Use of general practices.
(3) Examples.
(l) Controlled services transaction.
(1) In general.
(2) Activity.
(3) Benefit.
(i) In general.
(ii) Indirect or remote benefit.
(iii) Duplicative activities.
(iv) Shareholder activities.
(v) Passive association.
(4) Disaggregation of transactions.
(5) Examples.

(m) Coordination with transfer pricing rules for other transactions.

(1) Services transactions that include other types of transactions.

(2) Services transactions that effect a transfer of intangible property.

(3) Coordination with rules governing cost sharing arrangements.

(4) Other types of transactions that include controlled services transactions.

(5) Examples.

(n) Effective/applicability dates.

(1) In general.

(2) Election to apply regulations to earlier taxable years.

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§ 1.482–1 Allocation of income and deductions among taxpayers.

(a) *In general*—(1) *Purpose and scope.* The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This section sets forth general principles and guidelines to be followed under section 482. Section 1.482–2 provides rules for the determination of the true taxable income of controlled taxpayers in specific situations, including controlled transactions involving loans or advances or the use of tangible property. Sections 1.482–3 through 1.482–6 provide rules for the determination of the true taxable income of controlled taxpayers in cases involving the transfer of property. Section 1.482–7T sets forth the cost sharing provisions applicable to taxable years beginning on or after January 5, 2009. Section 1.482–8 provides examples illustrating the application of the best method rule. Finally, § 1.482–9 provides rules for the determination of the true taxable income of controlled taxpayers in cases involving the performance of services.

(2) *Authority to make allocations.* The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount.

(3) *Taxpayer's use of section 482.* If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Except as provided in this paragraph, section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions. Therefore, no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions. See § 1.6662–6T(a)(2) or successor regulations.

(b) *Arm's length standard*—(1) *In general.* In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances. See § 1.482–1(d)(2) (Standard of comparability). Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in § 1.482–1(c).

(2) *Arm's length methods*—(i) *Methods.* Sections 1.482–2 through 1.482–7 and 1.482–9 provide specific methods to be used to evaluate whether transactions

between or among members of the controlled group satisfy the arm's length standard, and if they do not, to determine the arm's length result. This section provides general principles applicable in determining arm's length results of such controlled transactions, but do not provide methods, for which reference must be made to those other sections in accordance with paragraphs (b)(2)(ii) and (iii) of this section. Section 1.482–7 provides the specific methods to be used to evaluate whether a cost sharing arrangement as defined in §1.482–7 produces results consistent with an arm's length result.

(ii) *Selection of category of method applicable to transaction.* The methods listed in §1.482–2 apply to different types of transactions, such as transfers of property, services, loans or advances, and rentals. Accordingly, the method or methods most appropriate to the calculation of arm's length results for controlled transactions must be selected, and different methods may be applied to interrelated transactions if such transactions are most reliably evaluated on a separate basis. For example, if services are provided in connection with the transfer of property, it may be appropriate to separately apply the methods applicable to services and property in order to determine an arm's length result. But see §1.482–1(f)(2)(i) (Aggregation of transactions). In addition, other applicable provisions of the Code may affect the characterization of a transaction, and therefore affect the methods applicable under section 482. See for example section 467.

(iii) *Coordination of methods applicable to certain intangible development arrangements.* Section 1.482–7 provides the specific methods to be used to determine arm's length results of controlled transactions in connection with a cost sharing arrangement as defined in §1.482–7. Sections 1.482–4 and 1.482–9, as appropriate, provide the specific methods to be used to determine arm's length results of arrangements, including partnerships, for sharing the costs and risks of developing intangibles, other than a cost sharing arrangement covered by §1.482–7. See also §§1.482–4(g) (Coordination with rules governing cost sharing arrangements) and 1.482–9(m)(3) (Coordination with rules governing cost sharing arrangements).

(c) *Best method rule*—(1) *In general.* The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result. See §1.482–8 for examples of the application of the best method rule. See §1.482–7 for the applicable methods in the case of a cost sharing arrangement.

(2) *Determining the best method.* Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length. Thus, in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. In addition, in certain circumstances, it also may be relevant to consider whether the results of an analysis are consistent with the results of an analysis under another method. These factors are explained in paragraphs (c)(2)(i), (ii), and (iii) of this section.

(i) *Comparability.* The relative reliability of a method based on the results of transactions between unrelated parties depends on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables, taking into account the factors described in §1.482–1(d)(3) (Factors for determining comparability), and after making adjustments for differences, as described in §1.482–1(d)(2) (Standard of comparability). As the degree of comparability increases, the number and extent of potential differences that could render the analysis inaccurate is reduced. In addition, if adjustments are made to increase the degree of comparability, the number, magnitude, and reliability of those adjustments will affect the reliability of the results of the analysis. Thus, an analysis under the comparable uncontrolled price method will generally be more reliable than analyses obtained under other methods if the analysis is based on closely comparable uncontrolled transactions, because such an analysis can be expected to achieve a higher degree of comparability and be susceptible to fewer differences than analyses under other methods. See §1.482–3(b)(2)(ii)(A). An analysis will be relatively less reliable, however, as the uncontrolled transactions become less comparable to the controlled transaction.

(ii) *Data and assumptions.* Whether a method provides the most reliable measure of an arm's length result also depends upon the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions. Such factors are particularly relevant in evaluating the degree of comparability between the controlled and uncontrolled transactions. These factors are discussed in paragraphs (c)(2)(ii) (A), (B), and (C) of this section.

(A) *Completeness and accuracy of data.* The completeness and accuracy of the data affects the ability to identify and quantify those factors that would affect the result under any particular method. For example, the completeness and accuracy of data will determine the extent to which it is possible to identify differences between the controlled and uncontrolled transactions, and the reliability of adjustments that are made to account for such differences. An analysis will be relatively more reliable as the completeness and accuracy of the data increases.

(B) *Reliability of assumptions.* All methods rely on certain assumptions. The reliability of the results derived from a method depends on the soundness of such assumptions. Some assumptions are relatively reliable. For example, adjustments for differences in payment terms between controlled and uncontrolled transactions may be based on the assumption that at arm's length such differences would lead to price differences that reflect the time value of money. Although selection of the appropriate interest rate to use in making such adjustments involves some judgement, the economic analysis on which the assumption is based is relatively sound. Other assumptions may be less reliable. For example, the residual profit split method may be based on the assumption that capitalized intangible development expenses reflect the relative value of the intangible property contributed by each party. Because the costs of developing an intangible may not be related to its market value, the soundness of this assumption will affect the reliability of the results derived from this method.

(C) *Sensitivity of results to deficiencies in data and assumptions.* Deficiencies in the data used or assumptions made may have a greater effect on some methods than others. In particular, the reliability of some methods is heavily dependent on the similarity of property or services involved in the controlled and uncontrolled transaction. For certain other methods, such as the resale price method, the analysis of the extent to which controlled and uncontrolled taxpayers undertake the same or similar functions, employ similar resources, and bear similar risks is particularly important. Finally, under other methods, such as the profit split method, defining the relevant business activity and appropriate allocation of costs, income, and assets may be of particular importance. Therefore, a difference between the controlled and uncontrolled transactions for which an accurate adjustment cannot be made may have a greater effect on the reliability of the results derived under one method than the results derived under another method. For example, differences in management efficiency may have a greater effect on a comparable profits method analysis than on a comparable uncontrolled price method analysis, while differences in product characteristics will ordinarily have a greater effect on a comparable uncontrolled price method analysis than on a comparable profits method analysis.

(iii) *Confirmation of results by another method.* If two or more methods produce inconsistent results, the best method rule will be applied to select the method that provides the most reliable measure of an arm's length result. If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method. Further, in evaluating different applications of the same method, the fact that a second method (or another application of the first method) produces results that are consistent with one of the competing applications may be taken into account.

(d) *Comparability*—(1) *In general.* Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. For this purpose, the comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm's length dealings (comparability factors). While a specific comparability factor may be of particular importance in applying a method, each method requires analysis of all of the factors that affect comparability under that method. Such factors include the following—

(i) Functions;

(ii) Contractual terms;

(iii) Risks;

(iv) Economic conditions; and

(v) Property or services.

(2) *Standard of comparability.* In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result. If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. For purposes of this section, a material difference is one that would materially affect the measure of an arm's length result under the method being applied. If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result, but the reliability of the analysis will be reduced. Generally, such adjustments must be made to the results of the uncontrolled comparable and must be based on commercial practices, economic principles, or statistical analyses. The extent and reliability of any adjustments will affect the relative reliability of the analysis. See §1.482–1(c)(1) (Best method rule). In any event, unadjusted industry average returns themselves cannot establish arm's length results.

(3) *Factors for determining comparability.* The comparability factors listed in §1.482–1(d)(1) are discussed in this section. Each of these factors must be considered in determining the degree of comparability between transactions or taxpayers and the extent to which comparability adjustments may be necessary. In addition, in certain cases involving special circumstances, the rules under paragraph (d)(4) of this section must be considered.

(i) *Functional analysis.* Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction. This comparison is based on a functional analysis that identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions. A functional analysis should also include consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles. A functional analysis is not a pricing method and does not itself determine the arm's length result for the controlled transaction under review. Functions that may need to be accounted for in determining the comparability of two transactions include—

(A) Research and development;

(B) Product design and engineering;

(C) Manufacturing, production and process engineering;

(D) Product fabrication, extraction, and assembly;

(E) Purchasing and materials management;

(F) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities;

(G) Transportation and warehousing; and

(H) Managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

(ii) *Contractual terms*—(A) *In general.* Determining the degree of comparability between the controlled and uncontrolled transactions requires a comparison of the significant contractual terms that could affect the results of the two transactions. These terms include—

(*1*) The form of consideration charged or paid;

(*2*) Sales or purchase volume;

(*3*) The scope and terms of warranties provided;

(*4*) Rights to updates, revisions or modifications;

(*5*) The duration of relevant license, contract or other agreements, and termination or renegotiation rights;

(*6*) Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and

(*7*) Extension of credit and payment terms. Thus, for example, if the time for payment of the amount charged in a controlled transaction differs from the time for payment of the amount charged in an uncontrolled transaction, an adjustment to reflect the difference in payment terms should be made if such difference would have a material effect on price. Such comparability adjustment is required even if no interest would be allocated or imputed under §1.482–2(a) or other applicable provisions of the Internal Revenue Code or regulations.

(B) *Identifying contractual terms*—(*1*) *Written agreement.* The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties (see, for example, §1.482–4(f)(3) (Ownership of intangible property)). If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

(*2*) *No written agreement.* In the absence of a written agreement, the district director may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction. In determining the economic substance of the transaction, greatest weight will be given to the actual conduct of the parties and their respective legal rights (see, for example, §1.482–4(f)(3) (Ownership of intangible property)). For example, if, without a written agreement, a controlled taxpayer operates at full capacity and regularly sells all of its output to another member of its controlled group, the district director may impute a purchasing contract from the course of conduct of the controlled taxpayers, and determine that the producer bears little risk that the buyer will fail to purchase its full output. Further, if an established industry convention or usage of trade assigns a risk or resolves an issue, that convention or usage will be followed if the conduct of the taxpayers is consistent with it. See UCC 1–205. For example, unless otherwise agreed, payment generally is due at the time and place at which the buyer is to receive goods. See UCC 2–310.

(C) *Examples*. The following examples illustrate this paragraph (d)(3)(ii).

Example 1. Differences in volume. USP, a United States agricultural exporter, regularly buys transportation services from FSub, its foreign subsidiary, to ship its products from the United States to overseas markets. Although FSub occasionally provides transportation services to URA, an unrelated domestic corporation, URA accounts for only 10% of the gross revenues of FSub, and the remaining 90% of FSub's gross revenues are attributable to FSub's transactions with USP. In determining the degree of comparability between FSub's uncontrolled transaction with URA and its controlled transaction with USP, the difference in volumes involved in the two transactions and the regularity with which these services are provided must be taken into account if such difference would have a material effect on the price charged. Inability to make reliable adjustments for these differences would affect the reliability of the results derived from the uncontrolled transaction as a measure of the arm's length result.

Example 2. Reliability of adjustment for differences in volume. (i) FS manufactures product XX and sells that product to its parent corporation, P. FS also sells product XX to uncontrolled taxpayers at a price of $100 per unit. Except for the volume of each transaction, the sales to P and to uncontrolled taxpayers take place under substantially the same economic conditions and contractual terms. In uncontrolled transactions, FS offers a 2% discount for quantities of 20 per order, and a 5% discount for quantities of 100 per order. If P purchases product XX in quantities of 60 per order, in the absence of other reliable information, it may reasonably be concluded that the arm's length price to P would be $100, less a discount of 3.5%.

(ii) If P purchases product XX in quantities of 1,000 per order, a reliable estimate of the appropriate volume discount must be based on proper economic or statistical analysis, not necessarily a linear extrapolation from the 2% and 5% catalog discounts applicable to sales of 20 and 100 units, respectively.

Example 3. Contractual terms imputed from economic substance. (i) FP, a foreign producer of wristwatches, is the registered holder of the YY trademark in the United States and in other countries worldwide. In year 1, FP enters the United States market by selling YY wristwatches to its newly organized United States subsidiary, USSub, for distribution in the United States market. USSub pays FP a fixed price per wristwatch. USSub and FP undertake, without separate compensation, marketing activities to establish the YY trademark in the United States market. Unrelated foreign producers of trademarked wristwatches and their authorized United States distributors respectively undertake similar marketing activities in independent arrangements involving distribution of trademarked wristwatches in the United States market. In years 1 through 6, USSub markets and sells YY wristwatches in the United States. Further, in years 1 through 6, USSub undertakes incremental marketing activities in addition to the activities similar to those observed in the independent distribution transactions in the United States market. FP does not directly or indirectly compensate USSub for performing these incremental activities during years 1 through 6. Assume that, aside from these incremental activities, and after any adjustments are made to improve the reliability of the comparison, the price paid per wristwatch by the independent, authorized distributors of wristwatches would provide the most reliable measure of the arm's length price paid per YY wristwatch by USSub.

(ii) By year 7, the wristwatches with the YY trademark generate a premium return in the United States market, as compared to wristwatches marketed by the independent distributors. In year 7, substantially all the premium return from the YY trademark in the United States market is attributed to FP, for example through an increase in the price paid per watch by USSub, or by some other means.

(iii) In determining whether an allocation of income is appropriate in year 7, the Commissioner may consider the economic substance of the arrangements between USSub and FP, and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, *ex ante*, an uncontrolled taxpayer operating at arm's length would engage in the incremental marketing activities to develop or enhance intangible property owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of receiving a future benefit from those activities. In this case, USSub's undertaking the incremental marketing activities in years 1 through 6 is a course of conduct that is inconsistent with the parties' attribution to FP in year 7 of substantially all the premium return from the enhanced YY trademark in the United States market. Therefore, the Commissioner may impute one or more agreements between USSub and FP, consistent with the economic substance of their course of conduct, which would afford USSub an appropriate portion of the premium return from the YY trademark wristwatches. For example, the Commissioner may impute a separate services agreement that affords USSub contingent-payment compensation for its incremental marketing activities in years 1 through 6, which benefited FP by contributing to the value of the trademark owned by FP. In the alternative, the Commissioner may impute a long-term, exclusive agreement to exploit the YY trademark in the United States that allows USSub to benefit from the incremental marketing activities it performed. As another alternative, the Commissioner may require FP to compensate USSub for terminating USSub's imputed long-term, exclusive agreement to exploit the YY trademark in the United States, an agreement that USSub made more valuable at its own expense and risk. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in the particular case.

Example 4. Contractual terms imputed from economic substance. (i) FP, a foreign producer of athletic gear, is the registered holder of the AA trademark in the United States and in other countries worldwide. In year 1, FP enters into a licensing agreement that affords its newly organized United States subsidiary, USSub, exclusive rights to certain manufacturing and marketing intangible property (including the AA trademark) for purposes of manufacturing and marketing athletic gear in the United States under the AA trademark. The contractual terms of this agreement obligate USSub to pay FP a royalty based on sales, and also obligate both FP and USSub to undertake without separate compensation specified types and levels of marketing activities. Unrelated foreign businesses license independent United States businesses to manufacture and market athletic gear in the United States, using trademarks owned by the unrelated foreign businesses. The contractual terms of these uncontrolled transactions require the licensees to pay royalties based on sales of the merchandise, and obligate the licensors and licensees to undertake without separate compensation specified types and levels of marketing activities. In years 1 through 6, USSub manufactures and sells athletic gear under the AA trademark in the United States. Assume that, after adjustments are made to improve the reliability of the comparison for any material differences relating to marketing activities, manufacturing or marketing intangible property, and other comparability factors, the royalties paid by independent licensees would provide the most reliable measure of the arm's length royalty owed by USSub to FP, apart from the additional facts in paragraph (ii) of this *Example 4*.

(ii) In years 1 through 6, USSub performs incremental marketing activities with respect to the AA trademark athletic gear, in addition to the activities required under the terms of the license agreement with FP, that are also incremental as compared to those observed in the comparables. FP does not directly or indirectly compensate USSub for performing these incremental activities during years 1 through 6. By year 7, AA trademark athletic gear generates a premium return in the United States, as compared to similar athletic gear marketed by independent licensees. In year 7, USSub and FP enter into a separate services agreement under which FP agrees to compensate USSub on a cost basis for the incremental marketing activities that USSub performed during years 1 through 6, and to compensate USSub on a cost basis for any incremental marketing activities it may perform in year 7 and subsequent years. In addition, the parties revise the license agreement executed in year 1, and increase the royalty to a level that attributes to FP substantially all the premium return from sales of the AA trademark athletic gear in the United States.

(iii) In determining whether an allocation of income is appropriate in year 7, the Commissioner may consider the economic substance of the arrangements between USSub and FP and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, ex ante, an uncontrolled taxpayer operating at arm's length would engage in the incremental marketing activities to develop or enhance intangible property owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of a future benefit. In this case, USSub's undertaking the incremental marketing activities in years 1 through 6 is a course of conduct that is inconsistent with the parties' adoption in year 7 of contractual terms by which FP compensates USSub on a cost basis for the incremental marketing activities that it performed. Therefore, the Commissioner may impute one or more agreements between USSub and FP, consistent with the economic substance of their course of conduct, which would afford USSub an appropriate portion of the premium return from the AA trademark athletic gear. For example, the Commissioner may impute a separate services agreement that affords USSub contingent-payment compensation for the incremental activities it performed during years 1 through 6, which benefited FP by contributing to the value of the trademark owned by FP. In the alternative, the Commissioner may impute a long-term, exclusive United States license agreement that allows USSub to benefit from the incremental activities. As another alternative, the Commissioner may require FP to compensate USSub for terminating USSub's imputed long-term United States license agreement, a license that USSub made more valuable at its own expense and risk. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in this particular case.

Example 5. Non-arm's length compensation. (i) The facts are the same as in paragraph (i) of *Example 4*. As in *Example 4*, assume that, after adjustments are made to improve the reliability of the comparison for any material differences relating to marketing activities, manufacturing or marketing intangible property, and other comparability factors, the royalties paid by independent licensees would provide the most reliable measure of the arm's length royalty owed by USSub to FP, apart from the additional facts described in paragraph (ii) of this *Example 5*.

(ii) In years 1 through 4, USSub performs certain incremental marketing activities with respect to the AA trademark athletic gear, in addition to the activities required under the terms of the basic license agreement, that are also incremental as compared with those activities observed in the comparables. At the start of year 1, FP enters into a separate services agreement with USSub, which states that FP will compensate USSub quarterly, in an amount equal to specified costs plus X%, for these incremental marketing functions. Further, these written agreements reflect the intent of the parties that USSub receive such compensation from FP throughout the term of the agreement, without regard to the success or failure of the promotional activities. During years 1 through 4, USSub performs marketing activities pursuant to the separate services agreement and in each year USSub receives the specified compensation from FP on a cost of services plus basis.

(iii) In evaluating year 4, the Commissioner performs an analysis of independent parties that perform promotional activities comparable to those performed by USSub and that receive separately-stated compensation on a current basis without contingency. The Commissioner determines that the magnitude of the specified cost plus X% is outside the arm's length range in each of years 1 through 4. Based on an evaluation of all the facts and circumstances, the Commissioner makes an allocation to require payment of compensation to USSub for the promotional activities performed in year 4, based on the median of the interquartile range of the arm's length markups charged by the uncontrolled comparables described in paragraph (e)(3) of this section.

(iv) Given that based on facts and circumstances, the terms agreed by the controlled parties were that FP would bear all risks associated with the promotional activities performed by USSub to promote the AA trademark product in the United States market, and given that the parties' conduct during the years examined was consistent with this allocation of risk, the fact that the cost of services plus markup on USSub's services was outside the arm's length range does not, without more, support imputation of additional contractual terms based on alternative views of the economic substance of the transaction, such as terms indicating that USSub, rather than FP, bore the risk associated with these activities.

Example 6. Contractual terms imputed from economic substance. (i) Company X is a member of a controlled group that has been in operation in the pharmaceutical sector for many years. In years 1 through 4, Company X undertakes research and development activities. As a result of those activities, Company X developed a compound that may be more effective than existing medications in the treatment of certain conditions.

(ii) Company Y is acquired in year 4 by the controlled group that includes Company X. Once Company Y is acquired, Company X makes available to Company Y a large amount of technical data concerning the new compound, which Company Y uses to register patent rights with respect to the compound in several jurisdictions, making Company Y the legal owner of such patents. Company Y then enters into licensing agreements with group members that afford Company Y 100% of the premium return attributable to use of the intangible property by its subsidiaries.

(iii) In determining whether an allocation is appropriate in year 4, the Commissioner may consider the economic substance of the arrangements between Company X and Company Y, and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that an uncontrolled taxpayer operating at arm's length would make available the results of its research and development or perform services that resulted in transfer of valuable know how to another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of receiving a future benefit from those activities. In this case, Company X's undertaking the research and development activities and then providing technical data and know-how to Company Y in year 4 is inconsistent with the registration and subsequent exploitation of the patent by Company Y. Therefore, the Commissioner may impute one or more agreements between Company X and Company Y consistent with the economic substance of their course of conduct, which would afford Company X an appropriate portion of the premium return from the patent rights. For example, the Commissioner may impute a separate services agreement that affords Company X contingent-payment compensation for its services in year 4 for the benefit of Company Y, consisting of making available to Company Y technical data, know-how, and other fruits of research and development conducted in previous years. These services benefited Company Y by giving rise to and contributing to the value of the patent rights that were ultimately registered by Company Y. In the alternative, the Commissioner may impute a transfer of patentable intangible property rights from Company X to Company Y immediately preceding the registration of patent rights by Company Y. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in the particular case.

(iii) *Risk*—(A) *Comparability*. Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant risks that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions. Relevant risks to consider include—

(*1*) Market risks, including fluctuations in cost, demand, pricing, and inventory levels;

(*2*) Risks associated with the success or failure of research and development activities;

(*3*) Financial risks, including fluctuations in foreign currency rates of exchange and interest rates;

(*4*) Credit and collection risks;

(*5*) Product liability risks; and

(*6*) General business risks related to the ownership of property, plant, and equipment.

(B) *Identification of taxpayer that bears risk*. In general, the determination of which controlled taxpayer bears a particular risk will be made in accordance with the provisions of §1.482–1(d)(3)(ii)(B) (Identifying contractual terms). Thus, the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance. In considering the economic substance of the transaction, the following facts are relevant—

(*1*) Whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk between the controlled taxpayers; or where the pattern is changed, whether the relevant contractual arrangements have been modified accordingly;

(*2*) Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's length, another party to the controlled transaction would ultimately suffer the consequences of such losses; and

(*3*) The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.

(C) *Examples*. The following examples illustrate this paragraph (d)(3)(iii).

Example 1. FD, the wholly-owned foreign distributor of USM, a U.S. manufacturer, buys widgets from USM under a written contract. Widgets are a generic electronic appliance. Under the terms of the contract, FD must buy and take title to 20,000 widgets for each of the five years of the contract at a price of $10 per widget. The widgets will be sold under FD's label, and FD must finance any marketing strategies to promote sales in the foreign market. There are no rebate or buy back provisions. FD has adequate financial capacity to fund its obligations under the contract under any circumstances that could reasonably be expected to arise. In Years 1, 2 and 3, FD sold only 10,000 widgets at a price of $11 per unit. In Year 4, FD sold its entire inventory of widgets at a price of $25 per unit. Since the contractual terms allocating market risk were agreed to before the outcome of such risk was known or reasonably knowable, FD had the financial capacity to bear the market risk that it would be unable to sell all of the widgets it purchased currently, and its conduct was consistent over time, FD will be deemed to bear the risk.

Example 2. The facts are the same as in *Example 1*, except that in Year 1 FD had only $100,000 in total capital, including loans. In subsequent years USM makes no additional contributions to the capital of FD, and FD is unable to obtain any capital through loans from an unrelated party. Nonetheless, USM continues to sell 20,000 widgets annually to FD under the terms of the contract, and USM extends credit to FD to enable it to finance the purchase. FD does not have the financial capacity in Years 1, 2 and 3 to finance the purchase of the widgets given that it could not sell most of the widgets it purchased during those years. Thus, notwithstanding the terms of the contract, USM and not FD assumed the market risk that a substantial portion of the widgets could not be sold, since in that event FD would not be able to pay USM for all of the widgets it purchased.

Example 3. S, a Country X corporation, manufactures small motors that it sells to P, its U.S. parent. P incorporates the motors into various products and sells those products to uncontrolled customers in the United States. The contract price for the motors is expressed in U.S. dollars, effectively allocating the currency risk for these transactions to S for any currency fluctuations between the time the contract is signed and payment is made. As long as S has adequate financial capacity to bear this currency risk (including by hedging all or part of the risk) and the conduct of S and P is consistent with the terms of the contract (i.e., the contract price is not adjusted to reflect exchange rate movements), the agreement of the parties to allocate the exchange risk to S will be respected.

Example 4. USSub is the wholly-owned U.S. subsidiary of FP, a foreign manufacturer. USSub acts as a distributor of goods manufactured by FP. FP and USSub execute an agreement providing that FP will bear any ordinary product liability costs arising from defects in the goods manufactured by FP. In practice, however, when ordinary product liability claims are sustained against USSub and FP, USSub pays the resulting damages. Therefore, the district director disregards the contractual arrangement regarding product liability costs between FP and USSub, and treats the risk as having been assumed by USSub.

(iv) *Economic conditions.* Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. These factors include—

(A) The similarity of geographic markets;

(B) The relative size of each market, and the extent of the overall economic development in each market;

(C) The level of the market (e.g., wholesale, retail, etc.);

(D) The relevant market shares for the products, properties, or services transferred or provided;

(E) The location-specific costs of the factors of production and distribution;

(F) The extent of competition in each market with regard to the property or services under review;

(G) The economic condition of the particular industry, including whether the market is in contraction or expansion; and

(H) The alternatives realistically available to the buyer and seller.

(v) *Property or services.* Evaluating the degree of comparability between controlled and uncontrolled transactions requires a comparison of the property or services transferred in the transactions. This comparison may include any intangible property that is embedded in tangible property or services being transferred (embedded intangibles). The comparability of the embedded intangibles will be analyzed using the factors listed in §1.482–4(c)(2)(iii)(B)(*1*) (comparable intangible property). The relevance of product comparability in evaluating the relative reliability of the results will depend on the method applied. For guidance concerning the specific comparability considerations applicable to transfers of tangible and intangible property and performance of services, *see* §§1.482–3 through 1.482–6 and §1.482–9; *see also* §§1.482–3(f), 1.482–4(f)(4), and 1.482–9(m), dealing with the coordination of intangible and tangible property and performance of services rules.

(4) *Special circumstances*—(i) *Market share strategy.* In certain circumstances, taxpayers may adopt strategies to enter new markets or to increase a product's share of an existing market (market share strategy). Such a strategy would be reflected by temporarily increased market development expenses or resale prices that are temporarily lower than the prices charged for comparable products in the same market. Whether or not the strategy is reflected in the transfer price depends on which party to the controlled transaction bears the costs of the pricing strategy. In any case, the effect of a market share strategy on a controlled transaction will be taken into account only if it can be shown that an uncontrolled taxpayer engaged

in a comparable strategy under comparable circumstances for a comparable period of time, and the taxpayer provides documentation that substantiates the following—

(A) The costs incurred to implement the market share strategy are borne by the controlled taxpayer that would obtain the future profits that result from the strategy, and there is a reasonable likelihood that the strategy will result in future profits that reflect an appropriate return in relation to the costs incurred to implement it;

(B) The market share strategy is pursued only for a period of time that is reasonable, taking into consideration the industry and product in question; and

(C) The market share strategy, the related costs and expected returns, and any agreement between the controlled taxpayers to share the related costs, were established before the strategy was implemented.

(ii) *Different geographic markets*—(A) *In general.* Uncontrolled comparables ordinarily should be derived from the geographic market in which the controlled taxpayer operates, because there may be significant differences in economic conditions in different markets. If information from the same market is not available, an uncontrolled comparable derived from a different geographic market may be considered if adjustments are made to account for differences between the two markets. If information permitting adjustments for such differences is not available, then information derived from uncontrolled comparables in the most similar market for which reliable data is available may be used, but the extent of such differences may affect the reliability of the method for purposes of the best method rule. For this purpose, a geographic market is any geographic area in which the economic conditions for the relevant product or service are substantially the same, and may include multiple countries, depending on the economic conditions.

(B) *Example.* The following example illustrates this paragraph (d)(4)(ii).

Example. Manuco, a wholly-owned foreign subsidiary of P, a U.S. corporation, manufactures products in Country Z for sale to P. No uncontrolled transactions are located that would provide a reliable measure of the arm's length result under the comparable uncontrolled price method. The district director considers applying the cost plus method or the comparable profits method. Information on uncontrolled taxpayers performing comparable functions under comparable circumstances in the same geographic market is not available. Therefore, adjusted data from uncontrolled manufacturers in other markets may be considered in order to apply the cost plus method. In this case, comparable uncontrolled manufacturers are found in the United States. Accordingly, data from the comparable U.S. uncontrolled manufacturers, as adjusted to account for differences between the United States and Country Z's geographic market, is used to test the arm's length price paid by P to Manuco. However, the use of such data may affect the reliability of the results for purposes of the best method rule. See §1.482–1(c).

(C) *Location savings.* If an uncontrolled taxpayer operates in a different geographic market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographic markets. These adjustments must be based on the effect such differences would have on the consideration charged or paid in the controlled transaction given the relative competitive positions of buyers and sellers in each market. Thus, for example, the fact that the total costs of operating in a controlled manufacturer's geographic market are less than the total costs of operating in other markets ordinarily justifies higher profits to the manufacturer only if the cost differences would increase the profits of comparable uncontrolled manufacturers operating at arm's length, given the competitive positions of buyers and sellers in that market.

(D) *Example.* The following example illustrates the principles of this paragraph (d)(4)(ii)(C).

Example. Couture, a U.S. apparel design corporation, contracts with Sewco, its wholly owned Country Y subsidiary, to manufacture its clothes. Costs of operating in Country Y are significantly lower than the operating costs in the United States. Although clothes with the Couture label sell for a premium price, the actual production of the clothes does not require significant specialized knowledge that could not be acquired by actual or potential competitors to Sewco at reasonable cost. Thus, Sewco's functions could be performed by several actual or potential competitors to Sewco in geographic markets that are similar to Country Y. Thus, the fact that production is less costly in Country Y will not, in and of itself, justify additional profits derived from lower operating costs in Country Y inuring to Sewco, because the competitive positions of the other actual or potential producers in similar geographic markets capable of performing the same functions at the same low costs indicate that at arm's length such profits would not be retained by Sewco.

(iii) *Transactions ordinarily not accepted as comparables*—(A) *In general.* Transactions ordinarily will not constitute reliable measures of an arm's length result for purposes of this section if—

(*1*) They are not made in the ordinary course of business; or

(*2*) One of the principal purposes of the uncontrolled transaction was to establish an arm's length result with respect to the controlled transaction.

(B) *Examples.* The following examples illustrate the principle of this paragraph (d)(4)(iii).

Example 1. Not in the ordinary course of business. USP, a United States manufacturer of computer software, sells its products to FSub, its foreign distributor in country X. Compco, a United States competitor of USP, also sells its products in X through unrelated distributors. However, in the year under review, Compco is forced into bankruptcy, and Compco liquidates its inventory by selling all of its products to unrelated distributors in X for a liquidation price. Because the sale of its entire inventory was not a sale in the ordinary course of business, Compco's sale cannot be used as an uncontrolled comparable to determine USP's arm's length result from its controlled transaction.

Example 2. Principal purpose of establishing an arm's length result. USP, a United States manufacturer of farm machinery, sells its products to FSub, its wholly-owned distributor in Country Y. USP, operating at nearly full capacity, sells 95% of its inventory to FSub. To make use of its excess capacity, and also to establish a comparable uncontrolled price for its transfer price to FSub, USP increases its production to full capacity. USP sells its excess inventory to Compco, an unrelated foreign distributor in Country X. Country X has approximately the same economic conditions as that of Country Y. Because one of the principal purposes of selling to Compco was to establish an arm's length price for its controlled transactions with FSub, USP's sale to Compco cannot be used as an uncontrolled comparable to determine USP's arm's length result from its controlled transaction.

(e) *Arm's length range*—(1) *In general.* In some cases, application of a pricing method will produce a single result that is the most reliable measure of an arm's length result. In other cases, application of a method may produce a number of results from which a range of reliable results may be derived. A taxpayer will not be subject to adjustment if its results fall within such range (arm's length range).

(2) *Determination of arm's length range*—(i) *Single method.* The arm's length range is ordinarily determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability. Use of more than one method may be appropriate for the purposes described in paragraph (c)(2)(iii) of this section (Best method rule).

(ii) *Selection of comparables.* Uncontrolled comparables must be selected based upon the comparability criteria relevant to the method applied and must be sufficiently similar to the controlled transaction that they provide a reliable measure of an arm's length result. If material differences exist between the controlled and uncontrolled transactions, adjustments must be made to the results of the uncontrolled transaction if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results. See §1.482–1(d)(2) (Standard of comparability). The arm's length range will be derived only from those uncontrolled comparables that have, or through adjustments can be brought to, a similar level of comparability and reliability, and uncontrolled comparables that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range.

(iii) *Comparables included in arm's length range*—(A) *In general.* The arm's length range will consist of the results of all of the uncontrolled comparables that meet the following conditions: the information on the controlled transaction and the uncontrolled comparables is sufficiently complete that it is likely that all material differences have been identified, each such difference has a definite and reasonably ascertainable effect on price or profit, and an adjustment is made to eliminate the effect of each such difference.

(B) *Adjustment of range to increase reliability.* If there are no uncontrolled comparables described in paragraph (e)(2)(iii)(A) of this section, the arm's length range is derived from the results of all the uncontrolled comparables, selected pursuant to paragraph (e)(2)(ii) of this section, that achieve a similar level of comparability and reliability. In such cases the reliability of the analysis must be increased, where it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables so selected. The reliability of the analysis is increased when statistical methods are used to establish a range of results in which the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. The interquartile range ordinarily provides an acceptable measure of this range; however a different statistical method may be applied if it provides a more reliable measure.

(C) *Interquartile range.* For purposes of this section, the interquartile range is the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables. For this purpose, the 25th percentile is the lowest result derived from an uncontrolled comparable such that at least 25 percent of the results are at or below the value of that result. However, if exactly 25 percent of the results are at or below a result, then the 25th percentile is equal to the average of that result and the next higher result derived from the uncontrolled comparables. The 75th percentile is determined analogously.

(3) *Adjustment if taxpayer's results are outside arm's length range.* If the results of a controlled transaction fall outside the arm's length range, the district director may make allocations that adjust the controlled taxpayer's result to any point within the arm's length range. If the interquartile range is used to determine the arm's length range, such adjustment will ordinarily be to the median of all the results. The median is the 50th percentile of the results, which is determined in a manner analogous to that described in paragraph (e)(2)(iii)(C) of this section (Interquartile range). In other cases, an adjustment normally will be made to the arithmetic mean of all the results. See §1.482–1(f)(2)(iii)(D) for determination of an adjustment when a controlled taxpayer's result for a multiple year period falls outside an arm's length range consisting of the average results of uncontrolled comparables over the same period.

(4) *Arm's length range not prerequisite to allocation.* The rules of this paragraph (e) do not require that the district director establish an arm's length range prior to making an allocation under section 482. Thus, for example, the district director may properly propose an allocation on the basis of a single comparable uncontrolled price if the comparable uncontrolled price method, as described in §1.482–3(b), has been properly applied. However, if the taxpayer subsequently demonstrates that the results claimed on its income tax return are within the range established by additional equally reliable comparable uncontrolled prices in a manner consistent with the requirements set forth in §1.482–1(e)(2)(iii), then no allocation will be made.

(5) *Examples.* The following examples illustrate the principles of this paragraph (e).

Example 1. Selection of comparables. (i) To evaluate the arm's length result of a controlled transaction between USSub, the United States taxpayer under review, and FP, its foreign parent, the district director considers applying the resale price method. The district director identifies ten potential uncontrolled transactions. The distributors in all ten uncontrolled transactions purchase and resell similar products and perform similar functions to those of USSub.

(ii) Data with respect to three of the uncontrolled transactions is very limited, and although some material differences can be identified and adjusted for, the level of comparability of these three uncontrolled comparables is significantly lower than that of the other seven. Further, of those seven, adjustments for the identified material differences can be reliably made for only four of the uncontrolled transactions. Therefore, pursuant to §1.482–1(e)(2)(ii) only these four uncontrolled comparables may be used to establish an arm's length range.

Example 2. Arm's length range consists of all the results. (i) The facts are the same as in *Example 1*. Applying the resale price method to the four uncontrolled comparables, and making adjustments to the uncontrolled comparables pursuant to §1.482-1(d)(2), the district director derives the following results:

Comparable	Result (price)
1	$44.00
2	45.00
3	45.00
4	45.50

(ii) The district director determines that data regarding the four uncontrolled transactions is sufficiently complete and accurate so that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, such differences have a definite and reasonably ascertainable effect, and appropriate adjustments were made for such differences. Accordingly, if the resale price method is determined to be the best method pursuant to §1.482–1(c), the arm's length range for the controlled transaction will consist of the results of all of the uncontrolled comparables, pursuant to paragraph (e)(2)(iii)(A) of this section. Thus, the arm's length range in this case would be the range from $44 to $45.50.

Example 3. Arm's length range limited to interquartile range. (i) The facts are the same as in *Example 2*, except in this case there are some product and functional differences between the four uncontrolled comparables and USSub. However, the data is insufficiently complete to determine the effect of the differences. Applying the resale price method to the four uncontrolled comparables, and making adjustments to the uncontrolled comparables pursuant to §1.482–1(d)(2), the district director derives the following results:

Uncontrolled comparable	Result (price)
1	$42.00
2	44.00
3	45.00
4	47.50

(ii) It cannot be established in this case that all material differences are likely to have been identified and reliable adjustments made for those differences. Accordingly, if the resale price method is determined to be the best method pursuant to §1.482–1(c), the arm's length range for the controlled transaction must be established pursuant to paragraph (e)(2)(iii)(B) of this section. In this case, the district director uses the interquartile range to determine the arm's length range, which is the range from $43 to $46.25. If USSub's price falls outside this range, the district director may make an allocation. In this case that allocation would be to the median of the results, or $44.50.

Example 4. Arm's length range limited to interquartile range. (i) To evaluate the arm's length result of controlled transactions between USP, a United States manufacturing company, and FSub, its foreign subsidiary, the district director considers applying the comparable profits method. The district director identifies 50 uncontrolled taxpayers within the same industry that potentially could be used to apply the method.

(ii) Further review indicates that only 20 of the uncontrolled manufacturers engage in activities requiring similar capital investments and technical know-how. Data with respect to five of the uncontrolled manufacturers is very limited, and although some material differences can be identified and adjusted for, the level of comparability of these five uncontrolled comparables is significantly lower than that of the other 15. In addition, for those five uncontrolled comparables it is not possible to accurately allocate costs between the business activity associated with the relevant transactions and other business activities. Therefore, pursuant to §1.482–1(e)(2)(ii) only the other fifteen uncontrolled comparables may be used to establish an arm's length range.

(iii) Although the data for the fifteen remaining uncontrolled comparables is relatively complete and accurate, there is a significant possibility that some material differences may remain. The district director has determined, for example, that it is likely that there are material differences in the level of technical expertise or in management efficiency. Accordingly, if the comparable profits method is determined to be the best method pursuant to §1.482–1(c), the arm's length range for the controlled transaction may be established only pursuant to paragraph (e)(2)(iii)(B) of this section.

(f) *Scope of review*—(1) *In general.* The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer, in the conduct of its affairs, been dealing at arm's length with an uncontrolled taxpayer.

(i) *Intent to evade or avoid tax not a prerequisite.* In making allocations under section 482, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances.

(ii) *Realization of income not a prerequisite*—(A) *In general.* The district director may make an allocation under section 482 even if the income ultimately anticipated from a series of transactions has not been or is never realized. For example, if a controlled taxpayer sells a product at less than an arm's length price to a related taxpayer in one taxable year and the second controlled taxpayer resells the product to an unrelated party in the next taxable year, the district director may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, even though the second controlled taxpayer had not realized any gross income from the resale of the product in the first year. Similarly, if a controlled taxpayer lends money to a related taxpayer in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second controlled taxpayer does not realize income during such year. Finally, even if two controlled taxpayers realize an overall loss that is attributable to a particular controlled transaction, an allocation under section 482 is not precluded.

(B) *Example.* The following example illustrates this paragraph (f)(1)(ii).

Example. USSub is a U.S. subsidiary of FP, a foreign corporation. Parent manufactures product X and sells it to USSub. USSub functions as a distributor of product X to unrelated customers in the United States. The fact that FP may incur a loss on the manufacture and sale of product X does not by itself establish that USSub, dealing with FP at arm's length, also would incur a loss. An independent distributor acting at arm's length with its supplier would in many circumstances be expected to earn a profit without regard to the level of profit earned by the supplier.

(iii) *Nonrecognition provisions may not bar allocation*—(A) *In general.* If necessary to prevent the avoidance of taxes or to clearly reflect income, the district director may make an allocation under section 482 with respect to transactions that otherwise qualify for nonrecognition of gain or loss under applicable provisions of the Internal Revenue Code (such as section 351 or 1031).

(B) *Example.* The following example illustrates this paragraph (f)(1)(iii).

Example. (i) In Year 1 USP, a United States corporation, bought 100 shares of UR, an unrelated corporation, for $100,000. In Year 2, when the value of the UR stock had decreased to $40,000, USP contributed all 100 shares of UR stock to its wholly-owned subsidiary in exchange for subsidiary's capital stock. In Year 3, the subsidiary sold all of the UR stock for $40,000 to an unrelated buyer, and on its U.S. income tax return, claimed a loss of $60,000 attributable to the sale of the UR stock. USP and its subsidiary do not file a consolidated return.

(ii) In determining the true taxable income of the subsidiary, the district director may disallow the loss of $60,000 on the ground that the loss was incurred by USP. *National Securities Corp. v Commissioner*, 137 F.2d 600 (3rd Cir. 1943), cert. denied, 320 U.S. 794 (1943).

(iv) *Consolidated returns.* Section 482 and the regulations thereunder apply to all controlled taxpayers, whether the controlled taxpayer files a separate or consolidated U.S. income tax return. If a controlled taxpayer files a separate return, its true separate taxable income will be determined. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer must be determined consistently with the principles of a consolidated return.

(2) *Rules relating to determination of true taxable income.* The following rules must be taken into account in determining the true taxable income of a controlled taxpayer.

(i)(A) through (E) [Reserved]. For further guidance see §1.482–1T(f)(2)(i)(A) through (E).

(ii) *Allocation based on taxpayer's actual transactions*—(A) *In general.* The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the Commissioner may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the alternative had been adopted by the taxpayer. *See* paragraph (d)(3) of this section (factors for determining comparability; contractual terms and risk); §§1.482–3(e), 1.482–4(d), and 1.482–9(h) (unspecified methods).

(B) [Reserved]. For further guidance see §1.482–1T(f)(2)(ii)(B).

(iii) *Multiple year data*—(A) *In general.* The results of a controlled transaction ordinarily will be compared with the results of uncontrolled comparables occurring in the taxable year under review. It may be appropriate, however, to consider data relating to the uncontrolled comparables or the controlled taxpayer for one or more years before or after the year under review. If data relating to uncontrolled comparables from multiple years is used, data relating to the controlled taxpayer for the same years ordinarily must be considered. However, if such data is not available, reliable data from other years, as adjusted under paragraph (d)(2) (Standard of comparability) of this section may be used.

(B) *Circumstances warranting consideration of multiple year data.* The extent to which it is appropriate to consider multiple year data depends on the method being applied and the issue being addressed. Circumstances that may warrant consideration of data from multiple years include the extent to which complete and accurate data are available for the taxable year under review, the effect of business cycles in the controlled taxpayer's industry, or the effects of life cycles of the product or intangible property being examined. Data from one or more years before or after the taxable year under review must ordinarily be considered for purposes of applying the provisions of paragraph (d)(3)(iii) of this section (risk), paragraph (d)(4)(i) of this section (market share strategy), §1.482–4(f)(2) (periodic adjustments), §1.482–5 (comparable profits method), §1.482–9(f) (comparable profits method for services), and §1.482–9(i) (contingent-payment contractual terms for services). On the other hand, multiple year data ordinarily will not be considered for purposes of applying the comparable uncontrolled price method of §1.482–3(b) or the comparable uncontrolled services price method of §1.482–9(c) (except to the extent that risk or market share strategy issues are present).

(C) *Comparable effect over comparable period.* Data from multiple years may be considered to determine whether the same economic conditions that caused the controlled taxpayer's results had a comparable effect over a comparable period of time on the uncontrolled comparables that establish the arm's length range. For example, given that uncontrolled taxpayers enter into transactions with the ultimate expectation of earning a profit, persistent losses among controlled taxpayers may be an indication of non-arm's length dealings. Thus, if a controlled taxpayer that realizes a loss with respect to a controlled transaction seeks to demonstrate that the loss is within the arm's length range, the district director may take into account data from taxable years other than the taxable year of the transaction to determine whether the loss was attributable to arm's length dealings. The rule of this paragraph (f)(2)(iii)(C) is illustrated by *Example 3* of paragraph (f)(2)(iii)(E) of this section.

(D) *Applications of methods using multiple year averages.* If a comparison of a controlled taxpayer's average result over a multiple year period with the average results of uncontrolled comparables over the same period would reduce the effect of short-term variations that may be unrelated to transfer pricing, it may be appropriate to establish a range derived from the average results of uncontrolled comparables over a multiple year period to determine if an adjustment should be made. In such a case the district director may make an adjustment if the controlled taxpayer's average result for the multiple year period is not within such range. Such a range must be determined in accordance with §1.482–1(e) (Arm's length range). An adjustment in such a case ordinarily will be equal to the difference, if any, between the controlled taxpayer's result for the taxable year and the mid-point of the uncontrolled comparables' results for that year. If the interquartile range is used to determine the range of average results for the multiple year period, such adjustment will ordinarily be made to the median of all the results of the uncontrolled comparables for the taxable year. See *Example 2* of §1.482–5(e). In other cases, the adjustment normally will be made to the arithmetic mean of all the results of the uncontrolled comparables for the taxable year. However, an adjustment will be made only to the extent that it would move the controlled taxpayer's multiple year average closer to the arm's length range for the multiple year period or to any point within such range. In determining a controlled taxpayer's average result for a multiple year period, adjustments made under this section for prior years will be taken into account only if such adjustments have been finally determined, as described in §1.482–1(g)(2)(iii). See *Example 3* of §1.482–5(e).

(E) *Examples*. The following examples, in which S and P are controlled taxpayers, illustrate this paragraph (f)(2)(iii). *Examples 1* and *4* also illustrate the principle of the arm's length range of paragraph (e) of this section.

Example 1. P sold product Z to S for $60 per unit in 1995. Applying the resale price method to data from uncontrolled comparables for the same year establishes an arm's length range of prices for the controlled transaction from $52 to $59 per unit. Since the price charged in the controlled transaction falls outside the range, the district director would ordinarily make an allocation under section 482. However, in this case there are cyclical factors that affect the results of the uncontrolled comparables (and that of the controlled transaction) that cannot be adequately accounted for by specific adjustments to the data for 1995. Therefore, the district director considers results over multiple years to account for these factors. Under these circumstances, it is appropriate to average the results of the uncontrolled comparables over the years 1993, 1994, and 1995 to determine an arm's length range. The averaged results establish an arm's length range of $56 to $58 per unit. For consistency, the results of the controlled taxpayers must also be averaged over the same years. The average price in the controlled transaction over the three years is $57. Because the controlled transfer price of product Z falls within the arm's length range, the district director makes no allocation.

Example 2. (i) FP, a Country X corporation, designs and manufactures machinery in Country X. FP's costs are incurred in Country X currency. USSub is the exclusive distributor of FP's machinery in the United States. The price of the machinery sold by FP to USSub is expressed in Country X currency. Thus, USSub bears all of the currency risk associated with fluctuations in the exchange rate between the time the contract is signed and the payment is made. The prices charged by FP to USSub for 1995 are under examination. In that year, the value of the dollar depreciated against the currency of Country X, and as a result, USSub's gross margin was only 8%.

(ii) UD is an uncontrolled distributor of similar machinery that performs distribution functions substantially the same as those performed by USSub, except that UD purchases and resells machinery in transactions where both the purchase and resale prices are denominated in U.S. dollars. Thus, UD had no currency exchange risk. UD's gross margin in 1995 was 10%. UD's average gross margin for the period 1990 to 1998 has been 12%.

(iii) In determining whether the price charged by FP to USSub in 1995 was arm's length, the district director may consider USSub's average gross margin for an appropriate period before and after 1995 to determine whether USSub's average gross margin during the period was sufficiently greater than UD's average gross margin during the same period such that USSub was sufficiently compensated for the currency risk it bore throughout the period. See §1.482-1(d)(3)(iii) (Risk).

Example 3. FP manufactures product X in Country M and sells it to USSub, which distributes X in the United States. USSub realizes losses with respect to the controlled transactions in each of five consecutive taxable years. In each of the five consecutive years a different uncontrolled comparable realized a loss with respect to comparable transactions equal to or greater than USSub's loss. Pursuant to paragraph (f)(3)(iii)(C) of this section, the district director examines whether the uncontrolled comparables realized similar losses over a comparable period of time, and finds that each of the five comparables realized losses in only one of the five years, and their average result over the five-year period was a profit. Based on this data, the district director may conclude that the controlled taxpayer's results are not within the arm's length range over the five year period, since the economic conditions that resulted in the controlled taxpayer's loss did not have a comparable effect over a comparable period of time on the uncontrolled comparables.

Example 4. (i) USP, a U.S. corporation, manufactures product Y in the United States and sells it to FSub, which acts as USP's exclusive distributor of product Y in Country N. The resale price method described in §1.482–3(c) is used to evaluate whether the transfer price charged by USP to FSub for the 1994 taxable year for product Y was arm's length. For the period 1992 through 1994, FSub had a gross profit margin for each year of 13%. A, B, C and D are uncontrolled distributors of products that compete directly with product Y in country N. After making appropriate adjustments in accordance with §§1.482–1(d)(2) and 1.482–3(c), the gross profit margins for A, B, C, and D are as follows:

	1992	1993	1994	Average
A	13	3	8	8.00
B	11	13	2	8.67
7C	4	7	13	8.00
7D	7	9	6	7.33

(ii) Applying the provisions of §1.482–1(e), the district director determines that the arm's length range of the average gross profit margins is between 7.33 and 8.67. The district director concludes that FSub's average gross margin of 13% is not within the arm's length range, despite the fact that C's gross profit margin for 1994 was also 13%, since the economic conditions that caused S's result did not have a comparable effect over a comparable period of time on the results of C or the other uncontrolled comparables. In this case, the district director makes an allocation equivalent to adjusting FSub's gross profit margin for 1994 from 13% to the mean of the uncontrolled comparables' results for 1994 (7.25%).

(iv) *Product lines and statistical techniques.* The methods described in §§1.482–2 through 1.482–6 are generally stated in terms of individual transactions. However, because a taxpayer may have controlled transactions involving many different products, or many separate transactions involving the same product, it may be impractical to analyze every individual transaction to determine its arm's length price. In such cases, it is permissible to evaluate the arm's length results by applying the appropriate methods to the overall results for product lines or other groupings. In addition, the arm's length results of all related party transactions entered into by a controlled taxpayer may be evaluated by employing sampling and other valid statistical techniques.

(v) *Allocations apply to results, not methods*—(A) *In general.* In evaluating whether the result of a controlled transaction is arm's length, it is not necessary for the district director to determine whether the method or procedure that a controlled taxpayer employs to set the terms for its controlled transactions corresponds to the method or procedure that might have been used by a taxpayer dealing at arm's length with an uncontrolled taxpayer. Rather, the district director will evaluate the result achieved rather than the method the taxpayer used to determine its prices.

(B) *Example.* The following example illustrates this paragraph (f)(2)(v).

Example. (i) FS is a foreign subsidiary of P, a U.S. corporation. P manufactures and sells household appliances. FS operates as P's exclusive distributor in Europe. P annually establishes the price for each of its appliances sold to FS as part of its annual budgeting, production allocation and scheduling, and performance evaluation processes. FS's aggregate gross margin earned in its distribution business is 18%.

(ii) ED is an uncontrolled European distributor of competing household appliances. After adjusting for minor differences in the level of inventory, volume of sales, and warranty programs conducted by FS and ED, ED's aggregate gross margin is also 18%. Thus, the district director may conclude that the aggregate prices charged by P for its appliances sold to FS are arm's length, without determining whether the budgeting, production, and performance evaluation processes of P are similar to such processes used by ED.

(g) *Collateral adjustments with respect to allocations under section 482*—(1) *In general.* The district director will take into account appropriate collateral adjustments with respect to allocations under section 482. Appropriate collateral adjustments may include correlative allocations, conforming adjustments, and setoffs, as described in this paragraph (g).

(2) *Correlative allocations*—(i) *In general.* When the district director makes an allocation under section 482 (referred to in this paragraph (g)(2) as the primary allocation), appropriate correlative allocations will also be made with respect to any other member of the group affected by the allocation.

Thus, if the district director makes an allocation of income, the district director will not only increase the income of one member of the group, but correspondingly decrease the income of the other member. In addition, where appropriate, the district director may make such further correlative allocations as may be required by the initial correlative allocation.

(ii) *Manner of carrying out correlative allocation.* The district director will furnish to the taxpayer with respect to which the primary allocation is made a written statement of the amount and nature of the correlative allocation. The correlative allocation must be reflected in the documentation of the other member of the group that is maintained for U.S. tax purposes, without regard to whether it affects the U.S. income tax liability of the other member for any open year. In some circumstances the allocation will have an immediate U.S. tax effect, by changing the taxable income computation of the other member (or the taxable income computation of a shareholder of the other member, for example, under the provisions of subpart F of the Internal Revenue Code). Alternatively, the correlative allocation may not be reflected on any U.S. tax return until a later year, for example when a dividend is paid.

(iii) *Events triggering correlative allocation.* For purposes of this paragraph (g)(2), a primary allocation will not be considered to have been made (and therefore, correlative allocations are not required to be made) until the date of a final determination with respect to the allocation under section 482. For this purpose, a final determination includes—

(A) Assessment of tax following execution by the taxpayer of a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) with respect to such allocation;

(B) Acceptance of a Form 870–AD (Offer of Waiver of Restriction on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment);

(C) Payment of the deficiency;

(D) Stipulation in the Tax Court of the United States; or

(E) Final determination of tax liability by offer-in-compromise, closing agreement, or final resolution (determined under the principles of section 7481) of a judicial proceeding.

(iv) *Examples.* The following examples illustrate this paragraph (g)(2). In each example, X and Y are members of the same group of controlled taxpayers and each regularly computes its income on a calendar year basis.

Example 1. (i) In 1996, Y, a U.S. corporation, rents a building owned by X, also a U.S. corporation. In 1998 the district director determines that Y did not pay an arm's length rental charge. The district director proposes to increase X's income to reflect an arm's length rental charge. X consents to the assessment reflecting such adjustment by executing Form 870, a Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment. The assessment of the tax with respect to the adjustment is made in 1998. Thus, the primary allocation, as defined in paragraph (g)(2)(i) of this section, is considered to have been made in 1998.

(ii) The adjustment made to X's income under section 482 requires a correlative allocation with respect to Y's income. The district director notifies X in writing of the amount and nature of the adjustment made with respect to Y. Y had net operating losses in 1993, 1994, 1995, 1996, and 1997. Although a correlative adjustment will not have an effect on Y's U.S. income tax liability for 1996, an adjustment increasing Y's net operating loss for 1996 will be made for purposes of determining Y's U.S. income tax liability for 1998 or a later taxable year to which the increased net operating loss may be carried.

Example 2. (i) In 1995, X, a U.S. construction company, provided engineering services to Y, a U.S. corporation, in the construction of Y's factory. In 1997, the district director determines that the fees paid by Y to X for its services were not arm's length and proposes to make an adjustment to the income of X. X consents to an assessment reflecting such adjustment by executing Form 870. An assessment of the tax with respect to such adjustment is made in 1997. The district director notifies X in writing of the amount and nature of the adjustment to be made with respect to Y.

(ii) The fees paid by Y for X's engineering services properly constitute a capital expenditure. Y does not place the factory into service until 1998. Therefore, a correlative adjustment increasing Y's basis in the factory does not affect Y's U.S. income tax liability for 1997. However, the correlative adjustment must be made in the books and records maintained by Y for its U.S. income tax purposes and such adjustment will be taken into account in computing Y's allowable depreciation or gain or loss on a subsequent disposition of the factory.

Example 3. In 1995, X, a U.S. corporation, makes a loan to Y, its foreign subsidiary not engaged in a U.S. trade or business. In 1997, the district director, upon determining that the interest charged on the loan was not arm's length, proposes to adjust X's income to reflect an arm's length interest rate. X consents to an assessment reflecting such allocation by executing Form 870, and an assessment of the tax with respect to the section 482 allocation is made in 1997. The district director notifies X in writing of the amount and nature of the correlative allocation to be made with respect to Y. Although the correlative adjustment does not have an effect on Y's U.S. income tax liability, the adjustment must be reflected in the documentation of Y that is maintained for U.S. tax purposes. Thus, the adjustment must be reflected in the determination of the amount of Y's earnings and profits for 1995 and subsequent years, and the adjustment must be made to the extent it has an effect on any person's U.S. income tax liability for any taxable year.

(3) *Adjustments to conform accounts to reflect section 482 allocations*—(i) *In general.* Appropriate adjustments must be made to conform a taxpayer's accounts to reflect allocations made under section 482. Such adjustments may include the treatment of an allocated amount as a dividend or a capital contribution (as appropriate), or, in appropriate cases, pursuant to such applicable revenue procedures as may be provided by the Commissioner (see §601.601(d)(2) of this chapter), repayment of the allocated amount without further income tax consequences.

(ii) *Example.* The following example illustrates the principles of this paragraph (g)(3).

Example. Conforming cash accounts. (i) USD, a United States corporation, buys Product from its foreign parent, FP. In reviewing USD's income tax return, the district director determines that the arm's length price would have increased USD's taxable income by $5 million. The district director accordingly adjusts USD's income to reflect its true taxable income.

(ii) To conform its cash accounts to reflect the section 482 allocation made by the district director, USD applies for relief under Rev. Proc. 65–17, 1965–1 C.B. 833 (see §601.601(d)(2)(ii)(*b*) of this chapter), to treat the $5 million adjustment as an account receivable from FP, due as of the last day of the year of the transaction, with interest accruing therefrom.

(4) *Setoffs*—(i) *In general.* If an allocation is made under section 482 with respect to a transaction between controlled taxpayers, the Commissioner will take into account the effect of any other non-arm's length transaction between the same controlled taxpayers in the same taxable year which will result in a setoff against the original section 482 allocation. Such setoff, however, will be taken into account only if the requirements of paragraph (g)(4)(ii) of this section are satisfied. If the effect of the setoff is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the U.S. tax liability of any member, adjustments will be made to reflect the correct amount of each category of income or deductions. For purposes of this setoff provision, the term arm's length refers to the amount defined in paragraph (b) of this section (arm's length standard), without regard to the rules in §1.482–2(a) that treat certain interest rates as arm's length rates of interest.

(ii) *Requirements.* The district director will take a setoff into account only if the taxpayer—

(A) Establishes that the transaction that is the basis of the setoff was not at arm's length and the amount of the appropriate arm's length charge;

(B) Documents, pursuant to paragraph (g)(2) of this section, all correlative adjustments resulting from the proposed setoff; and

(C) Notifies the district director of the basis of any claimed setoff within 30 days after the earlier of the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or the date of the issuance of the notice of deficiency.

(iii) *Examples.* The following examples illustrate this paragraph (g)(4).

Example 1. P, a U.S. corporation, renders construction services to S, its foreign subsidiary in Country Y, in connection with the construction of S's factory. An arm's length charge for such services determined under §1.482–9 would be $100,000. During the same taxable year P makes available to S the use of a machine to be used in the construction of the factory, and the arm's length rental value of the machine is $25,000. P bills S $125,000 for the services, but does not charge S for the use of the machine. No allocation will be made with respect to the undercharge for the machine if P notifies the district director of the basis of the claimed setoff within 30 days after the date of the letter from the district director transmitting the examination report notifying P of the proposed adjustment, establishes that the excess amount charged for services was equal to an arm's length charge for the use of the machine and that the taxable income and income tax liabilities of P are not distorted, and documents the correlative allocations resulting from the proposed setoff.

Example 2. The facts are the same as in *Example 1*, except that, if P had reported $25,000 as rental income and $25,000 less as service income, it would have been subject to the tax on personal holding companies. Allocations will be made to reflect the correct amounts of rental income and service income.

(h) *Special rules*—(1) *Small taxpayer safe harbor*. [Reserved]

(2) *Effect of foreign legal restrictions*—(i) *In general*. The district director will take into account the effect of a foreign legal restriction to the extent that such restriction affects the results of transactions at arm's length. Thus, a foreign legal restriction will be taken into account only to the extent that it is shown that the restriction affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time. In the absence of evidence indicating the effect of the foreign legal restriction on uncontrolled taxpayers, the restriction will be taken into account only to the extent provided in paragraphs (h)(2) (iii) and (iv) of this section (Deferred income method of accounting).

(ii) *Applicable legal restrictions*. Foreign legal restrictions (whether temporary or permanent) will be taken into account for purposes of this paragraph (h)(2) only if, and so long as, the conditions set forth in paragraphs (h)(2)(ii) (A) through (D) of this section are met.

(A) The restrictions are publicly promulgated, generally applicable to all similarly situated persons (both controlled and uncontrolled), and not imposed as part of a commercial transaction between the taxpayer and the foreign sovereign;

(B) The taxpayer (or other member of the controlled group with respect to which the restrictions apply) has exhausted all remedies prescribed by foreign law or practice for obtaining a waiver of such restrictions (other than remedies that would have a negligible prospect of success if pursued);

(C) The restrictions expressly prevented the payment or receipt, in any form, of part or all of the arm's length amount that would otherwise be required under section 482 (for example, a restriction that applies only to the deductibility of an expense for tax purposes is not a restriction on payment or receipt for this purpose); and

(D) The related parties subject to the restriction did not engage in any arrangement with controlled or uncontrolled parties that had the effect of circumventing the restriction, and have not otherwise violated the restriction in any material respect.

(iii) *Requirement for electing the deferred income method of accounting*. If a foreign legal restriction prevents the payment or receipt of part or all of the arm's length amount that is due with respect to a controlled transaction, the restricted amount may be treated as deferrable if the following requirements are met—

(A) The controlled taxpayer establishes to the satisfaction of the district director that the payment or receipt of the arm's length amount was prevented because of a foreign legal restriction and circumstances described in paragraph (h)(2)(ii) of this section; and

(B) The controlled taxpayer whose U.S. tax liability may be affected by the foreign legal restriction elects the deferred income method of accounting, as described in paragraph (h)(2)(iv) of this section, on a written statement attached to a timely U.S. income tax return (or an amended return) filed before the IRS first contacts any member of the controlled group concerning an examination of the return for the taxable year to which the foreign legal restriction applies. A written statement furnished by a taxpayer subject to the Coordinated Examination Program will be considered an amended return for purposes of this paragraph (h)(2)(iii)(B) if it satisfies the requirements of a qualified amended return for purposes of §1.6664–2(c)(3) as set forth in those regulations or as the Commissioner may prescribe by applicable revenue procedures. The election statement must identify the affected transactions, the parties to the transactions, and the applicable foreign legal restrictions.

(iv) *Deferred income method of accounting*. If the requirements of paragraph (h)(2)(ii) of this section are satisfied, any portion of the arm's length amount, the payment or receipt of which is prevented because of applicable foreign legal restrictions, will be treated as deferrable until payment or receipt of the relevant item ceases to be prevented by the foreign legal restriction. For purposes of the deferred income method of accounting under this paragraph (h)(2)(iv), deductions (including the cost or other basis of inventory and other assets sold or exchanged) and credits properly chargeable against any amount so deferred, are subject to deferral under the provisions of §1.461- 1(a)(4). In addition, income is deferrable under this deferred income method of accounting only to the extent that it exceeds the related deductions already claimed in open taxable years to which the foreign legal restriction applied.

(v) *Examples*. The following examples, in which Sub is a Country FC subsidiary of U.S. corporation, Parent, illustrate this paragraph (h)(2).

Example 1. Parent licenses an intangible to Sub. FC law generally prohibits payments by any person within FC to recipients outside the country. The FC law meets the requirements of paragraph (h)(2)(ii) of this section. There is no evidence of unrelated parties entering into transactions under comparable circumstances for a comparable period of time, and the foreign legal restrictions will not be taken into account in determining the arm's length amount. The arm's length royalty rate for the use of the intangible property in the absence of the foreign restriction is 10% of Sub's sales in country FC. However, because the requirements of paragraph (h)(2)(ii) of this section are satisfied, Parent can elect the deferred income method of accounting by attaching to its timely filed U.S. income tax return a written statement that satisfies the requirements of paragraph (h)(2)(iii)(B) of this section.

Example 2. (i) The facts are the same as in *Example 1*, except that Sub, although it makes no royalty payment to Parent, arranges with an unrelated intermediary to make payments equal to an arm's length amount on its behalf to Parent.

(ii) The district director makes an allocation of royalty income to Parent, based on the arm's length royalty rate of 10%. Further, the district director determines that because the arrangement with the third party had the effect of circumventing the FC law, the requirements of paragraph (h)(2)(ii)(D) of this section are not satisfied. Thus, Parent could not validly elect the deferred income method of accounting, and the allocation of royalty income cannot be treated as deferrable. In appropriate circumstances, the district director may permit the amount of the distribution to be treated as payment by Sub of the royalty allocated to Parent, under the provisions of §1.482–1(g) (Collateral adjustments).

Example 3. The facts are the same as in *Example 1*, except that the laws of FC do not prevent distributions from corporations to their shareholders. Sub distributes an amount equal to 8% of its sales in country FC. Because the laws of FC did not expressly prevent all forms of payment from Sub to Parent, Parent cannot validly elect the deferred income method of accounting with respect to any of the arm's length royalty amount. In appropriate circumstances, the district director may permit the 8% that was distributed to be treated as payment by Sub of the royalty allocated to Parent, under the provisions of §1.482–1(g) (Collateral adjustments).

Example 4. The facts are the same as in *Example 1*, except that Country FC law permits the payment of a royalty, but limits the amount to 5% of sales, and Sub pays the 5% royalty to Parent. Parent demonstrates the existence of a comparable uncontrolled transaction for purposes of the comparable uncontrolled transaction method in which an uncontrolled party accepted a royalty rate of 5%. Given the evidence of the comparable uncontrolled transaction, the 5% royalty rate is determined to be the arm's length royalty rate.

(3) *Coordination with section 936*—(i) *Cost sharing under section 936*. If a possessions corporation makes an election under section 936(h)(5)(C)(i)(I), the corporation must make a section 936 cost sharing payment that is at least equal to the payment that would be required under section 482 if the electing corporation were a foreign corporation. In determining the payment that would be required under section 482 for this purpose, the provisions of §§1.482–1 and

1.482–4 will be applied, and to the extent relevant to the valuation of intangibles, §§1.482–5 and 1.482–6 will be applied. The provisions of section 936(h)(5)(C)(i)(II) (Effect of Election—electing corporation treated as owner of intangible property) do not apply until the payment that would be required under section 482 has been determined.

(ii) *Use of terms.* A cost sharing payment, for the purposes of section 936(h)(5)(C)(i)(I), is calculated using the provisions of section 936 and the regulations thereunder and the provisions of this paragraph (h)(3). The provisions relating to cost sharing under section 482 do not apply to payments made pursuant to an election under section 936(h)(5)(C)(i)(I). Similarly, a profit split payment, for the purposes of section 936(h)(5)(C)(ii)(I), is calculated using the provisions of section 936 and the regulations thereunder, not section 482 and the regulations thereunder.

(i) *Definitions.* The definitions set forth in paragraphs (i)(1) through (i)(10) of this section apply to this section and §§1.482–2 through 1.482–9.

(1) *Organization* includes an organization of any kind, whether a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place of organization, operation, or conduct of the trade or business, and regardless of whether it is a domestic or foreign organization, whether it is an exempt organization, or whether it is a member of an affiliated group that files a consolidated U.S. income tax return, or a member of an affiliated group that does not file a consolidated U.S. income tax return.

(2) *Trade* or *business* includes a trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place of operation. Employment for compensation will constitute a separate trade or business from the employing trade or business.

(3) *Taxpayer* means any person, organization, trade or business, whether or not subject to any internal revenue tax.

(4) *Controlled* includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(5) *Controlled taxpayer* means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers. *Uncontrolled taxpayer* means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests.

(6) *Group, controlled group,* and *group of controlled taxpayers* mean the taxpayers owned or controlled directly or indirectly by the same interests.

(7) *Transaction* means any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented. A transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer.

(8) *Controlled transaction* or *controlled transfer* means any transaction or transfer between two or more members of the same group of controlled taxpayers. The term *uncontrolled transaction* means any transaction between two or more taxpayers that are not members of the same group of controlled taxpayers.

(9) *True taxable income* means, in the case of a controlled taxpayer, the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. It does not mean the taxable income resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement the controlled taxpayer chose to make (even though such contract, transaction, or arrangement is legally binding upon the parties thereto).

(10) *Uncontrolled comparable* means the uncontrolled transaction or uncontrolled taxpayer that is compared with a controlled transaction or taxpayer under any applicable pricing methodology. Thus, for example, under the comparable profits method, an uncontrolled comparable is any uncontrolled taxpayer from which data is used to establish a comparable operating profit.

(j) *Effective dates*—(1) The regulations in this are generally effective for taxable years beginning after October 6, 1994.

(2) Taxpayers may elect to apply retroactively all of the provisions of these regulations for any open taxable year. Such election will be effective for the year of the election and all subsequent taxable years.

(3) Although these regulations are generally effective for taxable years as stated, the final sentence of section 482 (requiring that the income with respect to transfers or licenses of intangible property be commensurate with the income attributable to the intangible) is generally effective for taxable years beginning after December 31, 1986. For the period prior to the effective date of these regulations, the final sentence of section 482 must be applied using any reasonable method not inconsistent with the statute. The IRS considers a method that applies these regulations or their general principles to be a reasonable method.

(4) These regulations will not apply with respect to transfers made or licenses granted to foreign persons before November 17, 1985, or before August 17, 1986, for transfers or licenses to others. Nevertheless, they will apply with respect to transfers or licenses before such dates if, with respect to property transferred pursuant to an earlier and continuing transfer agreement, such property was not in existence or owned by the taxpayer on such date.

(5) The last sentences of paragraphs (b)(2)(i) and (c)(1) of this section and of paragraph (c)(2)(iv) of §1.482–5 apply for taxable years beginning on or after August 26, 2003.

(6)(i) The provisions of paragraphs (a)(1), (d)(3)(ii)(C) *Example 3*, *Example 4*, *Example 5*, and *Example 6*, (d)(3)(v), (f)(2)(ii)(A), (f)(2)(iii)(B), (g)(4)(i), (g)(4)(iii), and (i) of this section are generally applicable for taxable years beginning after July 31, 2009. The provision of paragraph (b)(2)(iii) of this section is generally applicable on January 5, 2009.

(ii) A person may elect to apply the provisions of paragraphs (a)(1), (b)(2)(i), (d)(3)(ii)(C) *Example 3*, *Example 4*, *Example 5*, and *Example 6*, (d)(3)(v), (f)(2)(ii)(A), (f)(2)(iii)(B), (g)(4)(i), (g)(4)(iii), and (i) of this section to earlier taxable years in accordance with the rules set forth in §1.482–9(n)(2).

(7) [Reserved]. For further guidance see §1.482–1T(j)(7).

[T.D. 8552, 59 FR 34990, July 8, 1994, as amended by T.D. 9088, 68 FR 51177, Aug. 26, 2003; T.D. 9278, 71 FR 44481, Aug. 4, 2006; 71 FR 76903, Dec. 22, 2006; T.D. 9441, 74 FR 351, Jan. 5, 2009; T.D. 9456, 74 FR 38839, Aug. 4, 2009; 74 FR 46345, Sept. 9, 2009; T.D. 9568, 76 FR 80089, Dec. 22, 2011; 77 FR 3606, Jan. 25, 2012; T.D. 9738, 80 FR 55541, Sept. 16, 2015]

§1.482–1T Allocation of income and deductions among taxpayers (temporary).

(a) through (f)(2) [Reserved]. For further guidance see §1.482–1(a) through (f)(2).

(i) *Compensation independent of the form or character of controlled transaction*—(A) *In general.* All value provided between controlled taxpayers in a controlled transaction requires an arm's length amount of compensation determined under the best method rule of §1.482–1(c). Such amount must be consistent with, and must account for all of, the value provided between the parties in the transaction, without regard to the form or character of the transaction. For this purpose, it is necessary to consider the entire arrangement between the parties, as determined by the contractual terms, whether written or imputed in accordance with the economic substance of the arrangement, in light of the actual conduct of the parties. See, e.g., §1.482–1(d)(3)(ii)(B) (identifying contractual terms) and (f)(2)(ii)(A) (regarding reference to realistic alternatives).

(B) *Aggregation.* The combined effect of two or more separate transactions (whether before, during, or after the year under review), including for purposes of an analysis under multiple provisions of the Code or regulations, may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis of the transactions provides the most reliable measure of an arm's length result determined under the best method rule of §1.482–1(c). Whether two or more transactions are evaluated separately or in the aggregate depends on the extent to which the transactions are economically interrelated and on the relative reliability of the measure of an arm's length result provided by an aggregate analysis of the transactions as compared to a separate analysis of each transaction. For example, consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation in the transactions is consistent with the value provided, including any synergies among items and services provided.

(C) *Coordinated best method analysis and evaluation*. Consistent with the principles of paragraphs (f)(2)(i)(A) and (B) of this section, a coordinated best method analysis and evaluation of two or more controlled transactions to which one or more provisions of the Code or regulations apply may be necessary to ensure that the overall value provided, including any synergies, is properly taken into account. A coordinated best method analysis would include a consistent consideration of the facts and circumstances of the functions performed, resources employed, and risks assumed in the relevant transactions, and a consistent measure of the arm's length results, for purposes of all relevant statutory and regulatory provisions.

(D) *Allocations of value*. In some cases, it may be necessary to allocate one or more portions of the arm's length result that was properly determined under a coordinated best method analysis described in paragraph (f)(2)(i)(C) of this section. Any such allocation of the arm's length result determined under the coordinated best method analysis must be made using the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result for each allocated amount. For example, if the full value of compensation due in controlled transactions whose tax treatment is governed by multiple provisions of the Code or regulations has been most reliably determined on an aggregate basis, then that full value must be allocated in a manner that provides the most reliable measure of each allocated amount.

(E) *Examples*. The following examples illustrate the provisions of this paragraph (f)(2)(i). For purposes of the examples in this paragraph (E), P is a domestic corporation, and S1, S2, and S3 are foreign corporations that are wholly owned by P.

Example 1. Aggregation of interrelated licensing, manufacturing, and selling activities. P enters into a license agreement with S1 that permits S1 to use a proprietary manufacturing process and to sell the output from this process throughout a specified region. S1 uses the manufacturing process and sells its output to S2, which in turn resells the output to uncontrolled parties in the specified region. In evaluating whether the royalty paid by S1 to P is an arm's length amount, it may be appropriate to evaluate the royalty in combination with the transfer prices charged by S1 to S2 and the aggregate profits earned by S1 and S2 from the use of the manufacturing process and the sale to uncontrolled parties of the products produced by S1.

Example 2. Aggregation of interrelated manufacturing, marketing, and services activities. S1 is the exclusive Country Z distributor of computers manufactured by P. S2 provides marketing services in connection with sales of P computers in Country Z and in this regard uses significant marketing intangibles provided by P. S3 administers the warranty program with respect to P computers in Country Z, including maintenance and repair services. In evaluating whether the transfer prices paid by S1 to P, the fees paid by S2 to P for the use of P marketing intangibles, and the service fees earned by S2 and S3 are arm's length amounts, it would be appropriate to perform an aggregate analysis that considers the combined effects of these interrelated transactions if they are most reliably analyzed on an aggregated basis.

Example 3. Aggregation and reliability of comparable uncontrolled transactions. The facts are the same as in *Example 2*. In addition, U1, U2, and U3 are uncontrolled taxpayers that carry out functions comparable to those of S1, S2, and S3, respectively, with respect to computers produced by unrelated manufacturers. R1, R2, and R3 constitute a controlled group of taxpayers (unrelated to the P controlled group) that carry out functions comparable to those of S1, S2, and S3 with respect to computers produced by their common parent. Prices charged to uncontrolled customers of the R group differ from the prices charged to customers of U1, U2, and U3. In determining whether the transactions of U1, U2, and U3, or the transactions of R1, R2, and R3, would provide a more reliable measure of the arm's length result, it is determined that the interrelated R group transactions are more reliable than the wholly independent transactions of U1, U2, and U3, given the interrelationship of the P group transactions.

Example 4. Non-aggregation of transactions that are not interrelated. P enters into a license agreement with S1 that permits S1 to use a proprietary process for manufacturing product X and to sell product X to uncontrolled parties throughout a specified region. P also sells to S1 product Y, which is manufactured by P in the United States and unrelated to product X. Product Y is resold by S1 to uncontrolled parties in the specified region. There is no connection between product X and product Y other than the fact that they are both sold in the same specified region. In evaluating whether the royalty paid by S1 to P for the use of the manufacturing process for product X and the transfer prices charged for unrelated product Y are arm's length amounts, it would not be appropriate to consider the combined effects of these separate and unrelated transactions.

Example 5. Aggregation of interrelated patents. P owns 10 individual patents that, in combination, can be used to manufacture and sell a successful product. P anticipates that it could earn profits of $25x from the patents based on a discounted cash flow analysis that provides a more reliable measure of the value of the patents exploited as a bundle rather than separately. P licenses all 10 patents to S1 to be exploited as a bundle. Evidence of uncontrolled licenses of similar individual patents indicates that, exploited separately, each license of each patent would warrant a price of $1x, implying a total price for the patents of $10x. Under paragraph (f)(2)(i)(B) of this section, in determining the arm's length royalty for the license of the bundle of patents, it would not be appropriate to use the uncontrolled licenses as comparables for the license of the bundle of patents, because, unlike the discounted cash flow analysis, the uncontrolled licenses considered separately do not reliably reflect the enhancement to value resulting from the interrelatedness of the 10 patents exploited as a bundle.

Example 6. Consideration of entire arrangement, including imputed contractual terms—(i) P conducts a business (''Business'') from the United States, with a worldwide clientele, but until Date X has no foreign operations. The success of Business significantly depends on intangibles (including marketing, manufacturing, technological, and goodwill or going concern value intangibles, collectively the ''IP''), as well as ongoing support activities performed by P (including related research and development, central marketing, manufacturing process enhancement, and oversight activities, collectively ''Support''), to maintain and improve the IP and otherwise maximize the profitability of Business.

(ii) On Date X, Year 1, P contributes the foreign rights to conduct Business, including the foreign rights to the IP, to newly incorporated S1. S1, utilizing the IP of which it is now the owner, commences foreign operations consisting of local marketing, manufacturing, and back office activities in order to conduct and expand Business in the foreign market.

(iii) Later, on Date Y, Year 1, P and S1 enter into a cost sharing arrangement (''CSA'') to develop and exploit the rights to conduct the Business. Under the CSA, P is entitled to the U.S. rights to conduct the Business, and S1 is entitled to the rest-of-the-world (''ROW'') rights to conduct the Business. P continues after Date Y to perform the Support, employing resources, capabilities, and rights that as a factual matter were not contributed to S1 in the Date X transaction, for the benefit of the Business worldwide. Pursuant to the CSA, P and S1 share the costs of P's Support in proportion to their reasonably anticipated benefit shares from their respective rights to the Business.

(iv) P treats the Date X transaction as a transfer described in section 351 that is subject to 367 and treats the Date Y transaction as the commencement of a CSA subject to section 482 and §1.482–7. P takes the position that the only platform contribution transactions (''PCTs'') in connection with the Date Y CSA consist of P's contribution of the U.S. Business IP rights and S1's contribution of the ROW Business IP rights of which S1 had become the owner on account of the prior Date X transaction.

(v) Pursuant to paragraph (f)(2)(i)(A) of this section, in determining whether an allocation of income is appropriate in Year 1 or subsequent years, the Commissioner may consider the economic substance of the entire arrangement between P and S1, including the parties' actual conduct throughout their relationship, regardless of the form or character of the contractual arrangement the parties have expressly adopted. The Commissioner determines that the parties' formal arrangement fails to reflect the full scope of the value provided between the parties in accordance with the economic substance of their arrangement. Therefore, the Commissioner may impute one or more agreements between P and S1, consistent with the economic substance of their arrangement, that fully reflect their respective reasonably anticipated commitments in terms of functions performed, resources employed, and risks assumed over time. For example, because P continues after Date Y to perform the Support, employing resources, capabilities, and rights not contributed to S1, for the benefit of the Business worldwide, the Commissioner may impute another PCT on Date Y pursuant to which P commits to so continuing the Support. See §1.482–7(b)(1)(ii). The taxpayer may present additional facts that could indicate whether this or another alternative agreement best reflects the economic substance of the underlying transactions and course of conduct, provided that the taxpayer's position fully reflects the value of the entire arrangement consistent with the realistic alternatives principle.

Example 7. Distinguishing provision of value from characterization—(i) P developed a collection of resources, capabilities, and rights (''Collection'') that it uses on an interrelated basis in ongoing research and development of computer code that is used to create a successful line of software products. P can continue to use the Collection on such interrelated basis in the future to further develop computer code and, thus, further build on its successful line of software products. Under §1.482–7(g)(2)(ix), P determines that the interquartile range of the net present value of its own use of the Collection in future research and development and software product marketing is between $1000x and $1100x, and this range provides the most reliable measure of the value to P of continuing to use the Collection on an interrelated basis in future research, development, and exploitation. Instead, P enters into an exchange described in section 351 in which it transfers certain intangible property related to the Collection to S1 for use in future research, development, and exploitation but continues to perform the same development functions that it did prior to the exchange, now on behalf of S1, under express or implied commitments in connection with S1's use of the intangible property. P takes the position that a portion of the Collection, consisting of computer code and related instruction manuals and similar intangible property (Portion 1), was transferrable intangible property and was the subject of the section 351 exchange and compensable under section 367(d). P claims that another portion of the Collection consists of items that either do not constitute property for purposes of section 367 or are not transferrable (Portion 2). P then takes the position that the value of Portion 2 does not give rise to income under section 367(d) or gain under section 367(a).

(ii) Under paragraphs (f)(2)(i)(A) and (C) of this section, any part of the value in Portion 2 that is not taken into account in an exchange under section 367 must nonetheless be evaluated under section 482 and the regulations thereunder to determine arm's length compensation for any value provided to S1. Accordingly, even if P's assertion that certain items were either not property or not capable of being transferred were correct, arm's length compensation is nonetheless required for all of the value associated with P's contributions under the section 482 regulations. Alternatively, the Commissioner may determine under all the facts and circumstances that P's assertion is incorrect and that the transaction in fact constitutes an exchange of property subject to, and therefore to be taken into account under, section 367. Thus, whether any item that P identifies as being within Portion 2 is properly characterized as property under section 367 (transferable or otherwise) is irrelevant because any value in Portion 2 that is provided to S1 must be compensated by S1 in a manner consistent with the $1000x to $1100x interquartile range of the overall value.

Example 8. Arm's length compensation for equivalent provisions of intangibles under sections 351 and 482. P owns the worldwide rights to manufacturing and marketing intangibles that it uses to manufacture and market a product in the United States (''US intangibles'') and the rest of the world (''ROW intangibles''). P transfers all the ROW intangibles to S1 in an exchange described in section 351 and retains the US intangibles. Immediately after the exchange, P and S1 entered into a CSA described in §1.482–7(b) that covers all research and development of intangibles conducted by the parties. A realistic alternative that was available to P and that would have involved the controlled parties performing similar functions, employing similar resources, and assuming similar risks as in the controlled transaction, was to transfer all ROW intangibles to S1 upon entering into the CSA in a platform contribution transaction described in §1.482–7(c), rather than in an exchange described in section 351 immediately before entering into the CSA. Under paragraph (f)(2)(i)(A) of this section, the arm's length compensation for the ROW intangibles must correspond to the value provided between the parties, regardless of the form of the transaction. Accordingly, the arm's length compensation for the ROW intangibles is the same in both scenarios, and the analysis of the amount to be taken into account under section 367(d) pursuant to §§1.367(d)–1T(c) and 1.482–4 should include consideration of the amount that P would have charged for the realistic alternative determined under §1.482–7(g) (and §1.482–4, to the extent of any make-or-sell rights transferred). See §§1.482–1(b)(2)(iii) and 1.482–4(g).

Example 9. Aggregation of interrelated manufacturing and marketing intangibles governed by different statutes and regulations. The facts are the same as in *Example 8* except that P transfers only the ROW intangibles related to manufacturing to S1 in an exchange described in section 351 and, upon entering into the CSA, then transfers the ROW intangibles related to marketing to S1 in a platform contribution transaction described in §1.482–7(c) (rather than transferring all ROW intangibles only upon entering into the CSA or only in a prior exchange described in section 351). The value of the ROW intangibles that P transferred in the two transactions is greater in the aggregate, due to synergies among the different types of ROW intangibles, than if valued as two separate transactions. Under paragraph (f)(2)(i)(B) of this section, the arm's length standard requires these synergies to be taken into account in determining the arm's length results for the transactions.

Example 10. Services provided using intangibles.—(i) P's worldwide group produces and markets Product X and subsequent generations of products, which result from research and development performed by P's R&D Team. Through this collaboration with respect to P's proprietary products, the members of the R&D Team have individually and as a group acquired specialized knowledge and expertise subject to non-disclosure agreements (collectively, ''knowhow'').

(ii) P arranges for the R&D Team to provide research and development services to create a new line of products, building on the Product X platform, to be owned and exploited by S1 in the overseas market. P asserts that the arm's length charge for the services is only reimbursement to P of its associated R&D Team compensation costs.

(iii) Even though P did not transfer the platform or the R&D Team to S1, P is providing value associated with the use of the platform, along with the value associated with the use of the knowhow, to S1 by way of the services performed by the R&D Team for S1 using the platform and the knowhow. The R&D Team's use of intangible property, and any other valuable resources, in P's provision of services (regardless of whether the service effects a transfer of intangible property or valuable resources and regardless of whether the property is relatively high or low value) must be evaluated under the section 482 regulations, including the regulations specifically applicable to controlled services transactions in §1.482–9, to ensure that P receives arm's length compensation for any value (attributable to such property or services) provided to S1 in a controlled transaction. See §§1.482–4 and 1.482–9(m). Under paragraph (f)(2)(i)(A) of this section, the arm's length compensation for the services performed by the R&D Team for S1 must be consistent with the value provided to S1, including the value of the knowhow and any synergies with the platform. Under paragraphs (f)(2)(i)(B) and (C) of this section, the best method analysis may determine that the compensation is most reliably determined on an aggregate basis reflecting the interrelated value of the services and embedded value of the platform and knowhow.

(iv) In the alternative, the facts are the same as above, except that P assigns to S1 all or a pertinent portion of the R&D Team and the relevant rights in the platform. P takes the position that, although the transferred platform rights must be compensated, the knowhow does not have substantial value independent of the services of any individual on the R&D Team and therefore is not an intangible within the meaning of §1.482–4(b). In P's view, S1 owes no compensation to P on account of the R&D Team, as S1 will directly bear the cost of the relevant R&D Team compensation. However, in assembling and arranging to assign the relevant R&D Team, and thereby making available the value of the knowhow to S1, rather than other employees without the knowhow, P is performing services for S1 under imputed contractual terms based on the parties' course of conduct. Therefore, even if P's position were correct that the knowhow is not an intangible under §1.482–4(b), a position that the Commissioner may challenge, arm's length compensation is required for all of the value that P provides to S1 through the interrelated provision of platform rights, knowhow, and services under paragraphs (f)(2)(i)(A), (B), and (C) of this section.

Example 11. Allocating arm's length compensation determined under an aggregate analysis—(i) P provides services to S1, which is incorporated in Country A. In connection with those services, P licenses intellectual property to S2, which is incorporated in Country B. S2 sublicenses the intellectual property to S1.

(ii) Under paragraph (f)(2)(i)(B) of this section, if an aggregate analysis of the service and license transactions provides the most reliable measure of an arm's length result, then an aggregate analysis must be performed. Under paragraph (f)(2)(i)(D) of this section, if an allocation of the value that results from such an aggregate analysis is necessary, for example, for purposes of sourcing the services income that P receives from S1 or determining deductible expenses incurred by S1, then the value determined under the aggregate analysis must be allocated using the method that provides the most reliable measure of the services income and deductible expenses.

(ii)(A) [Reserved]. For further guidance see §1.482–1(f)(2)(ii)(A).

(B) *Example*. The following example illustrates this paragraph (f)(2)(ii):

Example. P and S are controlled taxpayers. P licenses a proprietary process to S for S's use in manufacturing product X. Using its sales and marketing employees, S sells product X to related and unrelated customers outside the United States. If the license between P and S has economic substance, the Commissioner ordinarily will not restructure the taxpayer's transaction to treat P as if it had elected to exploit directly the manufacturing process. However, because P could have directly exploited the manufacturing process and manufactured product X itself, this realistic alternative may be taken into account under § 1.482–4(d) in determining the arm's length consideration for the controlled transaction. For examples of such an analysis, see *Examples 7* and *8* in paragraph (f)(2)(i)(E) of this section and the *Example* in § 1.482–4(d)(2).

(iii) through (j)(6) [Reserved]. For further guidance see § 1.482–1(f)(2)(iii) through (j)(6).

(7) *Certain effective/applicability dates*—(i) Paragraphs (f)(2)(i)(A) through (E) and (f)(2)(ii)(B) of this section apply to taxable years ending on or after September 14, 2015.

(ii) *Expiration date.* The applicability of paragraphs (f)(2)(i)(A) through (E) and (f)(2)(ii)(B) of this section expires on or before September 14, 2018.

[T.D. 9738, 80 FR 55541, Sept. 16, 2015]

§ 1.482–2 Determination of taxable income in specific situations.

(a) *Loans or advances*—(1) *Interest on bona fide indebtedness*—(i) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.

(ii) *Application of paragraph (a) of this section*—(A) *Interest on bona fide indebtedness.* Paragraph (a) of this section applies only to determine the appropriateness of the rate of interest charged on the principal amount of a bona fide indebtedness between members of a group of controlled entities, including—

(*1*) Loans or advances of money or other consideration (whether or not evidenced by a written instrument); and

(*2*) Indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.

(B) *Alleged indebtedness.* This paragraph (a) does not apply to so much of an alleged indebtedness which is not in fact a bona fide indebtedness, even if the stated rate of interest thereon would be within the safe haven rates prescribed in paragraph (a)(2)(iii) of this section. For example, paragraph (a) of this section does not apply to payments with respect to all or a portion of such alleged indebtedness where in fact all or a portion of an alleged indebtedness is a contribution to the capital of a corporation or a distribution by a corporation with respect to its shares. Similarly, this paragraph (a) does not apply to payments with respect to an alleged purchase-money debt instrument given in consideration for an alleged sale of property between two controlled entities where in fact the transaction constitutes a lease of the property. Payments made with respect to alleged indebtedness (including alleged stated interest thereon) shall be treated according to their substance. See § 1.482–2(a)(3)(i).

(iii) *Period for which interest shall be charged*—(A) *General rule.* This paragraph (a)(1)(iii) is effective for indebtedness arising after June 30, 1988. See § 1.482–2(a)(3) (26 CFR Part 1 edition revised as of April 1, 1988) for indebtedness arising before July 1, 1988. Except as otherwise provided in paragraphs (a)(1)(iii)(B) through (E) of this section, the period for which interest shall be charged with respect to a bona fide indebtedness between controlled entities begins on the day after the day the indebtedness arises and ends on the day the indebtedness is satisfied (whether by payment, offset, cancellation, or otherwise). Paragraphs (a)(1)(iii)(B) through (E) of this section provide certain alternative periods during which interest is not required to be charged on certain indebtedness. These exceptions apply only to indebtedness described in paragraph (a)(1)(ii)(A)(*2*) of this section (relating to indebtedness incurred in the ordinary course of business from sales, services, etc., between members of the group) and not evidenced by a written instrument requiring the payment of interest. Such amounts are hereinafter referred to as intercompany trade receivables. The period for which interest is not required to be charged on intercompany trade receivables under this paragraph (a)(1)(iii) is called the interest-free period. In general, an intercompany trade receivable arises at the time economic performance occurs (within the meaning of section 461(h) and the regulations thereunder) with respect to the underlying transaction between controlled entities. For purposes of this paragraph (a)(1)(iii), the term United States includes any possession of the United States, and the term foreign country excludes any possession of the United States.

(B) *Exception for certain intercompany transactions in the ordinary course of business.* Interest is not required to be charged on an intercompany trade receivable until the first day of the third calendar month following the month in which the intercompany trade receivable arises.

(C) *Exception for trade or business of debtor member located outside the United States.* In the case of an intercompany trade receivable arising from a transaction in the ordinary course of a trade or business which is actively conducted outside the United States by the debtor member, interest is not required to be charged until the first day of the fourth calendar month following the month in which such intercompany trade receivable arises.

(D) *Exception for regular trade practice of creditor member or others in creditor's industry.* If the creditor member or unrelated persons in the creditor member's industry, as a regular trade practice, allow unrelated parties a longer period without charging interest than that described in paragraph (a)(1)(iii)(B) or (C) of this section (whichever is applicable) with respect to transactions which are similar to transactions that give rise to intercompany trade receivables, such longer interest-free period shall be allowed with respect to a comparable amount of intercompany trade receivables.

(E) *Exception for property purchased for resale in a foreign country*—*(1) General rule.* If in the ordinary course of business one member of the group (related purchaser) purchases property from another member of the group (related seller) for resale to unrelated persons located in a particular foreign country, the related purchaser and the related seller may use as the interest-free period for the intercompany trade receivables arising during the related seller's taxable year from the purchase of such property within the same product group an interest-free period equal the sum of—

(*i*) The number of days in the related purchaser's average collection period (as determined under paragraph (a)(1)(iii)(E)(*2*) of this section) for sales of property within the same product group sold in the ordinary course of business to unrelated persons located in the same foreign country; plus

(*ii*) Ten (10) calendar days.

(*2*) *Interest-free period.* The interest-free period under this paragraph (a)(1)(iii)(E), however, shall in no event exceed 183 days. The related purchaser does not have to conduct business outside the United States in order to be eligible to use the interest-free period of this paragraph (a)(1)(iii)(E). The interest-free period under this paragraph (a)(1)(iii)(E) shall not apply to intercompany trade receivables attributable to property which is manufactured, produced, or constructed (within the meaning of §1.954–3(a)(4)) by the related purchaser. For purposes of this paragraph (a)(1)(iii)(E) a product group includes all products within the same three-digit Standard Industrial Classification (SIC) Code (as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.)

(*3*) *Average collection period.* An average collection period for purposes of this paragraph (a)(1)(iii)(E) is determined as follows—

(*i*) *Step 1.* Determine total sales (less returns and allowances) by the related purchaser in the product group to unrelated persons located in the same foreign country during the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(*ii*) *Step 2.* Determine the related purchaser's average month-end accounts receivable balance with respect to sales described in paragraph (a)(1)(iii)(E)(*2*)(*i*) of this section for the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(*iii*) *Step 3*. Compute a receivables turnover rate by dividing the total sales amount described in paragraph (a)(1)(iii)(E)(*2*)(*i*) of this section by the average receivables balance described in paragraph (a)(1)(iii)(E)(*2*)(*ii*) of this section.

(*iv*) *Step 4*. Divide the receivables turnover rate determined under paragraph (a)(1)(iii)(E)(*2*)(*iii*) of this section into 365, and round the result to the nearest whole number to determine the number of days in the average collection period.

(*v*) *Other considerations*. If the related purchaser makes sales in more than one foreign country, or sells property in more than one product group in any foreign country, separate computations of an average collection period, by product group within each country, are required. If the related purchaser resells fungible property in more than one foreign country and the intercompany trade receivables arising from the related party purchase of such fungible property cannot reasonably be identified with resales in particular foreign countries, then solely for the purpose of assigning an interest-free period to such intercompany trade receivables under this paragraph (a)(1)(iii)(E), an amount of each such intercompany trade receivable shall be treated as allocable to a particular foreign country in the same proportion that the related purchaser's sales of such fungible property in such foreign country during the period described in paragraph (a)(1)(iii)(E)(2)(i) of this section bears to the related purchaser's sales of all such fungible property in all such foreign countries during such period. An interest-free period under this paragraph (a)(1)(iii)(E) shall not apply to any intercompany trade receivables arising in a taxable year of the related seller if the related purchaser made no sales described in paragraph (a)(1)(iii)(E)(2)(i) of this section from which the appropriate interest-free period may be determined.

(*4*) *Illustration*. The interest-free period provided under paragraph (a)(1)(iii)(E) of this section may be illustrated by the following example:

Example. (i)*Facts*. X and Y use the calendar year as the taxable year and are members of the same group of controlled entities within the meaning of section 482. For Y's 1988 calendar taxable year X and Y intend to use the interest-free period determined under this paragraph (a)(1)(iii)(E) for intercompany trade receivables attributable to X's purchases of certain products from Y for resale by X in the ordinary course of business to unrelated persons in country Z. For its 1987 calendar taxable year all of X's sales in country Z were of products within a single product group based upon a three-digit SIC code, were not manufactured, produced, or constructed (within the meaning of §1.954–3(a)(4)) by X, and were sold in the ordinary course of X's trade or business to unrelated persons located only in country Z. These sales and the month-end accounts receivable balances (for such sales and for such sales uncollected from prior months) are as follows:

Month	Sales	Accounts receivable
Jan. 1987	$500,000	$2,835,850
Feb.	600,000	2,840,300
Mar.	450,000	2,850,670
Apr.	550,000	2,825,700
May.	650,000	2,809,360
June	525,000	2,803,200
July	400,000	2,825,850
Aug.	425,000	2,796,240
Sept.	475,000	2,839,390
Oct.	525,000	2,650,550
Nov.	450,000	2,775,450
Dec. 1987	650,000	2,812,600
Totals	6,200,000	33,665,160

(ii) *Average collection period*. X's total sales within the same product group to unrelated persons within country Z for the period are $6,200,000. The average receivables balance for the period is $2,805,430 ($33,665,160/12). The average collection period in whole days is determined as follows:

$$\text{Receivables Turnover Rate} = \frac{\$6{,}200{,}000}{\$2{,}805{,}430} = 2.21$$

$$\text{Average Collection Period} = \frac{365}{2.21} = \text{165.16 days, rounded to the nearest whole day} = 165 \text{ days.}$$

(iii) *Interest-free period.* Accordingly, for intercompany trade receivables incurred by X during Y's 1988 calendar taxable year attributable to the purchase of property from Y for resale to unrelated persons located in country Z and included in the product group, X may use an interest-free period of 175 days (165 days in the average collection period plus 10 days, but not in excess of a maximum of 183 days). All other intercompany trade receivables incurred by X are subject to the interest-free periods described in paragraphs (a)(1)(iii) (B), (C), or (D), whichever are applicable. If X makes sales in other foreign countries in addition to country Z or makes sales of property in more than one product group in any foreign country, separate computations of X's average collection period, by product group within each country, are required in order for X and Y to determine an interest-free period for such product groups in such foreign countries under this paragraph (a)(1)(iii)(E).

(iv) *Payment; book entries*—(A) Except as otherwise provided in this paragraph (a)(1)(iv), in determining the period of time for which an amount owed by one member of the group to another member is outstanding, payments or other credits to an account are considered to be applied against the earliest amount outstanding, that is, payments or credits are applied against amounts in a first-in, first-out (FIFO) order. Thus, tracing payments to individual intercompany trade receivables is generally not required in order to determine whether a particular intercompany trade receivable has been paid within the applicable interest-free period determined under paragraph (a)(1)(iii) of this section. The application of this paragraph (a)(1)(iv)(A) may be illustrated by the following example:

Example. (i) *Facts.* X and Y are members of a group of controlled entities within the meaning of section 482. Assume that the balance of intercompany trade receivables owed by X to Y on June 1 is $100, and that all of the $100 balance represents amounts incurred by X to Y during the month of May. During the month of June X incurs an additional $200 of intercompany trade receivables to Y. Assume that on July 15, $60 is properly credited against X's intercompany account to Y, and that $240 is properly credited against the intercompany account on August 31. Assume that under paragraph (a)(1)(iii)(B) of this section interest must be charged on X's intercompany trade receivables to Y beginning with the first day of the third calendar month following the month the intercompany trade receivables arise, and that no alternative interest-free period applies. Thus, the interest-free period for intercompany trade receivables incurred during the month of May ends on July 31, and the interest-free period for intercompany trade receivables incurred during the month of June ends on August 31.

(ii) *Application of payments.* Using a FIFO payment order, the aggregate payments of $300 are applied first to the opening June balance, and then to the additional amounts incurred during the month of June. With respect to X's June opening balance of $100, no interest is required to be accrued on $60 of such balance paid by X on July 15, because such portion was paid within its interest-free period. Interest for 31 days, from August 1 to August 31 inclusive, is required to be accrued on the $40 portion of the opening balance not paid until August 31. No interest is required to be accrued on the $200 of intercompany trade receivables X incurred to Y during June because the $240 credited on August 31, after eliminating the $40 of indebtedness remaining from periods before June, also eliminated the $200 incurred by X during June prior to the end of the interest-free period for that amount. The amount of interest incurred by X to Y on the $40 amount during August creates bona fide indebtedness between controlled entities and is subject to the provisions of paragraph (a)(1)(iii)(A) of this section without regard to any of the exceptions contained in paragraphs (a)(1)(iii)(B) through (E).

(B) Notwithstanding the first-in, first-out payment application rule described in paragraph (a)(1)(iv)(A) of this section, the taxpayer may apply payments or credits against amounts owed in some other order on its books in accordance with an agreement or understanding of the related parties if the taxpayer can demonstrate that either it or others in its industry, as a regular trade practice, enter into such agreements or understandings in the case of similar balances with unrelated parties.

(2) *Arm's length interest rate*—(i) *In general*. For purposes of section 482 and paragraph (a) of this section, an arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors shall be considered, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.

(ii) *Funds obtained at situs of borrower*. Notwithstanding the other provisions of paragraph (a)(2) of this section, if the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's length rate for any taxable year shall be equal to the rate actually paid by the lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate under the standards set forth in paragraph (a)(2)(i) of this section.

(iii) *Safe haven interest rates for certain loans and advances made after May 8, 1986*—(A) *Applicability*—(*1*) *General rule*. Except as otherwise provided in paragraph (a)(2) of this section, paragraph (a)(2)(iii)(B) applies with respect to the rate of interest charged and to the amount of interest paid or accrued in any taxable year—

(*i*) Under a term loan or advance between members of a group of controlled entities where (except as provided in paragraph (a)(2)(iii)(A)(*2*)(*ii*) of this section) the loan or advance is entered into after May 8, 1986; and

(*ii*) After May 8, 1986 under a demand loan or advance between such controlled entities.

(*2*) *Grandfather rule for existing loans*. The safe haven rates prescribed in paragraph (a)(2)(iii)(B) of this section shall not apply, and the safe haven rates prescribed in §1.482–2(a)(2)(iii) (26 CFR part 1 edition revised as of April 1, 1985), shall apply to—

(*i*) Term loans or advances made before May 9, 1986; and

(*ii*) Term loans or advances made before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(B) *Safe haven interest rate based on applicable Federal rate*. Except as otherwise provided in this paragraph (a)(2), in the case of a loan or advance between members of a group of controlled entities, an arm's length rate of interest referred to in paragraph (a)(2)(i) of this section shall be for purposes of chapter 1 of the Internal Revenue Code—

(*1*) The rate of interest actually charged if that rate is—

(*i*) Not less than 100 percent of the applicable Federal rate (lower limit); and

(*ii*) Not greater than 130 percent of the applicable Federal rate (upper limit); or

(*2*) If either no interest is charged or if the rate of interest charged is less than the lower limit, then an arm's length rate of interest shall be equal to the lower limit, compounded semiannually; or

(*3*) If the rate of interest charged is greater than the upper limit, then an arm's length rate of interest shall be equal to the upper limit, compounded semiannually, unless the taxpayer establishes a more appropriate compound rate of interest under paragraph (a)(2)(i) of this section. However, if the compound rate of interest actually charged is greater than the upper limit and less than the rate determined under paragraph (a)(2)(i) of this section, or if the compound rate actually charged is less than the lower limit and greater than the rate determined under paragraph (a)(2)(i) of this section, then the compound rate actually charged shall be deemed to be an arm's length rate under paragraph (a)(2)(i). In the case of any sale-leaseback described in section 1274(e), the lower limit shall be 110 percent of the applicable Federal rate, compounded semiannually.

(C) *Applicable Federal rate*. For purposes of paragraph (a)(2)(iii)(B) of this section, the term applicable Federal rate means, in the case of a loan or advance to which this section applies and having a term of—

(*1*) Not over 3 years, the Federal short-term rate;

(*2*) Over 3 years but not over 9 years, the Federal mid-term rate; or

(*3*) Over 9 years, the Federal long-term rate, as determined under section 1274(d) in effect on the date such loan or advance is made. In the case of any sale or exchange between controlled entities, the lower limit shall be the lowest of the applicable Federal rates in effect for any month in the 3-calendar- month period ending with the first calendar month in which there is a binding written contract in effect for such sale or exchange (lowest 3-month rate, as defined in section 1274(d)(2)). In the case of a demand loan or advance to which this section applies, the applicable Federal rate means the Federal short-term rate determined under section 1274(d) (determined without regard to the lowest 3-month short term rate determined under section 1274(d)(2)) in effect for each day on which any amount of such loan or advance (including unpaid accrued interest determined under paragraph (a)(2) of this section) is outstanding.

(D) *Lender in business of making loans.* If the lender in a loan or advance transaction to which paragraph (a)(2) of this section applies is regularly engaged in the trade or business of making loans or advances to unrelated parties, the safe haven rates prescribed in paragraph (a)(2)(iii)(B) of this section shall not apply, and the arm's length interest rate to be used shall be determined under the standards described in paragraph (a)(2)(i) of this section, including reference to the interest rates charged in such trade or business by the lender on loans or advances of a similar type made to unrelated parties at and about the time the loan or advance to which paragraph (a)(2) of this section applies was made.

(E) *Foreign currency loans.* The safe haven interest rates prescribed in paragraph (a)(2)(iii)(B) of this section do not apply to any loan or advance the principal or interest of which is expressed in a currency other than U.S. dollars.

(3) *Coordination with interest adjustments required under certain other Code sections.* If the stated rate of interest on the stated principal amount of a loan or advance between controlled entities is subject to adjustment under section 482 and is also subject to adjustment under any other section of the Internal Revenue Code (for example, section 467, 483, 1274 or 7872), section 482 and paragraph (a) of this section may be applied to such loan or advance in addition to such other Internal Revenue Code section. After the enactment of the Tax Reform Act of 1964, Pub. L. 98–369, and the enactment of Pub. L. 99–121, such other Internal Revenue Code sections include sections 467, 483, 1274 and 7872. The order in which the different provisions shall be applied is as follows—

(i) First, the substance of the transaction shall be determined; for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, etc.) may apply. Only the rate of interest with respect to the stated principal amount of the bona fide indebtedness (within the meaning of paragraph (a)(1) of this section), if any, shall be subject to adjustment under section 482, paragraph (a) of this section, and any other Internal Revenue Code section.

(ii) Second, the other Internal Revenue Code section shall be applied to the loan or advance to determine whether any amount other than stated interest is to be treated as interest, and if so, to determine such amount according to the provisions of such other Internal Revenue Code section.

(iii) Third, whether or not the other Internal Revenue Code section applies to adjust the amounts treated as interest under such loan or advance, section 482 and paragraph (a) of this section may then be applied by the district director to determine whether the rate of interest charged on the loan or advance, as adjusted by any other Code section, is greater or less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

(iv) Fourth, section 482 and paragraphs (b) through (d) of this section and §§ 1.482–3 through 1.482–7, if applicable, may be applied by the district director to make any appropriate allocations, other than an interest rate adjustment, to reflect an arm's length transaction based upon the principal amount of the loan or advance and the interest rate as adjusted under paragraph (a)(3) (i), (ii) or (iii) of this section. For example, assume that two commonly controlled taxpayers enter into a deferred payment sale of tangible property and no interest is provided, and assume also that section 483 is applied to treat a portion of the stated sales price as interest, thereby reducing the stated sales price. If after this recharacterization of a portion of the stated sales price as interest, the recomputed sales price does not reflect an arm's length sales price under the principles of § 1.482–3, the district director may make other appropriate allocations (other than an interest rate adjustment) to reflect an arm's length sales price.

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

Example 1. An individual, A, transfers $20,000 to a corporation controlled by A in exchange for the corporation's note which bears adequate stated interest. The district director recharacterizes the transaction as a contribution to the capital of the corporation in exchange for preferred stock. Under paragraph (a)(3)(i) of this section, section 1.482–2(a) does not apply to the transaction because there is no bona fide indebtedness.

Example 2. B, an individual, is an employee of Z corporation, and is also the controlling shareholder of Z. Z makes a term loan of $15,000 to B at a rate of interest that is less than the applicable Federal rate. In this instance the other operative Code section is section 7872. Under section 7872(b), the difference between the amount loaned and the present value of all payments due under the loan using a discount rate equal to 100 percent of the applicable Federal rate is treated as an amount of cash transferred from the corporation to B and the loan is treated as having original issue discount equal to such amount. Under paragraph (a)(3)(iii) of this section, section 482 and paragraph (a) of this section may also be applied by the district director to determine if the rate of interest charged on this $15,000 loan (100 percent of the AFR, compounded semiannually, as adjusted by section 7872) is an arm's length rate of interest. Because the rate of interest on the loan, as adjusted by section 7872, is within the safe haven range of 100–130 percent of the AFR, compounded semiannually, no further interest rate adjustments under section 482 and paragraph (a) of this section will be made to this loan.

Example 3. The facts are the same as in Example 2 except that the amount lent by Z to B is $9,000, and that amount is the aggregate outstanding amount of loans between Z and B. Under the $10,000 de minimis exception of section 7872(c)(3), no adjustment for interest will be made to this $9,000 loan under section 7872. Under paragraph (a)(3)(iii) of this section, the district director may apply section 482 and paragraph (a) of this section to this $9,000 loan to determine whether the rate of interest charged is less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

Example 4. X and Y are commonly controlled taxpayers. At a time when the applicable Federal rate is 12 percent, compounded semiannually, X sells property to Y in exchange for a note with a stated rate of interest of 18 percent, compounded semiannually. Assume that the other applicable Code section to the transaction is section 483. Section 483 does not apply to this transaction because, under section 483(d), there is no total unstated interest under the contract using the test rate of interest equal to 100 percent of the applicable Federal rate. Under paragraph (a)(3)(iii) of this section, section 482 and paragraph (a) of this section may be applied by the district director to determine whether the rate of interest under the note is excessive, that is, to determine whether the 18 percent stated interest rate under the note exceeds an arm's length rate of interest.

Example 5. Assume that A and B are commonly controlled taxpayers and that the applicable Federal rate is 10 percent, compounded semiannually. On June 30, 1986, A sells property to B and receives in exchange B's purchase-money note in the amount of $2,000,000. The stated interest rate on the note is 9%, compounded semiannually, and the stated redemption price at maturity on the note is $2,000,000. Assume that the other applicable Code section to this transaction is section 1274. As provided in section 1274A(a) and (b), the discount rate for purposes of section 1274 will be nine percent, compounded semiannually, because the stated principal amount of B's note does not exceed $2,800,000. Section 1274 does not apply to this transaction because there is adequate stated interest on the debt instrument using a discount rate equal to 9%, compounded semiannually, and the stated redemption price at maturity does not exceed the stated principal amount. Under paragraph (a)(3)(iii) of this section, the district director may apply section 482 and paragraph (a) of this section to this $2,000,000 note to determine whether the 9% rate of interest charged is less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

(b) *Rendering of services.* For rules governing allocations under section 482 to reflect an arm's length charge for controlled transactions involving the rendering of services, *see* §1.482–9.

(c) *Use of tangible property*—(1) *General rule.* Where possession, use, or occupancy of tangible property owned or leased by one member of a group of controlled entities (referred to in this paragraph as the owner) is transferred by lease or other arrangement to another member of such group (referred to in this paragraph as the user) without charge or at a charge which is not equal to an arm's length rental charge (as defined in paragraph (c)(2)(i) of this section) the district director may make appropriate allocations to properly reflect such arm's length charge. Where possession, use, or occupancy of only a portion of such property is transferred, the determination of the arm's length charge and the allocation shall be made with reference to the portion transferred.

(2) *Arm's length charge*—(i) *In general.* For purposes of paragraph (c) of this section, an arm's length rental charge shall be the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, the type of property involved, its condition, and all other relevant facts.

(ii) *Safe haven rental charge.* See §1.482–2(c)(2)(ii) (26 CFR Part 1 revised as of April 1, 1985), for the determination of safe haven rental charges in the case of certain leases entered into before May 9, 1986, and for leases entered into before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(iii) *Subleases*—(A) Except as provided in paragraph (c)(2)(iii)(B) of this section, where possession, use, or occupancy of tangible property, which is leased by the owner (lessee) from an unrelated party is transferred by sublease or other arrangement to the user, an arm's length rental charge shall be considered to be equal to all the deductions claimed by the owner (lessee) which are attributable to the property for the period such property is used by the user. Where only a portion of such property was transferred, any allocations shall be made with reference to the portion transferred. The deductions to be considered include the rent paid or accrued by the owner (lessee) during the period of use and all other deductions directly and indirectly connected with the property paid or accrued by the owner (lessee) during such period. Such deductions include deductions for maintenance and repair, utilities, management and other similar deductions.

(B) The provisions of paragraph (c)(2)(iii)(A) of this section shall not apply if either—

(*1*) The taxpayer establishes a more appropriate rental charge under the general rule set forth in paragraph (c)(2)(i) of this section; or

(*2*) During the taxable year, the owner (lessee) or the user was regularly engaged in the trade or business of renting property of the same general type as the property in question to unrelated persons.

(d) *Transfer of property.* For rules governing allocations under section 482 to reflect an arm's length consideration for controlled transactions involving the transfer of property, see §§1.482–3 through 1.482–6.

(e) *Cost sharing arrangement.* For rules governing allocations under section 482 to reflect an arm's length consideration for controlled transactions involving a cost sharing arrangement, see §1.482–7.

(f) *Effective/applicability date*—(1) *In general.* The provision of paragraph (b) of this section is generally applicable for taxable years beginning after December 31, 2006. The provision of paragraph (e) of this section is generally applicable on January 5, 2009.

(2) *Election to apply paragraph (b) to earlier taxable years.* A person may elect to apply the provisions of paragraph (b) of this section to earlier taxable years

in accordance with the rules set forth in §1.482–9(n)(2).

[T.D. 8552, 59 FR 35002, July 8, 1994; 60 FR 16381, 16382, Mar. 30, 1995; T.D. 9278, 71 FR 44484, Aug. 4, 2006; T.D. 9456, 74 FR 38842, Aug. 4, 2009; T.D. 9568, 76 FR 80090, Dec. 22, 2011]

§ 1.482–3 Methods to determine taxable income in connection with a transfer of tangible property.

(a) *In general.* The arm's length amount charged in a controlled transfer of tangible property must be determined under one of the six methods listed in this paragraph (a). Each of the methods must be applied in accordance with all of the provisions of §1.482–1, including the best method rule of §1.482–1(c), the comparability analysis of §1.482–1(d), and the arm's length range of §1.482–1(e). The methods are—

(1) The comparable uncontrolled price method, described in paragraph (b) of this section;

(2) The resale price method, described in paragraph (c) of this section;

(3) The cost plus method, described in paragraph (d) of this section;

(4) The comparable profits method, described in §1.482–5;

(5) The profit split method, described in §1.482–6; and

(6) Unspecified methods, described in paragraph (e) of this section.

(b) *Comparable uncontrolled price method*—(1) *In general.* The comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction.

(2) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from applications of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482–1(c). The application of these factors under the comparable uncontrolled price method is discussed in paragraph (b)(2)(ii) and (iii) of this section.

(ii) *Comparability*—(A) *In general.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the provisions of §1.482–1(d). Although all of the factors described in §1.482–1(d)(3) must be considered, similarity of products generally will have the greatest effect on comparability under this method. In addition, because even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. The results derived from applying the comparable uncontrolled price method generally will be the most direct and reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences with the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the comparable uncontrolled price method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, if there are material product differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's length result.

(B) *Adjustments for differences between controlled and uncontrolled transactions.* If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability provisions of §1.482–1(d)(2). Specific examples of the factors that may be particularly relevant to this method include—

(*1*) Quality of the product;

(*2*) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);

(*3*) Level of the market (i.e., wholesale, retail, etc.);

(*4*) Geographic market in which the transaction takes place;

(*5*) Date of the transaction;

(*6*) Intangible property associated with the sale;

(*7*) Foreign currency risks; and

(*8*) Alternatives realistically available to the buyer and seller.

(iii) *Data and assumptions*. The reliability of the results derived from the comparable uncontrolled price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See §1.482–1(c) (Best method rule).

(3) *Arm's length range*. See §1.482–1(e)(2) for the determination of an arm's length range.

(4) *Examples*. The principles of this paragraph (b) are illustrated by the following examples.

Example 1. Comparable Sales of Same Product. USM, a U.S. manufacturer, sells the same product to both controlled and uncontrolled distributors. The circumstances surrounding the controlled and uncontrolled transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. USM's factory. Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments are made to the results of the uncontrolled transaction to account for such differences. No other material difference has been identified between the controlled and uncontrolled transactions. Because USM sells in both the controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. In addition, because the comparable uncontrolled price method is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences that have a definite and reasonably ascertainable effect on price, the results of this application of the comparable uncontrolled price method will provide the most direct and reliable measure of an arm's length result. See §1.482–3(b)(2)(ii)(A).

Example 2. Effect of Trademark. The facts are the same as in *Example 1*, except that USM affixes its valuable trademark to the property sold in the controlled transactions, but does not affix its trademark to the property sold in the uncontrolled transactions. Under the facts of this case, the effect on price of the trademark is material and cannot be reliably estimated. Because there are material product differences for which reliable adjustments cannot be made, the comparable uncontrolled price method is unlikely to provide a reliable measure of the arm's length result. See §1.482–3(b)(2)(ii)(A).

Example 3. Minor Product Differences. The facts are the same as in *Example 1*, except that USM, which manufactures business machines, makes minor modifications to the physical properties of the machines to satisfy specific requirements of a customer in controlled sales, but does not make these modifications in uncontrolled sales. If the minor physical differences in the product have a material effect on prices, adjustments to account for these differences must be made to the results of the uncontrolled transactions according to the provisions of §1.482- 1(d)(2), and such adjusted results may be used as a measure of the arm's length result.

Example 4. Effect of Geographic Differences. FM, a foreign specialty radio manufacturer, sells its radios to a controlled U.S. distributor, AM, that serves the West Coast of the United States. FM sells its radios to uncontrolled distributors to serve other regions in the United States. The product in the controlled and uncontrolled transactions is the same, and all other circumstances surrounding the controlled and uncontrolled transactions are substantially the same, other than the geographic differences. If the geographic differences are unlikely to have a material effect on price, or they have definite and reasonably ascertainable effects for which adjustments are made, then the adjusted results of the uncontrolled sales may be used under the comparable uncontrolled price method to establish an arm's length range pursuant to §1.482–1(e)(2)(iii)(A). If the effects of the geographic differences would be material but cannot be reliably ascertained, then the reliability of the results will be diminished. However, the comparable uncontrolled price method may still provide the most reliable measure of an arm's length result, pursuant to the best method rule of §1.482–1(c), and, if so, an arm's length range may be established pursuant to §1.482–1(e)(2)(iii)(B).

(5) *Indirect evidence of comparable uncontrolled transactions*—(i) *In general*. A comparable uncontrolled price may be derived from data from public exchanges or quotation media, but only if the following requirements are met—

(A) The data is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales;

(B) The data derived from public exchanges or quotation media is used to set prices in the controlled transaction in the same way it is used by uncontrolled taxpayers in the industry; and

(C) The amount charged in the controlled transaction is adjusted to reflect differences in product quality and quantity, contractual terms, transportation costs, market conditions, risks borne, and other factors that affect the price that would be agreed to by uncontrolled taxpayers.

(ii) *Limitation.* Use of data from public exchanges or quotation media may not be appropriate under extraordinary market conditions.

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

Example 1. Use of Quotation Medium. (i) On June 1, USOil, a United States corporation, enters into a contract to purchase crude oil from its foreign subsidiary, FS, in Country Z. USOil and FS agree to base their sales price on the average of the prices published for that crude in a quotation medium in the five days before August 1, the date set for delivery. USOil and FS agree to adjust the price for the particular circumstances of their transactions, including the quantity of the crude sold, contractual terms, transportation costs, risks borne, and other factors that affect the price.

(ii) The quotation medium used by USOil and FS is widely and routinely used in the ordinary course of business in the industry to establish prices for uncontrolled sales. Because USOil and FS use the data to set their sales price in the same way that unrelated parties use the data from the quotation medium to set their sales prices, and appropriate adjustments were made to account for differences, the price derived from the quotation medium used by USOil and FS to set their transfer prices will be considered evidence of a comparable uncontrolled price.

Example 2. Extraordinary Market Conditions. The facts are the same as in *Example 1,* except that before USOil and FS enter into their contract, war breaks out in Countries X and Y, major oil producing countries, causing significant instability in world petroleum markets. As a result, given the significant instability in the price of oil, the prices listed on the quotation medium may not reflect a reliable measure of an arm's length result. See §1.482–3(b)(5)(ii).

(c) *Resale price method*—(1) *In general.* The resale price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method measures the value of functions performed, and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by physically altering the goods before resale. For this purpose, packaging, repackaging, labelling, or minor assembly do not ordinarily constitute physical alteration. Further the resale price method is not ordinarily used in cases where the controlled taxpayer uses its intangible property to add substantial value to the tangible goods.

(2) *Determination of arm's length price*—(i) *In general.* The resale price method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review.

(ii) *Applicable resale price.* The applicable resale price is equal to either the resale price of the particular item of property involved or the price at which contemporaneous resales of the same property are made. If the property purchased in the controlled sale is resold to one or more related parties in a series of controlled sales before being resold in an uncontrolled sale, the applicable resale price is the price at which the property is resold to an uncontrolled party, or the price at which contemporaneous resales of the same property are made. In such case, the determination of the appropriate gross profit will take into account the functions of all members of the group participating in the series of controlled sales and final uncontrolled resales, as well as any other relevant factors described in §1.482–1(d)(3).

(iii) *Appropriate gross profit.* The appropriate gross profit is computed by multiplying the applicable resale price by the gross profit margin (expressed as a percentage of total revenue derived from sales) earned in comparable uncontrolled transactions.

(iv) *Arm's length range.* See §1.482–1(e)(2) for determination of the arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from applications of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482–1(c). The application of these factors under the resale price method is discussed in paragraphs (c)(3) (ii) and (iii) of this section.

(ii) *Comparability*—(A) *Functional comparability.* The degree of comparability between an uncontrolled transaction and a controlled transaction is determined by applying the comparability provisions of §1.482–1(d). A reseller's gross profit provides compensation for the performance of resale functions related to the product or products under review, including an operating profit in return for the reseller's investment of capital and the assumption of risks. Therefore, although all of the factors described in §1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, appropriate gross profit margins should be derived from comparable uncontrolled purchases and resales of the reseller involved in the controlled sale, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of comparable uncontrolled transactions involving the same reseller, an appropriate gross profit margin may be derived from comparable uncontrolled transactions of other resellers.

(B) *Other comparability factors.* Comparability under this method is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method. For example, distributors of a wide variety of consumer durables might perform comparable distribution functions without regard to the specific durable goods distributed. Substantial differences in the products may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions would involve the distribution of products of the same general type (e.g., consumer electronics). Furthermore, significant differences in the value of the distributed goods due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit margin, adjustments should be made to the gross profit margin earned with respect to the uncontrolled transaction according to the comparability provisions of §1.482–1(d)(2). For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, however, the effect on gross profit of such differences is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevant to this method include—

(*1*) Inventory levels and turnover rates, and corresponding risks, including any price protection programs offered by the manufacturer;

(*2*) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);

(*3*) Sales, marketing, advertising programs and services, (including promotional programs, rebates, and co-op advertising);

(*4*) The level of the market (e.g., wholesale, retail, etc.); and

(*5*) Foreign currency risks.

(D) *Sales agent.* If the controlled taxpayer is comparable to a sales agent that does not take title to goods or otherwise assume risks with respect to ownership of such goods, the commission earned by such sales agent, expressed as a percentage of the uncontrolled sales price of the goods involved, may be used as the comparable gross profit margin.

(iii) *Data and assumptions*—(A) *In general*. The reliability of the results derived from the resale price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See § 1.482–1(c) (Best method rule).

(B) *Consistency in accounting*. The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit margin affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit margin, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, the controlled transaction and the uncontrolled comparable should be consistent in the reporting of items (such as discounts, returns and allowances, rebates, transportation costs, insurance, and packaging) between cost of goods sold and operating expenses.

(4) *Examples*. The following examples illustrate the principles of this paragraph (c).

Example 1. A controlled taxpayer sells property to another member of its controlled group that resells the property in uncontrolled sales. There are no changes in the beginning and ending inventory for the year under review. Information regarding an uncontrolled comparable is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. If the applicable resale price of the property involved in the controlled sale is $100 and the appropriate gross profit margin is 20%, then an arm's length result of the controlled sale is a price of $80 ($100 minus (20% × $100)).

Example 2. (i) S, a U.S. corporation, is the exclusive distributor for FP, its foreign parent. There are no changes in the beginning and ending inventory for the year under review. S's total reported cost of goods sold is $800, consisting of $600 for property purchased from FP and $200 of other costs of goods sold incurred to unrelated parties. S's applicable resale price and reported gross profit are as follows:

Applicable resale price	$1000
Cost of goods sold:	
Cost of purchases from FP	600
Costs incurred to unrelated parties	200
Reported gross profit	200

(ii) The district director determines that the appropriate gross profit margin is 25%. Therefore, S's appropriate gross profit is $250 (i.e., 25% of the applicable resale price of $1000). Because S is incurring costs of sales to unrelated parties, an arm's length price for property purchased from FP must be determined under a two-step process. First, the appropriate gross profit ($250) is subtracted from the applicable resale price ($1000). The resulting amount ($750) is then reduced by the costs of sales incurred to unrelated parties ($200). Therefore, an arm's length price for S's cost of sales of FP's product in this case equals $550 (i.e., $750 minus $200).

Example 3. FP, a foreign manufacturer, sells Product to USSub, its U.S. subsidiary, which in turn sells Product to its domestic affiliate Sister. Sister sells Product to unrelated buyers. In this case, the applicable resale price is the price at which Sister sells Product in uncontrolled transactions. The determination of the appropriate gross profit margin for the sale from FP to USSub will take into account the functions performed by USSub and Sister, as well as other relevant factors described in § 1.482–1(d)(3).

Example 4. USSub, a U.S. corporation, is the exclusive distributor of widgets for its foreign parent. To determine whether the gross profit margin of 25% earned by USSub is an arm's length result, the district director considers applying the resale price method. There are several uncontrolled distributors that perform similar functions under similar circumstances in uncontrolled transactions. However, the uncontrolled distributors treat certain costs such as discounts and insurance as cost of goods sold, while USSub treats such costs as operating expenses. In such cases, accounting reclassifications, pursuant to § 1.482–3(c)(3)(iii)(B), must be made to ensure consistent treatment of such material items. Inability to make such accounting reclassifications will decrease the reliability of the results of the uncontrolled transactions.

Example 5. (i) USP, a U.S. corporation, manufactures Product X, an unbranded widget, and sells it to FSub, its wholly owned foreign subsidiary. FSub acts as a distributor of Product X in country M, and sells it to uncontrolled parties in that country. Uncontrolled distributors A, B, C, D, and E distribute competing products of approximately similar value in country M. All such products are unbranded.

(ii) Relatively complete data is available regarding the functions performed and risks borne by the uncontrolled distributors and the contractual terms under which they operate in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all of the uncontrolled distributors and FSub. Because the available data is sufficiently complete and accurate to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, such differences have a definite and reasonably ascertainable effect, and reliable adjustments are made to account for such differences, the results of each of the uncontrolled distributors may be used to establish an arm's length range pursuant to §1.482–1(e)(2)(iii)(A).

Example 6. The facts are the same as *Example 5*, except that sufficient data is not available to determine whether any of the uncontrolled distributors provide warranties or to determine the payment terms of the contracts. Because differences in these contractual terms could materially affect price or profits, the inability to determine whether these differences exist between the controlled and uncontrolled transactions diminishes the reliability of the results of the uncontrolled comparables. However, the reliability of the results may be enhanced by the application of a statistical method when establishing an arm's length range pursuant to §1.482–1(e)(2)(iii)(B).

Example 7. The facts are the same as in *Example 5*, except that Product X is branded with a valuable trademark that is owned by P. A, B, and C distribute unbranded competing products, while D and E distribute products branded with other trademarks. D and E do not own any rights in the trademarks under which their products are sold. The value of the products that A, B, and C sold are not similar to the value of the products sold by S. The value of products sold by D and E, however, is similar to that of Product X. Although close product similarity is not as important for a reliable application of the resale price method as for the comparable uncontrolled price method, significant differences in the value of the products involved in the controlled and uncontrolled transactions may affect the reliability of the results. In addition, because in this case it is difficult to determine the effect the trademark will have on price or profits, reliable adjustments for the differences cannot be made. Because D and E have a higher level of comparability than A, B, and C with respect to S, pursuant to §1.482–1(e)(2)(ii), only D and E may be included in an arm's length range.

(d) *Cost plus method*—(1) *In general.* The cost plus method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit markup realized in comparable uncontrolled transactions. The cost plus method is ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties.

(2) *Determination of arm's length price*—(i) *In general.* The cost plus method measures an arm's length price by adding the appropriate gross profit to the controlled taxpayer's costs of producing the property involved in the controlled transaction.

(ii) *Appropriate gross profit.* The appropriate gross profit is computed by multiplying the controlled taxpayer's cost of producing the transferred property by the gross profit markup, expressed as a percentage of cost, earned in comparable uncontrolled transactions.

(iii) *Arm's length range.* See §1.482–1(e)(2) for determination of an arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482–1(c).

(ii) *Comparability*—(A) *Functional comparability.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of §1.482–1(d). A producer's gross profit provides compensation for the performance of the production functions related to the product or products under review, including an operating profit for the producer's investment of capital and assumption of risks. Therefore, although all of the factors described in §1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross profit markup should be derived from comparable uncontrolled transactions of the taxpayer involved in the controlled sale, because similar characteristics are more likely to be found among sales of property by the same producer than among sales by other producers. In the absence of such sales, an appropriate gross profit markup may be derived from comparable uncontrolled sales of other producers whether or not such producers are members of the same controlled group.

(B) *Other comparability factors.* Comparability under this method is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method. Substantial differences in the products may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions involve the production of goods within the same product categories. Furthermore, significant differences in the value of the products due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit markup, adjustments should be made to the gross profit markup earned in the comparable uncontrolled transaction according to the provisions of §1.482–1(d)(2). For this purpose, consideration of the operating expenses associated with the functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, however, the effect on gross profit of such differences is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevant to this method include—

(*1*) The complexity of manufacturing or assembly;

(*2*) Manufacturing, production, and process engineering;

(*3*) Procurement, purchasing, and inventory control activities;

(*4*) Testing functions;

(*5*) Selling, general, and administrative expenses;

(*6*) Foreign currency risks; and

(*7*) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms).

(D) *Purchasing agent.* If a controlled taxpayer is comparable to a purchasing agent that does not take title to property or otherwise assume risks with respect to ownership of such goods, the commission earned by such purchasing agent, expressed as a percentage of the purchase price of the goods, may be used as the appropriate gross profit markup.

(iii) *Data and assumptions*—(A) *In general.* The reliability of the results derived from the cost plus method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See §1.482–1(c) (Best method rule).

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit markup affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit markup, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, the controlled transaction and the comparable uncontrolled transaction should be consistent in the reporting of costs between cost of goods sold and operating expenses. The term *cost of producing* includes the cost of acquiring property that is held for resale.

(4) *Examples*. The following examples illustrate the principles of this paragraph (d).

Example 1. (i) USP, a domestic manufacturer of computer components, sells its products to FS, its foreign distributor. UT1, UT2, and UT3 are domestic computer component manufacturers that sell to uncontrolled foreign purchasers.

(ii) Relatively complete data is available regarding the functions performed and risks borne by UT1, UT2, and UT3, and the contractual terms in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all of the uncontrolled manufacturers and USP. Because the available data is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, the effect of the differences are definite and reasonably ascertainable, and reliable adjustments are made to account for the differences, an arm's length range can be established pursuant to §1.482–1(e)(2)(iii)(A).

Example 2. The facts are the same as in *Example 1*, except that USP accounts for supervisory, general, and administrative costs as operating expenses, which are not allocated to its sales to FS. The gross profit markups of UT1, UT2, and UT3, however, reflect supervisory, general, and administrative expenses because they are accounted for as costs of goods sold. Accordingly, the gross profit markups of UT1, UT2, and UT3 must be adjusted as provided in paragraph (d)(3)(iii)(B) of this section to provide accounting consistency. If data is not sufficient to determine whether such accounting differences exist between the controlled and uncontrolled transactions, the reliability of the results will be decreased.

Example 3. The facts are the same as in *Example 1*, except that under its contract with FS, USP uses materials consigned by FS. UT1, UT2, and UT3, on the other hand, purchase their own materials, and their gross profit markups are determined by including the costs of materials. The fact that USP does not carry an inventory risk by purchasing its own materials while the uncontrolled producers carry inventory is a significant difference that may require an adjustment if the difference has a material effect on the gross profit markups of the uncontrolled producers. Inability to reasonably ascertain the effect of the difference on the gross profit markups will affect the reliability of the results of UT1, UT2, and UT3.

Example 4. (i) FS, a foreign corporation, produces apparel for USP, its U.S. parent corporation. FS purchases its materials from unrelated suppliers and produces the apparel according to designs provided by USP. The district director identifies 10 uncontrolled foreign apparel producers that operate in the same geographic market and are similar in many respect to FS.

(ii) Relatively complete data is available regarding the functions performed and risks borne by the uncontrolled producers. In addition, data is sufficiently detailed to permit adjustments for differences in accounting practices. However, sufficient data is not available to determine whether it is likely that all material differences in contractual terms have been identified. For example, it is not possible to determine which parties in the uncontrolled transactions bear currency risks. Because differences in these contractual terms could materially affect price or profits, the inability to determine whether differences exist between the controlled and uncontrolled transactions will diminish the reliability of these results. Therefore, the reliability of the results of the uncontrolled transactions must be enhanced by the application of a statistical method in establishing an arm's length range pursuant to §1.482–1(e)(2)(iii)(B).

(e) *Unspecified methods*—(1) *In general*. Methods not specified in paragraphs (a)(1), (2), (3), (4), and (5) of this section may be used to evaluate whether the amount charged in a controlled transaction is arm's length. Any method used under this paragraph (e) must be applied in accordance with the provisions of §1.482–1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled transaction. Therefore, in establishing whether a controlled transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See §1.482–1(c). Therefore, in accordance with §1.482–1(d) (Comparability), to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(2) *Example.* The following example illustrates an application of the principle of this paragraph (e).

Example. Amcan, a U.S. company, produces unique vessels for storing and transporting toxic waste, toxicans, at its U.S. production facility. Amcan agrees by contract to supply its Canadian subsidiary, Cancan, with 4000 toxicans per year to serve the Canadian market for toxicans. Prior to entering into the contract with Cancan, Amcan had received a bona fide offer from an independent Canadian waste disposal company, Cando, to serve as the Canadian distributor for toxicans and to purchase a similar number of toxicans at a price of $5,000 each. If the circumstances and terms of the Cancan supply contract are sufficiently similar to those of the Cando offer, or sufficiently reliable adjustments can be made for differences between them, then the Cando offer price of $5,000 may provide reliable information indicating that an arm's length consideration under the Cancan contract will not be less than $5,000 per toxican.

(f) *Coordination with intangible property rules.* The value of an item of tangible property may be affected by the value of intangible property, such as a trademark affixed to the tangible property (embedded intangible). Ordinarily, the transfer of tangible property with an embedded intangible will not be considered a transfer of such intangible if the controlled purchaser does not acquire any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal commercial practices. Pursuant to §1.482–1(d)(3)(v), however, the embedded intangible must be accounted for in evaluating the comparability of the controlled transaction and uncontrolled comparables. For example, because product comparability has the greatest effect on an application of the comparable uncontrolled price method, trademarked tangible property may be insufficiently comparable to unbranded tangible property to permit a reliable application of the comparable uncontrolled price method. The effect of embedded intangibles on comparability will be determined under the principles of §1.482–4. If the transfer of tangible property conveys to the recipient a right to exploit an embedded intangible (other than in connection with the resale of that item of tangible property), it may be necessary to determine the arm's length consideration for such intangible separately from the tangible property, applying methods appropriate to determining the arm's length result for a transfer of intangible property under §1.482–4. For example, if the transfer of a machine conveys the right to exploit a manufacturing process incorporated in the machine, then the arm's length consideration for the transfer of that right must be determined separately under §1.482–4.

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§ 1.482–4 Methods to determine taxable income in connection with a transfer of intangible property.

(a) *In general.* The arm's length amount charged in a controlled transfer of intangible property must be determined under one of the four methods listed in this paragraph (a). Each of the methods must be applied in accordance with all of the provisions of §1.482–1, including the best method rule of §1.482–1(c), the comparability analysis of §1.482–1(d), and the arm's length range of §1.482–1(e). The arm's length consideration for the transfer of an intangible determined under this section must be commensurate with the income attributable to the intangible. See §1.482–4(f)(2) (Periodic adjustments). The available methods are—

(1) The comparable uncontrolled transaction method, described in paragraph (c) of this section;

(2) The comparable profits method, described in §1.482–5;

(3) The profit split method, described in §1.482–6; and

(4) Unspecified methods described in paragraph (d) of this section.

(b) *Definition of intangible.* For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual—

(1) Patents, inventions, formulae, processes, designs, patterns, or know-how;

(2) Copyrights and literary, musical, or artistic compositions;

(3) Trademarks, trade names, or brand names;

(4) Franchises, licenses, or contracts;

(5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and

(6) Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

(c) *Comparable uncontrolled transaction method*—(1) *In general.* The comparable uncontrolled transaction method evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction. The amount determined under this method may be adjusted as required by paragraph (f)(2) of this section (Periodic adjustments).

(2) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from applications of this method are the most reliable measure of an arm's length result is determined using the factors described under the best method rule in §1.482–1(c). The application of these factors under the comparable uncontrolled transaction method is discussed in paragraphs (c)(2)(ii), (iii), and (iv) of this section.

(ii) *Reliability.* If an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances as the controlled transaction, the results derived from applying the comparable uncontrolled transaction method will generally be the most direct and reliable measure of the arm's length result for the controlled transfer of an intangible. Circumstances between the controlled and uncontrolled transactions will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made. If such uncontrolled transactions cannot be identified, uncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances may be used to apply this method, but the reliability of the analysis will be reduced.

(iii) *Comparability*—(A) *In general.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of §1.482–1(d). Although all of the factors described in §1.482–1(d)(3) must be considered, specific factors may be particularly relevant to this method. In particular, the application of this method requires that the controlled and uncontrolled transactions involve either the same intangible property or comparable intangible property, as defined in paragraph (c)(2)(iii)(B)(*1*) of this section. In addition, because differences in contractual terms, or the economic conditions in which transactions take place, could materially affect the amount charged, comparability under this method also depends on similarity with respect to these factors, or adjustments to account for material differences in such circumstances.

(B) *Factors to be considered in determining comparability*—(*1*) *Comparable intangible property.* In order for the intangible property involved in an uncontrolled transaction to be considered comparable to the intangible property involved in the controlled transaction, both intangibles must—

(*i*) Be used in connection with similar products or processes within the same general industry or market; and

(*ii*) Have similar profit potential. The profit potential of an intangible is most reliably measured by directly calculating the net present value of the benefits to be realized (based on prospective profits to be realized or costs to be saved) through the use or subsequent transfer of the intangible, considering the capital investment and start-up expenses required, the risks to be assumed, and other relevant considerations. The need to reliably measure profit potential increases in relation to both the total amount of potential profits and the potential rate of return on investment necessary to exploit the intangible. If the information necessary to directly calculate net present value of the benefits to be realized is unavailable, and the need to reliably measure profit potential is reduced because the potential profits are relatively small in terms of total amount and rate of return, comparison of profit potential may be based upon the factors referred to in paragraph (c)(2)(iii)(B)(*2*) of this section. See *Example 3* of §1.482–4(c)(4). Finally, the reliability of a measure of profit potential is affected by the extent to which the profit attributable to the intangible can be isolated from the profit attributable to other factors, such as functions performed and other resources employed.

(*2*) *Comparable circumstances.* In evaluating the comparability of the circumstances of the controlled and uncontrolled transactions, although all of the factors described in §1.482–1(d)(3) must be considered, specific factors that may be particularly relevant to this method include the following—

(*i*) The terms of the transfer, including the exploitation rights granted in the intangible, the exclusive or nonexclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area in which the rights may be exploited;

(*ii*) The stage of development of the intangible (including, where appropriate, necessary governmental approvals, authorizations, or licenses) in the market in which the intangible is to be used;

(*iii*) Rights to receive updates, revisions, or modifications of the intangible;

(*iv*) The uniqueness of the property and the period for which it remains unique, including the degree and duration of protection afforded to the property under the laws of the relevant countries;

(*v*) The duration of the license, contract, or other agreement, and any termination or renegotiation rights;

(*vi*) Any economic and product liability risks to be assumed by the transferee;

(*vii*) The existence and extent of any collateral transactions or ongoing business relationships between the transferee and transferor; and

(*viii*) The functions to be performed by the transferor and transferee, including any ancillary or subsidiary services.

(iv) *Data and assumptions.* The reliability of the results derived from the comparable uncontrolled transaction method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See §1.482–1(c) (Best method rule).

(3) *Arm's length range.* See §1.482–1(e)(2) for the determination of an arm's length range.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. (i) USpharm, a U.S. pharmaceutical company, develops a new drug Z that is a safe and effective treatment for the disease zeezee. USpharm has obtained patents covering drug Z in the United States and in various foreign countries. USpharm has also obtained the regulatory authorizations necessary to market drug Z in the United States and in foreign countries.

(ii) USpharm licenses its subsidiary in country X, Xpharm, to produce and sell drug Z in country X. At the same time, it licenses an unrelated company, Ydrug, to produce and sell drug Z in country Y, a neighboring country. Prior to licensing the drug, USpharm had obtained patent protection and regulatory approvals in both countries and both countries provide similar protection for intellectual property rights. Country X and country Y are similar countries in terms of population, per capita income and the incidence of disease zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, costs of producing and marketing drug Z in each country are expected to be approximately the same.

(iii) USpharm and Xpharm establish terms for the license of drug Z that are identical in every material respect, including royalty rate, to the terms established between USpharm and Ydrug. In this case the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm's length royalty rate for the Xpharm license agreement.

Example 2. The facts are the same as in *Example 1*, except that the incidence of the disease zeezee in Country Y is much higher than in Country X. In this case, the profit potential from exploitation of the right to make and sell drug Z is likely to be much higher in country Y than it is in Country X. Consequently, the Ydrug license agreement is unlikely to provide a reliable measure of the arm's length royalty rate for the Xpharm license.

Example 3. (i) FP, is a foreign company that designs, manufactures and sells industrial equipment. FP has developed proprietary components that are incorporated in its products. These components are important in the operation of FP's equipment and some of them have distinctive features, but other companies produce similar components and none of these components by itself accounts for a substantial part of the value of FP's products.

(ii) FP licenses its U.S. subsidiary, USSub, exclusive North American rights to use the patented technology for producing component X, a heat exchanger used for cooling operating mechanisms in industrial equipment. Component X incorporates proven technology that makes it somewhat more efficient than the heat exchangers commonly used in industrial equipment. FP also agrees to provide technical support to help adapt component X to USSub's products and to assist with initial production. Under the terms of the license agreement USSub pays FP a royalty equal to 3 percent of sales of USSub equipment incorporating component X.

(iii) FP does not license unrelated parties to use component X, but many similar components are transferred between uncontrolled taxpayers. Consequently, the district director decides to apply the comparable uncontrolled transaction method to evaluate whether the 3 percent royalty for component X is an arm's length royalty.

(iv) The district director uses a database of company documents filed with the Securities and Exchange Commission (SEC) to identify potentially comparable license agreements between uncontrolled taxpayers that are on file with the SEC. The district director identifies 40 license agreements that were entered into in the same year as the controlled transfer or in the prior or following year, and that relate to transfers of technology associated with industrial equipment that has similar applications to USSub's products. Further review of these uncontrolled agreements indicates that 25 of them involved components that have a similar level of technical sophistication as component X and could be expected to play a similar role in contributing to the total value of the final product.

(v) The district director makes a detailed review of the terms of each of the 25 uncontrolled agreements and finds that 15 of them are similar to the controlled agreement in that they all involve—

(A) The transfer of exclusive rights for the North American market;

(B) Products for which the market could be expected to be of a similar size to the market for the products into which USSub incorporates component X;

(C) The transfer of patented technology;

(D) Continuing technical support;

(E) Access to technical improvements;

(F) Technology of a similar age; and

(G) A similar duration of the agreement.

(vi) Based on these factors and the fact that none of the components to which these license agreements relate accounts for a substantial part of the value of the final products, the district director concludes that these fifteen intangibles have similar profit potential to the component X technology.

(vii) The 15 uncontrolled comparables produce the following royalty rates:

License	Royalty rate (percent)
1	1.0
2	1.0
3	1.25
4	1.25
5	1.5
6	1.5
7	1.75
8	2.0
9	2.0
10	2.0
11	2.25
12	2.5
13	2.5
14	2.75
15	3.0

(viii) Although the uncontrolled comparables are clearly similar to the controlled transaction, it is likely that unidentified material differences exist between the uncontrolled comparables and the controlled transaction. Therefore, an appropriate statistical technique must be used to establish the arm's length range. In this case the district director uses the interquartile range to determine the arm's length range. Therefore, the arm's length range covers royalty rates from 1.25 to 2.5 percent, and an adjustment is warranted to the 3 percent royalty charged in the controlled transfer. The district director determines that the appropriate adjustment corresponds to a reduction in the royalty rate to 2.0 percent, which is the median of the uncontrolled comparables.

Example 4. (i) USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no significant side effects. Nosplit replaces another drug, Lessplit, that USdrug had previously produced and marketed as a treatment for migraine headaches. A number of other drugs for treating migraine headaches are already on the market, but Nosplit can be expected rapidly to dominate the worldwide market for such treatments and to command a premium price since all other treatments produce side effects. Thus, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. market and other markets.

(ii) USdrug licenses its newly established European subsidiary, Eurodrug, the rights to produce and market Nosplit in the European market. In setting the royalty rate for this license, USdrug considers the royalty that it established previously when it licensed the right to produce and market Lessplit in the European market to an unrelated European pharmaceutical company. In many respects the two license agreements are closely comparable. The drugs were licensed at the same stage in their development and the agreements conveyed identical rights to the licensees. Moreover, there appear to have been no significant changes in the European market for migraine headache treatments since Lessplit was licensed. However, at the time that Lessplit was licensed there were several other similar drugs already on the market to which Lessplit was not in all cases superior. Consequently, the projected and actual Lessplit profits were substantially less than the projected Nosplit profits. Thus, USdrug concludes that the profit potential of Lessplit is not similar to the profit potential of Nosplit, and the Lessplit license agreement consequently is not a comparable uncontrolled transaction for purposes of this paragraph (c) in spite of the other indicia of comparability between the two intangibles.

(d) *Unspecified methods*—(1) *In general.* Methods not specified in paragraphs (a)(1), (2), and (3) of this section may be used to evaluate whether the amount charged in a controlled transaction is arm's length. Any method used under this paragraph (d) must be applied in accordance with the provisions of §1.482–1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled transaction method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction. Therefore, in establishing whether a controlled transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See §1.482–1(c). Therefore, in accordance with §1.482–1(d) (Comparability), to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(2) *Example.* The following example illustrates an application of the principle of this paragraph (d).

Example. (i) USbond is a U.S. company that licenses to its foreign subsidiary, Eurobond, a proprietary process that permits the manufacture of Longbond, a long-lasting industrial adhesive, at a substantially lower cost than otherwise would be possible. Using the proprietary process, Eurobond manufactures Longbond and sells it to related and unrelated parties for the market price of $550 per ton. Under the terms of the license agreement, Eurobond pays USbond a royalty of $100 per ton of Longbond sold. USbond also manufactures and markets Longbond in the United States.

(ii) In evaluating whether the consideration paid for the transfer of the proprietary process to Eurobond was arm's length, the district director may consider, subject to the best method rule of §1.482–1(c), USbond's alternative of producing and selling Longbond itself. Reasonably reliable estimates indicate that if USbond directly supplied Longbond to the European market, a selling price of $300 per ton would cover its costs and provide a reasonable profit for its functions, risks and investment of capital associated with the production of Longbond for the European market. Given that the market price of Longbond was $550 per ton, by licensing the proprietary process to Eurobond, USbond forgoes $250 per ton of profit over the profit that would be necessary to compensate it for the functions, risks and investment involved in supplying Longbond to the European market itself. Based on these facts, the district director concludes that a royalty of $100 for the proprietary process is not arm's length.

(e) *Coordination with tangible property rules.* See §1.482–3(f) for the provisions regarding the coordination between the tangible property and intangible property rules.

(f) *Special rules for transfers of intangible property*—(1) *Form of consideration.* If a transferee of an intangible pays nominal or no consideration and the transferor has retained a substantial interest in the property, the arm's length consideration shall be in the form of a royalty, unless a different form is demonstrably more appropriate.

(2) *Periodic adjustments*—(i) General rule. If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. Adjustments made pursuant to this paragraph (f)(2) shall be consistent with the arm's length standard and the provisions of §1.482–1. In determining whether to make such adjustments in the taxable year under examination, the district director may consider all relevant facts and circumstances throughout the period the intangible is used. The determination in an earlier year that the amount charged for an intangible was an arm's length amount will not preclude the district director in a subsequent taxable year from making an adjustment to the amount charged for the intangible in the subsequent year. A periodic adjustment under the commensurate with income requirement of section 482 may be made in a subsequent taxable year without regard to whether the taxable year of the original transfer remains open for statute of limitation purposes. For exceptions to this rule see paragraph (f)(2)(ii) of this section.

(ii) *Exceptions*—(A) *Transactions involving the same intangible.* If the same intangible was transferred to an uncontrolled taxpayer under substantially the same circumstances as those of the controlled transaction; this transaction serves as the basis for the application of the comparable uncontrolled transaction method in the first taxable year in which substantial periodic consideration was required to be paid; and the amount paid in that year was an arm's length amount, then no allocation in a subsequent year will be made under paragraph (f)(2)(i) of this paragraph for a controlled transfer of intangible property.

(B) *Transactions involving comparable intangible.* If the arm's length result is derived from the application of the comparable uncontrolled transaction method based on the transfer of a comparable intangible under comparable circumstances to those of the controlled transaction, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established—

(*1*) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, such consideration was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid under the agreement, and such agreement remained in effect for the taxable year under review;

(*2*) There is a written agreement setting forth the terms of the comparable uncontrolled transaction relied upon to establish the arm's length consideration (uncontrolled agreement), which contains no provisions that would permit any change to the amount of consideration, a renegotiation, or a termination of the agreement, in circumstances comparable to those of the controlled transaction in the taxable year under review (or that contains provisions permitting only specified, non-contingent, periodic changes to the amount of consideration);

(*3*) The controlled agreement is substantially similar to the uncontrolled agreement, with respect to the time period for which it is effective and the provisions described in paragraph (f)(2)(ii)(B)(*2*) of this section;

(*4*) The controlled agreement limits use of the intangible to a specified field or purpose in a manner that is consistent with industry practice and any such limitation in the uncontrolled agreement;

(*5*) There were no substantial changes in the functions performed by the controlled transferee after the controlled agreement was executed, except changes required by events that were not foreseeable; and

(*6*) The aggregate profits actually earned or the aggregate cost savings actually realized by the controlled taxpayer from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the comparability of the uncontrolled agreement was established under paragraph (c)(2) of this section.

(C) *Methods other than comparable uncontrolled transaction.* If the arm's length amount was determined under any method other than the comparable uncontrolled transaction method, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established—

(*1*) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, and such agreement remained in effect for the taxable year under review;

(*2*) The consideration called for in the controlled agreement was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid, and relevant supporting documentation was prepared contemporaneously with the execution of the controlled agreement;

(*3*) There have been no substantial changes in the functions performed by the transferee since the controlled agreement was executed, except changes required by events that were not foreseeable; and

(*4*) The total profits actually earned or the total cost savings realized by the controlled transferee from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the controlled agreement was entered into.

(D) *Extraordinary events.* No allocation will be made under paragraph (f)(2)(i) of this section if the following requirements are met—

(*1*) Due to extraordinary events that were beyond the control of the controlled taxpayers and that could not reasonably have been anticipated at the time the controlled agreement was entered into, the aggregate actual profits or aggregate cost savings realized by the taxpayer are less than 80% or more than 120% of the prospective profits or cost savings; and

(*2*) All of the requirements of paragraph (f)(2)(ii) (B) or (C) of this section are otherwise satisfied.

(E) *Five-year period.* If the requirements of §1.482–4 (f)(2)(ii)(B) or (f)(2)(ii)(C) are met for each year of the five-year period beginning with the first year in which substantial periodic consideration was required to be paid, then no periodic adjustment will be made under paragraph (f)(2)(i) of this section in any subsequent year.

(iii) *Examples.* The following examples illustrate this paragraph (f)(2).

Example 1. (i) USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no significant side effects. A number of other drugs for treating migraine headaches are already on the market, but Nosplit can be expected rapidly to dominate the worldwide market for such treatments and to command a premium price since all other treatments produce side effects. Thus, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. and European markets.

(ii) USdrug licenses its newly established European subsidiary, Eurodrug, the rights to produce and market Nosplit for the European market for 5 years. In setting the royalty rate for this license, USdrug makes projections of the annual sales revenue and the annual profits to be derived from the exploitation of Nosplit by Eurodrug. Based on the projections, a royalty rate of 3.9% is established for the term of the license.

(iii) In Year 1, USdrug evaluates the royalty rate it received from Eurodrug. Given the high profit potential of Nosplit, USdrug is unable to locate any uncontrolled transactions dealing with licenses of comparable intangible property. USdrug therefore determines that the comparable uncontrolled transaction method will not provide a reliable measure of an arm's length royalty. However, applying the comparable profits method to Eurodrug, USdrug determines that a royalty rate of 3.9% will result in Eurodrug earning an arm's length return for its manufacturing and marketing functions.

(iv) In Year 5, the U.S. income tax return for USdrug is examined, and the district director must determine whether the royalty rate between USdrug and Eurodrug is commensurate with the income attributable to Nosplit. In making this determination, the district director considers whether any of the exceptions in § 1.482–4(f)(2)(ii) are applicable. In particular, the district director compares the profit projections attributable to Nosplit made by USdrug against the actual profits realized by Eurodrug. The projected and actual profits are as follows:

	Profit projections	Actual profits
Year 1	200	250
Year 2	250	300
Year 3	500	600
Year 4	350	200
Year 5	100	100
Total	1400	1450

(v) The total profits earned through Year 5 were not less than 80% nor more than 120% of the profits that were projected when the license was entered into. If the district director determines that the other requirements of § 1.482–4(f)(2)(ii)(C) were met, no adjustment will be made to the royalty rate between USdrug and Eurodrug for the license of Nosplit.

Example 2. (i) The facts are the same as in *Example 1*, except that Eurodrug's actual profits earned were much higher than the projected profits, as follows:

	Profit projections	Actual profits
Year 1	200	250
Year 2	250	500
Year 3	500	800
Year 4	350	700
Year 5	100	600
Total	1400	2850

(ii) In examining USdrug's tax return for Year 5, the district director considers the actual profits realized by Eurodrug in Year 5, and all past years. Accordingly, although Years 1 through 4 may be closed under the statute of limitations, for purposes of determining whether an adjustment should be made with respect to the royalty rate in Year 5 with respect to Nosplit, the district director aggregates the actual profits from those years with the profits of Year 5. However, the district director will make an adjustment, if any, only with respect to Year 5.

Example 3. (i) FP, a foreign corporation, licenses to USS, its U.S. subsidiary, a new air-filtering process that permits manufacturing plants to meet new environmental standards. The license runs for a 10-year period, and the profit derived from the new process is projected to be $15 million per year, for an aggregate profit of $150 million.

(ii) The royalty rate for the license is based on a comparable uncontrolled transaction involving a comparable intangible under comparable circumstances. The requirements of paragraphs (f)(2)(ii)(B)(*1*) through (*5*) of this section have been met. Specifically, FP and USS have entered into a written agreement that provides for a royalty in each year of the license, the royalty rate is considered arm's length for the first taxable year in which a substantial royalty was required to be paid, the license limited the use of the process to a specified field, consistent with industry practice, and there are no substantial changes in the functions performed by USS after the license was entered into.

(iii) In examining Year 4 of the license, the district director determines that the aggregate actual profits earned by USS through Year 4 are $30 million, less than 80% of the projected profits of $60 million. However, USS establishes to the satisfaction of the district director that the aggregate actual profits from the process are less than 80% of the projected profits in Year 3 because an earthquake severely damaged USS's manufacturing plant. Because the difference between the projected profits and actual profits was due to an extraordinary event that was beyond the control of USS, and could not reasonably have been anticipated at the time the license was entered into, the requirement under § 1.482–4(f)(2)(ii)(D) has been met, and no adjustment under this section is made.

(3) *Ownership of intangible property*—(i) *Identification of owner*—(A) *In general.* The legal owner of intangible property pursuant to the intellectual property law of the relevant jurisdiction, or the holder of rights constituting an intangible property pursuant to contractual terms (such as the terms of a license) or other legal provision, will be considered the sole owner of the respective intangible property for purposes of this section unless such ownership is inconsistent with the economic substance of the underlying transactions. *See* § 1.482–1(d)(3)(ii)(B) (identifying contractual terms). If no owner of the respective intangible property is identified under the intellectual property law of the relevant jurisdiction, or pursuant to contractual terms (including terms imputed pursuant to § 1.482–1(d)(3)(ii)(B)) or other legal provision, then the controlled taxpayer who has control of the intangible property, based on all the facts and circumstances, will be considered the sole owner of the intangible property for purposes of this section.

(B) *Cost sharing arrangements.* The rules in this paragraph (f)(3) regarding ownership with respect to cost shared intangibles and cost sharing arrangements will apply only as provided in §1.482–7.

(ii) *Examples.* The principles of this paragraph (f)(3) are illustrated by the following examples:

Example 1. FP, a foreign corporation, is the registered holder of the AA trademark in the United States. FP licenses to its U.S. subsidiary, USSub, the exclusive rights to manufacture and market products in the United States under the AA trademark. FP is the owner of the trademark pursuant to intellectual property law. USSub is the owner of the license pursuant to the terms of the license, but is not the owner of the trademark. *See* paragraphs (b)(3) and (4) of this section (defining an intangible as, among other things, a trademark or a license).

Example 2. The facts are the same as in *Example 1.* As a result of its sales and marketing activities, USSub develops a list of several hundred creditworthy customers that regularly purchase AA trademarked products. Neither the terms of the contract between FP and USSub nor the relevant intellectual property law specify which party owns the customer list. Because USSub has knowledge of the contents of the list, and has practical control over its use and dissemination, USSub is considered the sole owner of the customer list for purposes of this paragraph (f)(3).

(4) *Contribution to the value of intangible property owned by another*—(i) *In general.* The arm's length consideration for a contribution by one controlled taxpayer that develops or enhances the value, or may be reasonably anticipated to develop or enhance the value, of intangible property owned by another controlled taxpayer will be determined in accordance with the applicable rules under section 482. If the consideration for such a contribution is embedded within the contractual terms for a controlled transaction that involves such intangible property, then ordinarily no separate allocation will be made with respect to such contribution. In such cases, pursuant to §1.482–1(d)(3), the contribution must be accounted for in evaluating the comparability of the controlled transaction to uncontrolled comparables, and accordingly in determining the arm's length consideration in the controlled transaction.

(ii) *Examples.* The principles of this paragraph (f)(4) are illustrated by the following examples:

Example 1. A, a member of a controlled group, allows B, another member of the controlled group, to use tangible property, such as laboratory equipment, in connection with B's development of an intangible that B owns. By furnishing tangible property, A makes a contribution to the development of intangible property owned by another controlled taxpayer, B. Pursuant to paragraph (f)(4)(i) of this section, the arm's length charge for A's furnishing of tangible property will be determined under the rules for use of tangible property in §1.482–2(c).

Example 2. (i) *Facts.* FP, a foreign producer of wristwatches, is the registered holder of the YY trademark in the United States and in other countries worldwide. FP enters into an exclusive, five-year, renewable agreement with its newly organized U.S. subsidiary, USSub. The contractual terms of the agreement grant USSub the exclusive right to re-sell YY trademark wristwatches in the United States, obligate USSub to pay a fixed price per wristwatch throughout the entire term of the contract, and obligate both FP and USSub to undertake without separate compensation specified types and levels of marketing activities.

(ii) The consideration for FP's and USSub's marketing activities, as well as the consideration for the exclusive right to re-sell YY trademarked merchandise in the United States, are embedded in the transfer price paid for the wristwatches. Accordingly, pursuant to paragraph (f)(4)(i) of this section, ordinarily no separate allocation would be appropriate with respect to these embedded contributions.

(iii) Whether an allocation is warranted with respect to the transfer price for the wristwatches is determined under §§1.482–1, 1.482–3, and this section through §1.482–6. The comparability analysis would include consideration of all relevant factors, including the nature of the intangible property embedded in the wristwatches and the nature of the marketing activities required under the agreement. This analysis would also take into account that the compensation for the activities performed by USSub and FP, as well as the consideration for USSub's use of the YY trademark, is embedded in the transfer price for the wristwatches, rather than provided for in separate agreements. *See* §§1.482–3(f) and 1.482–9(m)(4).

Example 3. (i) *Facts.* FP, a foreign producer of athletic gear, is the registered holder of the AA trademark in the United States and in other countries. In year 1, FP licenses to a newly organized U.S. subsidiary, USSub, the exclusive rights to use certain manufacturing and marketing intangible property to manufacture and market athletic gear in the United States under the AA trademark. The license agreement obligates USSub to pay a royalty based on sales of trademarked merchandise. The license agreement also obligates FP and USSub to perform without separate compensation specified types and levels of marketing activities. In year 1, USSub manufactures and sells athletic gear under the AA trademark in the United States.

(ii) The consideration for FP's and USSub's respective marketing activities is embedded in the contractual terms of the license for the AA trademark. Accordingly, pursuant to paragraph (f)(4)(i) of this section, ordinarily no separate allocation would be appropriate with respect to the embedded contributions in year 1. *See* §1.482–9(m)(4).

(iii) Whether an allocation is warranted with respect to the royalty under the license agreement would be analyzed under §1.482–1, and this section through §1.482–6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of the license, the nature of the intangible property subject to the license, and the nature of the marketing activities required to be undertaken pursuant to the license. Pursuant to paragraph (f)(4)(i) of this section, the analysis would also take into account the fact that the compensation for the marketing services is embedded in the royalty paid for use of the AA trademark, rather than provided for in a separate services agreement. For illustrations of application of the best method rule, *see* §1.482–8 *Examples 10*, *11*, and *12*.

Example 4. (i) *Facts*. The year 1 facts are the same as in *Example 3*, with the following exceptions. In year 2, USSub undertakes certain incremental marketing activities in addition to those required by the contractual terms of the license for the AA trademark executed in year 1. The parties do not execute a separate agreement with respect to these incremental marketing activities performed by USSub. The license agreement executed in year 1 is of sufficient duration that it is reasonable to anticipate that USSub will obtain the benefit of its incremental activities, in the form of increased sales or revenues of trademarked products in the U.S. market.

(ii) To the extent that it was reasonable to anticipate that USSub's incremental marketing activities would increase the value only of USSub's intangible property (that is, USSub's license to use the AA trademark for a specified term), and not the value of the AA trademark owned by FP, USSub's incremental activities do not constitute a contribution for which an allocation is warranted under paragraph (f)(4)(i) of this section.

Example 5. (i) *Facts*. The year 1 facts are the same as in *Example 3*. In year 2, FP and USSub enter into a separate services agreement that obligates USSub to perform certain incremental marketing activities to promote AA trademark athletic gear in the United States, above and beyond the activities specified in the license agreement executed in year 1. In year 2, USSub begins to perform these incremental activities, pursuant to the separate services agreement with FP.

(ii) Whether an allocation is warranted with respect to USSub's incremental marketing activities covered by the separate services agreement would be evaluated under §§1.482–1 and 1.482–9, including a comparison of the compensation provided for the services with the results obtained under a method pursuant to §1.482–9, selected and applied in accordance with the best method rule of §1.482–1(c).

(iii) Whether an allocation is warranted with respect to the royalty under the license agreement is determined under §1.482–1, and this section through §1.482–6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of the license, the nature of the intangible property subject to the license, and the nature of the marketing activities required to be undertaken pursuant to the license. The comparability analysis would take into account that the compensation for the incremental activities by USSub is provided for in the separate services agreement, rather than embedded in the royalty paid for use of the AA trademark. For illustrations of application of the best method rule, *see* §1.482–8 *Examples 10*, *11*, and *12*.

Example 6. (i) *Facts*. The year 1 facts are the same as in *Example 3*. In year 2, FP and USSub enter into a separate services agreement that obligates FP to perform incremental marketing activities, not specified in the year 1 license, by advertising AA trademarked athletic gear in selected international sporting events, such as the Olympics and the soccer World Cup. FP's corporate advertising department develops and coordinates these special promotions. The separate services agreement obligates USSub to pay an amount to FP for the benefit to USSub that may reasonably be anticipated as the result of FP's incremental activities. The separate services agreement is not a qualified cost sharing arrangement under §1.482–7T. FP begins to perform the incremental activities in year 2 pursuant to the separate services agreement.

(ii) Whether an allocation is warranted with respect to the incremental marketing activities performed by FP under the separate services agreement would be evaluated under §1.482–9. Under the circumstances, it is reasonable to anticipate that FP's activities would increase the value of USSub's license as well as the value of FP's trademark. Accordingly, the incremental activities by FP may constitute in part a controlled services transaction for which USSub must compensate FP. The analysis of whether an allocation is warranted would include a comparison of the compensation provided for the services with the results obtained under a method pursuant to § 1.482–9, selected and applied in accordance with the best method rule of § 1.482–1(c).

(iii) Whether an allocation is appropriate with respect to the royalty under the license agreement would be evaluated under §§ 1.482–1 through 1.482–3, this section, and §§ 1.482–5 and 1.482–6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of USSub's license, the nature of the intangible property subject to the license, and the marketing activities required to be undertaken by both FP and USSub pursuant to the license. This comparability analysis would take into account that the compensation for the incremental activities performed by FP was provided for in the separate services agreement, rather than embedded in the royalty paid for use of the AA trademark. For illustrations of application of the best method rule, *see* § 1.482–8, *Example 10*, *Example 11*, and *Example 12*.

(5) *Consideration not artificially limited.* The arm's length consideration for the controlled transfer of an intangible is not limited by the consideration paid in any uncontrolled transactions that do not meet the requirements of the comparable uncontrolled transaction method described in paragraph (c) of this section. Similarly, the arm's length consideration for an intangible is not limited by the prevailing rates of consideration paid for the use or transfer of intangibles within the same or similar industry.

(6) *Lump sum payments*—(i) *In general.* If an intangible is transferred in a controlled transaction for a lump sum, that amount must be commensurate with the income attributable to the intangible. A lump sum is commensurate with income in a taxable year if the equivalent royalty amount for that taxable year is equal to an arm's length royalty. The equivalent royalty amount for a taxable year is the amount determined by treating the lump sum as an advance payment of a stream of royalties over the useful life of the intangible (or the period covered by an agreement, if shorter), taking into account the projected sales of the licensee as of the date of the transfer. Thus, determining the equivalent royalty amount requires a present value calculation based on the lump sum, an appropriate discount rate, and the projected sales over the relevant period. The equivalent royalty amount is subject to periodic adjustments under § 1.482–4(f)(2)(i) to the same extent as an actual royalty payment pursuant to a license agreement.

(ii) *Exceptions.* No periodic adjustment will be made under paragraph (f)(2)(i) of this section if any of the exceptions to periodic adjustments provided in paragraph (f)(2)(ii) of this section apply.

(iii) *Example.* The following example illustrates the principle of this paragraph (f)(5).

Example. Calculation of the equivalent royalty amount. (i) FSub is the foreign subsidiary of USP, a U.S. company. USP licenses FSub the right to produce and sell the whopperchopper, a patented new kitchen appliance, for the foreign market. The license is for a period of five years, and payment takes the form of a single lump-sum charge of $500,000 that is paid at the beginning of the period.

(ii) The equivalent royalty amount for this license is determined by deriving an equivalent royalty rate equal to the lump-sum payment divided by the present discounted value of FSub's projected sales of whopperchoppers over the life of the license. Based on the riskiness of the whopperchopper business, an appropriate discount rate is determined to be 10 percent. Projected sales of whopperchoppers for each year of the license are as follows:

Year	Projected sales
1	$2,500,000
2	2,600,000
3	2,700,000
4	2,700,000
5	2,750,000

(iii) Based on this information, the present discounted value of the projected whopperchopper sales is approximately $10 million, yielding an equivalent royalty rate of approximately 5%. Thus, the equivalent royalty amounts for each year are as follows:

Year	Projected sales	Equivalent royalty amount
1	$2,500,000	$125,000
2	2,600,000	130,000
3	2,700,000	135,000
4	2,700,000	135,000
5	2,750,000	137,500

(iv) If in any of the five taxable years the equivalent royalty amount is determined not to be an arm's length amount, a periodic adjustment may be made pursuant to §1.482–4(f)(2)(i). The adjustment in such case would be equal to the difference between the equivalent royalty amount and the arm's length royalty in that taxable year.

(g) *Coordination with rules governing cost sharing arrangements.* Section 1.482–7 provides the specific methods to be used to determine arm's length results of controlled transactions in connection with a cost sharing arrangement. This section provides the specific methods to be used to determine arm's length results of a transfer of intangible property, including in an arrangement for sharing the costs and risks of developing intangibles other than a cost sharing arrangement covered by §1.482–7. In the case of such an arrangement, consideration of the principles, methods, comparability, and reliability considerations set forth in §1.482–7 is relevant in determining the best method, including an unspecified method, under this section, as appropriately adjusted in light of the differences in the facts and circumstances between such arrangement and a cost sharing arrangement.

(h) *Effective/applicability date*—(1) *In general.* Except as provided in the succeeding sentence, the provisions of paragraphs (f)(3) and (4) of this section are generally applicable for taxable years beginning after December 31, 2006. The provisions of paragraphs (f)(3)(i)(B) and (g) of this section are generally applicable on January 5, 2009.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of paragraphs (f)(3) and (4) of this section to earlier taxable years in accordance with the rules set forth in §1.482–9(n)(2).

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§ 1.482–5 Comparable profits method.

(a) *In general.* The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.

(b) *Determination of arm's length result*—(1) *In general.* Under the comparable profits method, the determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable (comparable operating profit). Comparable operating profit is calculated by determining a profit level indicator for an uncontrolled comparable, and applying the profit level indicator to the financial data related to the tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available (relevant business activity). To the extent possible, profit level indicators should be applied solely to the tested party's financial data that is related to controlled transactions. The tested party's reported operating profit is compared to the comparable operating profits derived from the profit level indicators of uncontrolled comparables to determine whether the reported operating profit represents an arm's length result.

(2) *Tested party*—(i) *In general.* For purposes of this section, the tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. Consequently, in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

(ii) *Adjustments for tested party.* The tested party's operating profit must first be adjusted to reflect all other allocations under section 482, other than adjustments pursuant to this section.

(3) *Arm's length range.* See §1.482–1(e)(2) for the determination of the arm's length range. For purposes of the comparable profits method, the arm's length range will be established using comparable operating profits derived from a single profit level indicator.

(4) *Profit level indicators.* Profit level indicators are ratios that measure relationships between profits and costs incurred or resources employed. A variety of profit level indicators can be calculated in any given case. Whether use of a particular profit level indicator is appropriate depends upon a number of factors, including the nature of the activities of the tested party, the reliability of the available data with respect to uncontrolled comparables, and the extent to which the profit level indicator is likely to produce a reliable measure of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length, taking into account all of the facts and circumstances. The profit level indicators should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables. Generally, such a period should encompass at least the taxable year under review and the preceding two taxable years. This analysis must be applied in accordance with §1.482–1(f)(2)(iii)(D). Profit level indicators that may provide a reliable basis for comparing operating profits of the tested party and uncontrolled comparables include the following—

(i) *Rate of return on capital employed.* The rate of return on capital employed is the ratio of operating profit to operating assets. The reliability of this profit level indicator increases as operating assets play a greater role in generating operating profits for both the tested party and the uncontrolled comparable. In addition, reliability under this profit level indicator depends on the extent to which the composition of the tested party's assets is similar to that of the uncontrolled comparable. Finally, difficulties in properly valuing operating assets will diminish the reliability of this profit level indicator.

(ii) *Financial ratios.* Financial ratios measure relationships between profit and costs or sales revenue. Since functional differences generally have a greater effect on the relationship between profit and costs or sales revenue than the relationship between profit and operating assets, financial ratios are more sensitive to functional differences than the rate of return on capital employed. Therefore, closer functional comparability normally is required under a financial ratio than under the rate of return on capital employed to achieve a similarly reliable measure of an arm's length result. Financial ratios that may be appropriate include the following—

(A) Ratio of operating profit to sales; and

(B) Ratio of gross profit to operating expenses. Reliability under this profit level indicator also depends on the extent to which the composition of the tested party's operating expenses is similar to that of the uncontrolled comparables.

(iii) *Other profit level indicators.* Other profit level indicators not described in this paragraph (b)(4) may be used if they provide reliable measures of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length. However, profit level indicators based solely on internal data may not be used under this paragraph (b)(4) because they are not objective measures of profitability derived from operations of uncontrolled taxpayers engaged in similar business activities under similar circumstances.

(c) *Comparability and reliability considerations*—(1) *In general.* Whether results derived from application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482–1(c).

(2) *Comparability*—(i) *In general.* The degree of comparability between an uncontrolled taxpayer and the tested party is determined by applying the provisions of §1.482–1(d)(2). The comparable profits method compares the profitability of the tested party, measured by a profit level indicator (generally based on operating profit), to the profitability of uncontrolled taxpayers in similar circumstances. As with all methods that rely on external market benchmarks, the greater the degree of comparability between the tested party and the uncontrolled taxpayer, the more reliable will be the results derived from the application of this method. The determination of the degree of comparability between the tested party and the uncontrolled taxpayer

depends upon all the relevant facts and circumstances, including the relevant lines of business, the product or service markets involved, the asset composition employed (including the nature and quantity of tangible assets, intangible assets and working capital), the size and scope of operations, and the stage in a business or product cycle.

(ii) *Functional, risk and resource comparability*. An operating profit represents a return for the investment of resources and assumption of risks. Therefore, although all of the factors described in §1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on resources employed and risks assumed. Moreover, because resources and risks usually are directly related to functions performed, it is also important to consider functions performed in determining the degree of comparability between the tested party and an uncontrolled taxpayer. The degree of functional comparability required to obtain a reliable result under the comparable profits method, however, is generally less than that required under the resale price or cost plus methods. For example, because differences in functions performed often are reflected in operating expenses, taxpayers performing different functions may have very different gross profit margins but earn similar levels of operating profit.

(iii) *Other comparability factors*. Other factors listed in §1.482–1(d)(3) also may be particularly relevant under the comparable profits method. Because operating profit usually is less sensitive than gross profit to product differences, reliability under the comparable profits method is not as dependent on product similarity as the resale price or cost plus method. However, the reliability of profitability measures based on operating profit may be adversely affected by factors that have less effect on results under the comparable uncontrolled price, resale price, and cost plus methods. For example, operating profit may be affected by varying cost structures (as reflected, for example, in the age of plant and equipment), differences in business experience (such as whether the business is in a start-up phase or is mature), or differences in management efficiency (as indicated, for example, by objective evidence such as expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(iv) *Adjustments for the differences between the tested party and the uncontrolled taxpayers*. If there are differences between the tested party and an uncontrolled comparable that would materially affect the profits determined under the relevant profit level indicator, adjustments should be made according to the comparability provisions of §1.482–1(d)(2). In some cases, the assets of an uncontrolled comparable may need to be adjusted to achieve greater comparability between the tested party and the uncontrolled comparable. In such cases, the uncontrolled comparable's operating income attributable to those assets must also be adjusted before computing a profit level indicator in order to reflect the income and expense attributable to the adjusted assets. In certain cases it may also be appropriate to adjust the operating profit of the tested party and comparable parties. For example, where there are material differences in accounts payable among the comparable parties and the tested party, it will generally be appropriate to adjust the operating profit of each party by increasing it to reflect an imputed interest charge on each party's accounts payable. As another example, it may be appropriate to adjust the operating profit of a party to account for material differences in the utilization of or accounting for stock-based compensation (as defined by §1.482–7(d)(3)(i)) among the tested party and comparable parties.

(3) *Data and assumptions*—(i) *In general*. The reliability of the results derived from the comparable profits method is affected by the quality of the data and assumptions used to apply this method.

(ii) *Consistency in accounting*. The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect operating profit affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results.

(iii) *Allocations between the relevant business activity and other activities*. The reliability of the allocation of costs, income, and assets between the relevant business activity and other activities of the tested party or an uncontrolled comparable will affect the reliability of the determination of operating profit and profit level indicators. If it is not possible to allocate costs, income, and assets directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from the application of this method is reduced relative to the results of a method that requires fewer allocations of costs, income, and assets. Similarly, the reliability of the results derived from the application of this method is affected by the extent to which it is possible to apply the profit level indicator to the tested party's financial data that is related solely to the controlled transactions. For example, if the relevant business activity is the assembly of components purchased from both controlled and uncontrolled suppliers, it may not be possible to apply the profit level indicator solely to financial data related to the controlled transactions. In such a case, the reliability of the results derived from the application of this method will be reduced.

(d) *Definitions*. The definitions set forth in paragraphs (d)(1) through (6) of this section apply for purposes of this section.

(1) *Sales revenue* means the amount of the total receipts from sale of goods and provision of services, less returns and allowances. Accounting principles and conventions that are generally accepted in the trade or industry of the controlled taxpayer under review must be used.

(2) *Gross profit* means sales revenue less cost of goods sold.

(3) *Operating expenses* includes all expenses not included in cost of goods sold except for interest expense, foreign income taxes (as defined in §1.901–2(a)), domestic income taxes, and any other expenses not related to the operation of the relevant business activity. Operating expenses ordinarily include expenses associated with advertising, promotion, sales, marketing, warehousing and distribution, administration, and a reasonable allowance for depreciation and amortization.

(4) *Operating profit* means gross profit less operating expenses. Operating profit includes all income derived from the business activity being evaluated by the comparable profits method, but does not include interest and dividends, income derived from activities not being tested by this method, or extraordinary gains and losses that do not relate to the continuing operations of the tested party.

(5) *Reported operating profit* means the operating profit of the tested party reflected on a timely filed U.S. income tax return. If the tested party files a U.S. income tax return, its operating profit is considered reflected on a U.S. income tax return if the calculation of taxable income on its return for the taxable year takes into account the income attributable to the controlled transaction under review. If the tested party does not file a U.S. income tax return, its operating profit is considered reflected on a U.S. income tax return in any taxable year for which income attributable to the controlled transaction under review affects the calculation of the U.S. taxable income of any other member of the same controlled group. If the comparable operating profit of the tested party is determined from profit level indicators derived from financial statements or other accounting records and reports of comparable parties, adjustments may be made to the reported operating profit of the tested party in order to account for material differences between the tested party's operating profit reported for U.S income tax purposes and the tested party's operating profit for financial statement purposes. In addition, in accordance with §1.482–1(f)(2)(iii)(D), adjustments under section 482 that are finally determined may be taken into account in determining reported operating profit.

(6) *Operating assets.* The term operating assets means the value of all assets used in the relevant business activity of the tested party, including fixed assets and current assets (such as cash, cash equivalents, accounts receivable, and inventories).

The term does not include investments in subsidiaries, excess cash, and portfolio investments. Operating assets may be measured by their net book value or by their fair market value, provided that the same method is consistently applied to the tested party and the comparable parties, and consistently applied from year to year. In addition, it may be necessary to take into account recent acquisitions, leased assets, intangibles, currency fluctuations, and other items that may not be explicitly recorded in the financial statements of the tested party or uncontrolled comparable. Finally, operating assets must be measured by the average of the values for the beginning of the year and the end of the year, unless substantial fluctuations in the value of operating assets during the year make this an inaccurate measure of the average value over the year. In such a case, a more accurate measure of the average value of operating assets must be applied.

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

Example 1. Transfer of tangible property resulting in no adjustment. (i) FP is a publicly traded foreign corporation with a U.S. subsidiary, USSub, that is under audit for its 1996 taxable year. FP manufactures a consumer product for worldwide distribution. USSub imports the assembled product and distributes it within the United States at the wholesale level under the FP name.

(ii) FP does not allow uncontrolled taxpayers to distribute the product. Similar products are produced by other companies but none of them is sold to uncontrolled taxpayers or to uncontrolled distributors.

(iii) Based on all the facts and circumstances, the district director determines that the comparable profits method will provide the most reliable measure of an arm's length result. USSub is selected as the tested party because it engages in activities that are less complex than those undertaken by FP.

There is data from a number of independent operators of wholesale distribution businesses. These potential comparables are further narrowed to select companies in the same industry segment that perform similar functions and bear similar risks to USSub. An analysis of the information available on these taxpayers shows that the ratio of operating profit to sales is the most appropriate profit level indicator, and this ratio is relatively stable where at least three years are included in the average. For the taxable years 1994 through 1996, USSub shows the following results:

	1994	1995	1996	Average
Sales	$500,000	$560,000	$500,000	$520,000
Cost of Goods Sold	393,000	412,400	400,000	401,800
Operating Expenses	80,000	110,000	104,600	98,200
Operating Profit	27,000	37,600	(4,600)	20,000

(iv) After adjustments have been made to account for identified material differences between USSub and the uncontrolled distributors, the average ratio of operating profit to sales is calculated for each of the uncontrolled distributors. Applying each ratio to USSub would lead to the following comparable operating profit (COP) for USSub:

Uncontrolled distributor	OP/S (percent)	USSub COP
A	1.7	$8,840
B	3.1	16,120
C	3.8	19,760
D	4.5	23,400
E	4.7	24,440
F	4.8	24,960
G	4.9	25,480
H	6.7	34,840
I	9.9	51,480
J	10.5	54,600

(v) The data is not sufficiently complete to conclude that it is likely that all material differences between USSub and the uncontrolled distributors have been identified. Therefore, an arm's length range can be established only pursuant to §1.482-1(e)(2)(iii)(B). The district director measures the arm's length range by the interquartile range of results, which consists of the results ranging from $19,760 to $34,840. Although USSub's operating income for 1996 shows a loss of $4,600, the district director determines that no allocation should be made, because USSub's average reported operating profit of $20,000 is within this range.

Example 2. Transfer of tangible property resulting in adjustment. (i) The facts are the same as in *Example 1* except that USSub reported the following income and expenses:

	1994	1995	1996	Average
Sales	$500,000	$560,000	$500,000	$520,000
Cost of Good Sold	370,000	460,000	400,000	410,000
Operating Expenses	110,000	110,000	110,000	110,000
Operating Profit	20,000	(10,000)	(10,000)	0

(ii) The interquartile range of comparable operating profits remains the same as derived in *Example 1:* $19,760 to $34,840. USSub's average operating profit for the years 1994 through 1996 ($0) falls outside this range. Therefore, the district director determines that an allocation may be appropriate.

(iii) To determine the amount, if any, of the allocation, the district director compares USSub's reported operating profit for 1996 to comparable operating profits derived from the uncontrolled distributors' results for 1996. The ratio of operating profit to sales in 1996 is calculated for each of the uncontrolled comparables and applied to USSub's 1996 sales to derive the following results:

Uncontrolled distributor	OP/S (percent)	USSub COP
C	0.5	$2,500
D	1.5	7,500
E	2.0	10,000
A	1.6	13,000
F	2.8	14,000
B	2.9	14,500
J	3.0	15,000
I	4.4	22,000
H	6.9	34,500
G	7.4	37,000

(iv) Based on these results, the median of the comparable operating profits for 1996 is $14,250. Therefore, USSub's income for 1996 is increased by $24,250, the difference between USSub's reported operating profit for 1996 and the median of the comparable operating profits for 1996.

Example 3. Multiple year analysis. (i) The facts are the same as in *Example 2.* In addition, the district director examines the taxpayer's results for the 1997 taxable year. As in *Example 2,* the district director increases USSub's income for the 1996 taxable year by $24,250. The results for the 1997 taxable year, together with the 1995 and 1996 taxable years, are as follows:

	1995	1996	1997	Average
Sales	$560,000	$500,000	$530,000	$530,000
Cost of Good Sold	460,000	400,000	430,000	430,000
Operating Expenses	110,000	110,000	110,000	110,000
Operating Profit	(10,000)	(10,000)	(10,000)	(10,000)

(ii) The interquartile range of comparable operating profits, based on average results from the uncontrolled comparables and average sales for USSub for the years 1995 through 1997, ranges from $15,500 to $30,000. In determining whether an allocation for the 1997 taxable year may be made, the district director compares USSub's average reported operating profit for the years 1995 through 1997 to the interquartile range of average comparable operating profits over this period. USSub's average reported operating profit is determined without regard to the adjustment made with respect to the 1996 taxable year. See §1.482–1(f)(2)(iii)(D). Therefore, USSub's average reported operating profit for the years 1995 through 1997 is ($10,000). Because this amount of income falls outside the interquartile range, the district director determines that an allocation may be appropriate.

(iii) To determine the amount, if any, of the allocation for the 1997 taxable year, the district director compares USSub's reported operating profit for 1997 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 1997. The median of the comparable operating profits derived from the uncontrolled comparables results for the 1997 taxable year is $12,000. Based on this comparison, the district director increases USSub's 1997 taxable income by $22,000, the difference between the median of the comparable operating profits for the 1997 taxable year and USSub's reported operating profit of ($10,000) for the 1997 taxable year.

Example 4. Transfer of intangible to offshore manufacturer. (i) DevCo is a U.S. developer, producer and marketer of widgets. DevCo develops a new ''high tech widget'' (htw) that is manufactured by its foreign subsidiary ManuCo located in Country H. ManuCo sells the htw to MarkCo (a U.S. subsidiary of DevCo) for distribution and marketing in the United States. The taxable year 1996 is under audit, and the district director examines whether the royalty rate of 5 percent paid by ManuCo to DevCo is an arm's length consideration for the htw technology.

(ii) Based on all the facts and circumstances, the district director determines that the comparable profits method will provide the most reliable measure of an arm's length result. ManuCo is selected as the tested party because it engages in relatively routine manufacturing activities, while DevCo engages in a variety of complex activities using unique and valuable intangibles. Finally, because ManuCo engages in manufacturing activities, it is determined that the ratio of operating profit to operating assets is an appropriate profit level indicator.

(iii) Uncontrolled taxpayers performing similar functions cannot be found in country H. It is determined that data available in countries M and N provides the best match of companies in a similar market performing similar functions and bearing similar risks. Such data is sufficiently complete to identify many of the material differences between ManuCo and the uncontrolled comparables, and to make adjustments to account for such differences. However, data is not sufficiently complete so that it is likely that no material differences remain. In particular, the differences in geographic markets might have materially affected the results of the various companies.

(iv) In a separate analysis, it is determined that the price that ManuCo charged to MarkCo for the htw's is an arm's length price under §1.482–3(b). Therefore, ManuCo's financial data derived from its sales to MarkCo are reliable. ManuCo's financial data from 1994–1996 is as follows:

	1994	1995	1996	Average
Assets	$24,000	$25,000	$26,000	$25,000
Sales to MarkCo	25,000	30,000	35,000	30,000
Cost of Goods Sold	6,250	7,500	8,750	7,500
Royalty to DevCo (5%)	1,250	1,500	1,750	1,500
Other	5,000	6,000	7,000	6,000
Operating Expenses	1,000	1,000	1,000	1,000
Operating Profit	17,750	21,500	25,250	21,500

(v) Applying the ratios of average operating profit to operating assets for the 1994 through 1996 taxable years derived from a group of similar uncontrolled comparables located in country M and N to ManuCo's average operating assets for the same period provides a set of comparable operating profits. The interquartile range for these average comparable operating profits is $3,000 to $4,500. ManuCo's average reported operating profit for the years 1994 through 1996 ($21,500) falls outside this range. Therefore, the district director determines that an allocation may be appropriate for the 1996 taxable year.

(vi) To determine the amount, if any, of the allocation for the 1996 taxable year, the district director compares ManuCo's reported operating profit for 1996 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 1996. The median result for the uncontrolled comparables for 1996 is $3,750. Based on this comparison, the district director increases royalties that ManuCo paid by $21,500 (the difference between $25,250 and the median of the comparable operating profits, $3,750).

Example 5. Adjusting operating assets and operating profit for differences in accounts receivable. (i) USM is a U.S. company that manufactures parts for industrial equipment and sells them to its foreign parent corporation. For purposes of applying the comparable profits method, 15 uncontrolled manufacturers that are similar to USM have been identified.

(ii) USM has a significantly lower level of accounts receivable than the uncontrolled manufacturers. Since the rate of return on capital employed is to be used as the profit level indicator, both operating assets and operating profits must be adjusted to account for this difference. Each uncontrolled comparable's operating assets is reduced by the amount (relative to sales) by which they exceed USM's accounts receivable. Each uncontrolled comparable's operating profit is adjusted by deducting imputed interest income on the excess accounts receivable. This imputed interest income is calculated by multiplying the uncontrolled comparable's excess accounts receivable by an interest rate appropriate for short-term debt.

Example 6. Adjusting operating profit for differences in accounts payable. (i) USD is the U.S. subsidiary of a foreign corporation. USD purchases goods from its foreign parent and sells them in the U.S. market. For purposes of applying the comparable profits method, 10 uncontrolled distributors that are similar to USD have been identified.

(ii) There are significant differences in the level of accounts payable among the uncontrolled distributors and USD. To adjust for these differences, the district director increases the operating profit of the uncontrolled distributors and USD to reflect interest expense imputed to the accounts payable. The imputed interest expense for each company is calculated by multiplying the company's accounts payable by an interest rate appropriate for its short-term debt.

[T.D. 8552, 59 FR 35021, July 8, 1994; 60 FR 16703, Mar. 31, 1995; T.D. 9088, 68 FR 51177, Aug. 26, 2003; T.D. 9441, 74 FR 352, Jan. 5, 2009;T.D. 9568, 76 FR 80090, Dec. 22, 2011]

§ 1.482–6 Profit split method.

(a) *In general.* The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).

(b) *Appropriate share of profits and losses.* The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity, consistent with the comparability provisions of §1.482–1(d)(3). Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity. The profit allocated to any particular member of a controlled group is not necessarily limited to the total operating profit of the group from the relevant business activity. For example, in a given year, one member of the group may earn a profit while another member incurs a loss. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion. The specific method of allocation must be determined under paragraph (c) of this section.

(c) *Application*—(1) *In general.* The allocation of profit or loss under the profit split method must be made in accordance with one of the following allocation methods—(i) The comparable profit split, described in paragraph (c)(2) of this section; or

(ii) The residual profit split, described in paragraph (c)(3) of this section.

(2) *Comparable profit split*—(i) *In general.* A comparable profit split is derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. Under this method, each uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity.

(ii) *Comparability and reliability considerations—(A) In general.* Whether results derived from application of this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule in §1.482–1(c).

(B) *Comparability*—(*1*) *In general.* The degree of comparability between the controlled and uncontrolled taxpayers is determined by applying the comparability provisions of §1.482–1(d). The comparable profit split compares the division of operating profits among the controlled taxpayers to the division of operating profits among uncontrolled taxpayers engaged in similar activities under similar circumstances. Although all of the factors described in §1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on the considerations described under the comparable profits method in §1.482–5(c)(2) or §1.482–9(f)(2)(iii) because this method is based on a comparison of the operating profit of the controlled and uncontrolled taxpayers. In addition, because the contractual terms of the relationship among the participants in the relevant business activity will be a principal determinant of the allocation of functions and risks among them, comparability under this method also depends particularly on the degree of similarity of the contractual terms of the controlled and uncontrolled taxpayers. Finally, the comparable profit split may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.

(*2*) *Adjustments for differences between the controlled and uncontrolled taxpayers.* If there are differences between the controlled and uncontrolled taxpayers that would materially affect the division of operating profit, adjustments must be made according to the provisions of § 1.482–1(d)(2).

(C) *Data and assumptions.* The reliability of the results derived from the comparable profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered—

(*1*) The reliability of the allocation of costs, income, and assets between the relevant business activity and the participants' other activities will affect the accuracy of the determination of combined operating profit and its allocation among the participants. If it is not possible to allocate costs, income, and assets directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from the application of this method is reduced relative to the results of a method that requires fewer allocations of costs, income, and assets. Similarly, the reliability of the results derived from the application of this method is affected by the extent to which it is possible to apply the method to the parties' financial data that is related solely to the controlled transactions. For example, if the relevant business activity is the assembly of components purchased from both controlled and uncontrolled suppliers, it may not be possible to apply the method solely to financial data related to the controlled transactions. In such a case, the reliability of the results derived from the application of this method will be reduced.

(*2*) The degree of consistency between the controlled and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, accounting consistency among the participants in the controlled transaction is required to ensure that the items determining the amount and allocation of operating profit are measured on a consistent basis.

(D) *Other factors affecting reliability.* Like the methods described in §§ 1.482–3, 1.482–4, 1.482–5, and 1.482–9, the comparable profit split relies exclusively on external market benchmarks. As indicated in § 1.482–1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the comparable profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(3) *Residual profit split*—(i) *In general.* Under this method, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following the two-step process set forth in paragraphs (c)(3)(i)(A) and (B) of this section.

(A) *Allocate income to routine contributions.* The first step allocates operating income to each party to the controlled transactions to provide a market return for its routine contributions to the relevant business activity. Routine contributions are contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and intangible property that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled taxpayers. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities, consistent with the methods described in §§1.482–3, 1.482–4, 1.482–5 and 1.482–9.

(B) *Allocate residual profit*—(*1*) *Nonroutine contributions generally.* The allocation of income to the controlled taxpayer's routine contributions will not reflect profits attributable to each controlled taxpayer's contributions to the relevant business activity that are not routine (nonroutine contributions). A nonroutine contribution is a contribution that is not accounted for as a routine contribution. Thus, in cases where such nonroutine contributions are present, there normally will be an unallocated residual profit after the allocation of income described in paragraph (c)(3)(i)(A) of this section. Under this second step, the residual profit generally should be divided among the controlled taxpayers based upon the relative value of their nonroutine contributions to the relevant business activity. The relative value of the nonroutine contributions of each taxpayer should be measured in a manner that most reliably reflects each nonroutine contribution made to the controlled transaction and each controlled taxpayer's role in the nonroutine contributions. If the nonroutine contribution by one of the controlled taxpayers is also used in other business activities (such as transactions with other controlled taxpayers), an appropriate allocation of the value of the nonroutine contribution must be made among all the business activities in which it is used.

(*2*) *Nonroutine contributions of intangible property.* In many cases, nonroutine contributions of a taxpayer to the relevant business activity may be contributions of intangible property. For purposes of paragraph (c)(3)(i)(B)(*1*) of this section, the relative value of nonroutine intangible property contributed by taxpayers may be measured by external market benchmarks that reflect the fair market value of such intangible property. Alternatively, the relative value of nonroutine intangible property contributions may be estimated by the capitalized cost of developing the intangible property and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible property. Finally, if the intangible property development expenditures of the parties are relatively constant over time and the useful life of the intangible property contributed by all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of nonroutine intangible property contributions.

(ii) *Comparability and reliability considerations*—(A) *In general.* Whether results derived from this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule in §1.482–1(c). Thus, comparability and the quality of data and assumptions must be considered in determining whether this method provides the most reliable measure of an arm's length result. The application of these factors to the residual profit split is discussed in paragraph (c)(3)(ii)(B), (C), and (D) of this section.

(B) *Comparability.* The first step of the residual profit split relies on market benchmarks of profitability. Thus, the comparability considerations that are relevant for the first step of the residual profit split are those that are relevant for the methods that are used to determine market returns for the routine contributions. The second step of the residual profit split, however, may not rely so directly on market benchmarks. Thus, the reliability of the results under this method is reduced to the extent that the allocation of profits in the second step does not rely on market benchmarks.

(C) *Data and assumptions.* The reliability of the results derived from the residual profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered—

(*1*) The reliability of the allocation of costs, income, and assets as described in paragraph (c)(2)(ii)(C)(*1*) of this section;

(*2*) Accounting consistency as described in paragraph (c)(2)(ii)(C)(*2*) of this section;

(*3*) The reliability of the data used and the assumptions made in valuing the intangible property contributed by the participants. In particular, if capitalized costs of development are used to estimate the value of intangible property, the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate, for the following reasons. First, in any given case, the costs of developing the intangible may not be related to its market value. Second, the calculation of the capitalized costs of development may require the allocation of indirect costs between the relevant business activity and the controlled taxpayer's other activities, which may affect the reliability of the analysis. Finally, the calculation of costs may require assumptions regarding the useful life of the intangible property.

(D) *Other factors affecting reliability.* Like the methods described in §§1.482–3, 1.482–4, 1.482–5, and 1.482–9, the first step of the residual profit split relies exclusively on external market benchmarks. As indicated in §1.482–1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, to the extent the allocation of profits in the second step is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks. Finally, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the residual profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(iii) *Example.* The provisions of this paragraph (c)(3) are illustrated by the following example.

Example—Application of Residual Profit Split. (i) XYZ is a U.S. corporation that develops, manufactures and markets a line of products for police use in the United States. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Nulon). XYZ obtains patent protection for the chemical formula for Nulon. Since its introduction in the U.S., Nulon has captured a substantial share of the U.S. market for bulletproof material.

(ii) XYZ licensed its European subsidiary, XYZ-Europe, to manufacture and market Nulon in Europe. XYZ-Europe is a well- established company that manufactures and markets XYZ products in Europe. XYZ-Europe has a research unit that adapts XYZ products for the defense market, as well as a well-developed marketing network that employs brand names that it developed.

(iii) XYZ-Europe's research unit alters Nulon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defense industry in several European countries. Beginning with the 1995 taxable year, XYZ-Europe manufactures and sells Nulon in Europe through its marketing network under one of its brand names.

(iv) For the 1995 taxable year, XYZ has no direct expenses associated with the license of Nulon to XYZ-Europe and incurs no expenses related to the marketing of Nulon in Europe. For the 1995 taxable year, XYZ-Europe's Nulon sales and pre-royalty expenses are $500 million and $300 million, respectively, resulting in net pre-royalty profit of $200 million related to the Nulon business. The operating assets employed in XYZ-Europe's Nulon business are $200 million. Given the facts and circumstances, the district director determines under the best method rule that a residual profit split will provide the most reliable measure of an arm's length result. Based on an examination of a sample of European companies performing functions similar to those of XYZ-Europe, the district director determines that an average market return on XYZ-Europe's operating assets in the Nulon business is 10 percent, resulting in a market return of $20 million (10% × $200 million) for XYZ- Europe's Nulon business, and a residual profit of $180 million.

(v) Since the first stage of the residual profit split allocated profits to XYZ-Europe's contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of $180 million is attributable to the valuable intangibles related to Nulon, i.e., the European brand name for Nulon and the Nulon formula (including XYZ-Europe's modifications). To estimate the relative values of these intangibles, the district director compares the ratios of the capitalized value of expenditures as of 1995 on Nulon-related research and development and marketing over the 1995 sales related to such expenditures.

(vi) Because XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. The district director determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the district director capitalizes and amortizes XYZ's protective product research and development expenses. This analysis indicates that the capitalized research and development expenditures have a value of $0.20 per dollar of global protective product sales in 1995.

(vii) XYZ-Europe's expenditures on Nulon research and development and marketing support only its sales in Europe. Using information on the average useful life of XYZ-Europe's investments in marketing and research and development, the district director capitalizes and amortizes XYZ-Europe's expenditures and determines that they have a value in 1995 of $0.40 per dollar of XYZ-Europe's Nulon sales.

(viii) Thus, XYZ and XYZ-Europe together contributed $0.60 in capitalized intangible development expenses for each dollar of XYZ-Europe's protective product sales for 1995, of which XYZ contributed one-third (or $0.20 per dollar of sales). Accordingly, the district director determines that an arm's length royalty for the Nulon license for the 1995 taxable year is $60 million, i.e., one-third of XYZ-Europe's $180 million in residual Nulon profit.

(d) *Effective/applicability date*—(1) *In general*. The provisions of paragraphs (c)(2)(ii)(B)(*1*) and (D), (c)(3)(i)(A) and (B), and (c)(3)(ii)(D) of this section are generally applicable for taxable years beginning after July 31, 2009.

(2) *Election to apply regulation to earlier taxable years*. A person may elect to apply the provisions of paragraphs (c)(2)(ii)(B)(*1*) and (D), (c)(3)(i)(A) and (B), and (c)(3)(ii)(D) of this section to earlier taxable years in accordance with the rules set forth in §1.482–9(n)(2).

[T.D. 8552, 59 FR 35025, July 8, 1994; 60 FR 16382, Mar. 30, 1995, as amended by T.D. 9278, 71 FR 44486, Aug. 4, 2006; T.D. 9456, 74 FR 38844, Aug. 4, 2009; 74 FR 46345, Sept. 9, 2009]

§ 1.482–7 Methods to determine taxable income in connection with a cost sharing arrangement.

(a) *In general*. The arm's length amount charged in a controlled transaction reasonably anticipated to contribute to developing intangibles pursuant to a cost sharing arrangement (CSA), as described in paragraph (b) of this section, must be determined under a method described in this section. Each method must be applied in accordance with the provisions of §1.482–1, except as those provisions are modified in this section.

(1) *RAB share method for cost sharing transactions (CSTs)*. See paragraph (b)(1)(i) of this section regarding the requirement that controlled participants, as defined in section (j)(1)(i) of this section, share intangible development costs (IDCs) in proportion to their shares of reasonably anticipated benefits (RAB shares) by entering into cost sharing transactions (CSTs).

(2) *Methods for platform contribution transactions (PCTs)*. The arm's length amount charged in a platform contribution transaction (PCT) described in paragraph (b)(1)(ii) of this section must be determined under the method or methods applicable under the other section or sections of the section 482 regulations, as supplemented by paragraph (g) of this section. See §1.482–1(b)(2)(ii) (Selection of category of method applicable to transaction), §1.482–1(b)(2)(iii) (Coordination of methods applicable to certain intangible development arrangements), and

paragraph (g) of this section (Supplemental guidance on methods applicable to PCTs).

(3) *Methods for other controlled transactions*—(i) *Contribution to a CSA by a controlled taxpayer that is not a controlled participant.* If a controlled taxpayer that is not a controlled participant contributes to developing a cost shared intangible, as defined in section (j)(1)(i) of this section, it must receive consideration from the controlled participants under the rules of §1.482–4(f)(4) (Contribution to the value of an intangible owned by another). Such consideration will be treated as an intangible development cost for purposes of paragraph (d) of this section.

(ii) *Transfer of interest in a cost shared intangible.* If at any time (during the term, or upon or after the termination, of a CSA) a controlled participant transfers an interest in a cost shared intangible to another controlled taxpayer, the controlled participant must receive an arm's length amount of consideration from the transferee under the rules of §§1.482–4 through 1.482–6 as supplemented by paragraph (f)(4) of this section regarding arm's length consideration for a change in participation. For this purpose, a capability variation described in paragraph (f)(3) of this section is considered to be a controlled transfer of interests in cost shared intangibles.

(iii) *Other controlled transactions in connection with a CSA.* Controlled transactions between controlled participants that are not PCTs or CSTs and are not described in paragraph (a)(3)(ii) of this section (for example, provision of a cross operating contribution, as defined in paragraph (j)(1)(i) of this section, or make-or-sell rights, as defined in paragraph (c)(4) of this section) require arm's length consideration under the rules of §§1.482–1 through 1.482–6, and 1.482–9 as supplemented by paragraph (g)(2)(iv) of this section.

(iv) *Controlled transactions in the absence of a CSA.* If a controlled transaction is reasonably anticipated to contribute to developing intangibles pursuant to an arrangement that is not a CSA described in paragraph (b)(1) or (5) of this section, whether the results of any such controlled transaction are consistent with an arm's length result must be determined under the applicable rules of the other sections of the regulations under section 482. For example, an arrangement for developing intangibles in which one controlled taxpayer's costs of developing the intangibles significantly exceeds its share of reasonably anticipated benefits from exploiting the developed intangibles would not in substance be a CSA, as described in paragraphs (b)(1)(i) through (iii) of this section or paragraph (b)(5)(i) of this section. In such a case, unless the rules of this section are applicable by reason of paragraph (b)(5) of this section, the arrangement must be analyzed under other applicable sections of regulations under section 482 to determine whether it achieves arm's length results, and if not, to determine any allocations by the Commissioner that are consistent with such other regulations under section 482. See §1.482–1(b)(2)(ii) (Selection of category of method applicable to transaction) and (iii) (Coordination of methods applicable to certain intangible development arrangements).

(4) *Coordination with the arm's length standard.* A CSA produces results that are consistent with an arm's length result within the meaning of §1.482–1(b)(1) if, and only if, each controlled participant's IDC share (as determined under paragraph (d)(4) of this section) equals its RAB share, each controlled participant compensates its RAB share of the value of all platform contributions by other controlled participants, and all other requirements of this section are satisfied.

(b) *Cost sharing arrangement.* A cost sharing arrangement is an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their RAB shares. An arrangement is a CSA if and only if the requirements of paragraphs (b)(1) through (4) of this section are met.

(1) *Substantive requirements*—(i) *CSTs.* All controlled participants must commit to, and in fact, engage in cost sharing transactions. In CSTs, the controlled participants make payments to each other (CST Payments) as appropriate, so that in each taxable year each controlled participant's IDC share

is in proportion to its respective RAB share.

(ii) *PCTs.* All controlled participants must commit to, and in fact, engage in platform contributions transactions to the extent that there are platform contributions pursuant to paragraph (c) of this section. In a PCT, each other controlled participant (PCT Payor) is obligated to, and must in fact, make arm's length payments (PCT Payments) to each controlled participant (PCT Payee) that provides a platform contribution. For guidance on determining such arm's length obligation, see paragraph (g) of this section.

(iii) *Divisional interests.* Each controlled participant must receive a non-overlapping interest in the cost shared intangibles without further obligation to compensate another controlled participant for such interest.

(iv) *Examples.* The following examples illustrate the principles of this paragraph (b)(1):

Example 1. Company A and Company B, who are members of the same controlled group, execute an agreement to jointly develop vaccine X and own the exclusive rights to commercially exploit vaccine X in their respective territories, which together comprise the whole world. The agreement provides that they will share some, but not all, of the costs for developing Vaccine X in proportion to RAB share. Such agreement is not a CSA because Company A and Company B have not agreed to share all of the IDCs in proportion to their respective RAB shares.

Example 2. Company A and Company B agree to share all the costs of developing Vaccine X. The agreement also provides for employing certain resources and capabilities of Company A in this program including a skilled research team and certain research facilities, and provides for Company B to make payments to Company A in this respect. However, the agreement expressly provides that the program will not employ, and so Company B is expressly relieved of the payments in regard to, certain software developed by Company A as a medical research tool to model certain cellular processes expected to be implicated in the operation of Vaccine X even though such software would reasonably be anticipated to be relevant to developing Vaccine X and, thus, would be a platform contribution. See paragraph (c) of this section. Such agreement is not a CSA because Company A and Company B have not engaged in a necessary PCT for purposes of developing Vaccine X.

Example 3. Companies C and D, who are members of the same controlled group, enter into a CSA. In the first year of the CSA, C and D conduct the intangible development activity, as described in paragraph (d)(1) of this section. The total IDCs in regard to such activity are $3,000,000 of which C and D pay $2,000,000 and $1,000,000, respectively, directly to third parties. As between C and D, however, their CSA specifies that they will share all IDCs in accordance with their RAB shares (as described in paragraph (e)(1) of this section), which are 60% for C and 40% for D. It follows that C should bear $1,800,000 of the total IDCs (60% of total IDCs of $3,000,000) and D should bear $1,200,000 of the total IDCs (40% of total IDCs of $3,000,000). D makes a CST payment to C of $200,000, that is, the amount by which D's share of IDCs in accordance with its RAB share exceeds the amount of IDCs initially borne by D ($1,200,000–$1,000,000), and which also equals the amount by which the total IDCs initially borne by C exceeds its share of IDCS in accordance with its RAB share ($2,000,000—$1,800,000). As a result of D's CST payment to C, the IDC shares of C and D are in proportion to their respective RAB shares.

(2) *Administrative requirements.* The CSA must meet the requirements of paragraph (k) of this section.

(3) *Date of a PCT.* The controlled participants must enter into a PCT as of the earliest date on or after the CSA is entered into on which a platform contribution is reasonably anticipated to contribute to developing cost shared intangibles.

(4) *Divisional interests*—(i) *In general.* Pursuant to paragraph (b)(1)(iii) of this section, each controlled participant must receive a non-overlapping interest in the cost shared intangibles without further obligation to compensate another controlled participant for such interest. Each controlled participant must be entitled to the perpetual and exclusive right to the profits from transactions of any member of the controlled group that includes the controlled participant with uncontrolled taxpayers to the extent that such profits are attributable to such interest in the cost shared intangibles.

(ii) *Territorial based divisional interests.* The CSA may divide all interests in cost shared intangibles on a territorial basis as follows. The entire world must be divided into two or more non-overlapping geographic territories. Each controlled participant must receive at least one such territory, and in the aggregate all the participants must receive all such territories. Each controlled participant will be assigned the perpetual and exclusive right to exploit the cost shared intangibles through the use, consumption, or disposition of property or services in its territories. Thus, compensation will be required if other members of the controlled group exploit the cost shared intangibles in such territory.

(iii) *Field of use based divisional interests.* The CSA may divide all interests in cost shared intangibles on the basis of all uses (whether or not known at the time of the division) to which cost shared intangibles are to be put as follows. All anticipated uses of cost shared intangibles must be identified. Each controlled participant must be assigned at least one such anticipated use, and in the aggregate all the participants must be assigned all such anticipated uses. Each controlled participant will be assigned the perpetual and exclusive right to exploit the cost shared intangibles through the use or uses assigned to it and one controlled participant must be assigned the exclusive and perpetual right to exploit cost shared intangibles through any unanticipated uses.

(iv) *Other divisional bases.* (A) In the event that the CSA does not divide interests in the cost shared intangibles on the basis of exclusive territories or fields of use as described in paragraphs (b)(4)(ii) and (iii) of this section, the CSA may adopt some other basis on which to divide all interests in the cost shared intangibles among the controlled participants, provided that each of the following criteria is met:

(*1*) The basis clearly and unambiguously divides all interests in cost shared intangibles among the controlled participants.

(*2*) The consistent use of such basis for the division of all interests in the cost shared intangibles can be dependably verified from the records maintained by the controlled participants.

(*3*) The rights of the controlled participants to exploit cost shared intangibles are non-overlapping, exclusive, and perpetual.

(*4*) The resulting benefits associated with each controlled participant's interest in cost shared intangibles are predictable with reasonable reliability.

(B) See paragraph (f)(3) of this section for rules regarding the requirement of arm's length consideration for changes in participation in CSAs involving divisions of interest described in this paragraph (b)(4)(iv).

(v) *Examples.* The following examples illustrate the principles of this paragraph (b)(4):

Example 1. Companies P and S, both members of the same controlled group, enter into a CSA to develop product Z. Under the CSA, P receives the interest in product Z in the United States and S receives the interest in product Z in the rest of the world, as described in paragraph (b)(4)(ii) of this section. Both P and S have plants for manufacturing product Z located in their respective geographic territories. However, for commercial reasons, product Z is nevertheless manufactured by P in the United States for sale to customers in certain locations just outside the United States in close proximity to P's U.S. manufacturing plant. Because S owns the territorial rights outside the United States, P must compensate S to ensure that S realizes all the cost shared intangible profits from P's sales of product Z in S's territory. The pricing of such compensation must also ensure that P realizes an appropriate return for its manufacturing efforts. Benefits projected with respect to such sales will be included for purposes of estimating S's, but not P's, RAB share.

Example 2. The facts are the same as in *Example 1* except that P and S agree to divide their interest in product Z based on site of manufacturing. P will have exclusive and perpetual rights in product Z manufactured in facilities owned by P. S will have exclusive and perpetual rights to product Z manufactured in facilities owned by S. P and S agree that neither will license manufacturing rights in product Z to any related or unrelated party. Both P and S maintain books and records that allow production at all sites to be verified. Both own facilities that will manufacture product Z and the relative capacities of these sites are known. All facilities are currently operating at near capacity and are expected to continue to operate at near capacity when product Z enters production so that it will not be feasible to shift production between P's and S's facilities. P and S have no plans to build new facilities and the lead time required to plan and build a manufacturing facility precludes the possibility that P or S will build a new facility during the period for which sales of Product Z are expected. Based on these facts, this basis for the division of interests in Product Z is a division described in paragraph (b)(4)(iv) of this section. The basis for the division of interest is unambiguous and clearly defined and its use can be dependably verified. P and S both have non-overlapping, exclusive and perpetual rights in Product Z. The division of interest results in the participant's relative benefits being predictable with reasonable reliability.

Example 3. The facts are the same as in *Example 2* except that P's and S's manufacturing facilities are not expected to operate at full capacity when product Z enters production. Production of Product Z can be shifted at any time between sites owned by P and sites owned by S, although neither P nor S intends to shift production as a result of the agreement. The division of interests in Product Z between P and S based on manufacturing site is not a division described in paragraph (b)(4)(iv) of this section because their relative shares of benefits are not predictable with reasonable reliability. The fact that neither P nor S intends to shift production is irrelevant.

(5) *Treatment of certain arrangements as CSAs*—(i) *Situation in which Commissioner must treat arrangement as a CSA.* The Commissioner must apply the rules of this section to an arrangement among controlled taxpayers if the administrative requirements of paragraph (b)(2) of this section are met with respect to such arrangement and the controlled taxpayers reasonably concluded that such arrangement was a CSA meeting the requirements of paragraphs (b)(1), (3), and (4) of this section.

(ii) *Situation in which Commissioner may treat arrangement as a CSA.* For arrangements among controlled taxpayers not described in paragraph (b)(5)(i) of this section, the Commissioner may apply the provisions of this section if the Commissioner concludes that the administrative requirements of paragraph (b)(2) of this section are met, and, notwithstanding technical failure to meet the substantive requirements of paragraph (b)(1), (3), or (4) of this section, the rules of this section will provide the most reliable measure of an arm's length result. See §1.482–1(c)(1) (the best method rule). For purposes of applying this paragraph (b)(5)(ii), any such arrangement shall be interpreted by reference to paragraph (k)(1)(iv) of this section.

(iii) *Examples.* The following examples illustrate the principles of this paragraph (b)(5). In the examples, assume that Companies P and S are both members of the same controlled group.

Example 1. (i) P owns the patent on a formula for a capsulated pain reliever, P-Cap. P reasonably anticipates, pending further research and experimentation, that the P-Cap formula could form the platform for a formula for P-Ves, an effervescent version of P-Cap. P also owns proprietary software that it reasonably anticipates to be critical to the research efforts. P and S execute a contract that purports to be a CSA by which they agree to proportionally share the costs and risks of developing a formula for P-Ves. The agreement reflects the various contractual requirements described in paragraph (k)(1) of this section and P and S comply with the documentation, accounting, and reporting requirements of paragraphs (k)(2) through (4) of this section. Both the patent rights for P-Cap and the software are reasonably anticipated to contribute to the development of P-Ves and therefore are platform contributions for which compensation is due from S as part of PCTs. Though P and S enter into and implement a PCT for the P-Cap patent rights that satisfies the arm's length standard, they fail to enter into a PCT for the software.

(ii) In this case, P and S have substantially complied with the contractual requirements of paragraph (k)(1) of this section and the documentation, accounting, and reporting requirements of paragraphs (k)(2) through (4) of this section and therefore have met the administrative requirements of paragraph (b)(2) of this section. However, because they did not enter into a PCT, as required under paragraphs (b)(1)(ii) and (b)(3) of this section, for the software that was reasonably anticipated to contribute to the development of P-Ves (see paragraph (c) of this section), they cannot reasonably conclude that their arrangement was a CSA. Accordingly, the Commissioner is not required under paragraph (b)(5)(i) of this section to apply the rules of this section to their arrangement.

(iii) Nevertheless, the arrangement between P and S closely resembles a CSA. If the Commissioner concludes that the rules of this section provide the most reliable measure of an arm's length result for such arrangement, then pursuant to paragraph (b)(5)(ii) of this section, the Commissioner may apply the rules of this section and treat P and S as entering into a PCT for the software in accordance with the requirements of paragraph (b)(1)(ii) of this section, and make any appropriate allocations under paragraph (i) of this section. Alternatively, the Commissioner may conclude that the rules of this section do not provide the most reliable measure of an arm's length result. In such case, the arrangement would be analyzed under the methods under other sections of the 482 regulations to determine whether the arrangement reaches an arm's length result.

Example 2. The facts are the same as in *Example 1* except that P and S do enter into and implement a PCT for the software as required under this paragraph (b). The Commissioner determines that the PCT Payments for the software were not arm's length; nevertheless, under the facts and circumstances at the time they entered into the CSA and PCTs, P and S reasonably concluded their arrangement to be a CSA. Because P and S have met the requirements of paragraph (b)(2) of this section and reasonably concluded their arrangement is a CSA, pursuant to paragraph (b)(5)(i) of this section, the Commissioner must apply the rules of this section to their arrangement. Accordingly, the Commissioner treats the arrangement as a CSA and makes adjustments to the PCT Payments as appropriate under this section to achieve an arm's length result for the PCT for the software.

Example 3. (i) The facts are the same as in *Example 1* except that P and S do enter into a PCT for the software as required under this paragraph (b). The agreement entered into by P and S provides for a fixed consideration of $50 million per year for four years, payable at the end of each year. This agreement satisfies the arm's length standard. However, S actually pays P consideration at the end of each year in the form of four annual royalties equal to two percent of sales. While such royalties at the time of the PCT were expected to be $50 million per year, actual sales during the first year were less than anticipated and the first royalty payment was only $25 million.

(ii) In this case, P and S failed to implement the terms of their agreement. Under these circumstances, P and S could not reasonably conclude that their arrangement was a CSA, as described in paragraph (b)(1) of this section. Accordingly, the Commissioner is not required under paragraph (b)(5)(i) of this section to apply the rules of this section to their arrangement.

(iii) Nevertheless, the arrangement between P and S closely resembles a CSA. If the Commissioner concludes that the rules of this section provide the most reliable measure of an arm's length result for such arrangement, then pursuant to paragraph (b)(5)(ii) of this section, the Commissioner may apply the rules of this section and make any appropriate allocations under paragraph (i) of this section. Alternatively, the Commissioner may conclude that the rules of this section do not provide the most reliable measure of an arm's length result. In such case, the arrangement would be analyzed under the methods under other sections of the 482 regulations to determine whether the arrangement reaches an arm's length result.

Example 4. (i) The facts are the same as in *Example 1* except that P does not own proprietary software and P and S use a method for determining the arm's length amount of the PCT Payment for the P-Cap patent rights different from the method used in *Example 1*.

(ii) P and S determine that the arm's length amount of the PCT Payments for the P-Cap patent is $10 million. However, the Commissioner determines the best method for determining the arm's length amount of the PCT Payments for the P-Cap patent rights and under such method the arm's length amount is $100 million. To determine this $10 million present value, P and S assumed a useful life of eight years for the platform contribution, because the P-Cap patent rights will expire after eight years. However, the P-Cap patent rights are expected to lead to benefits attributable to exploitation of the cost shared intangibles extending many years beyond the expiration of the P-Cap patent, because use of the P-Cap patent rights will let P and S bring P-Ves to market before the competition, and because P and S expect to apply for additional patents covering P-Ves, which would bar competitors from selling that product for many future years. The assumption by P and S of a useful life for the platform contribution that is less than the anticipated period of exploitation of the cost shared intangibles is contrary to paragraph (g)(2)(ii) of this section, and reduces the reliability of the method used by P and S.

(iii) The method used by P and S employs a declining royalty. The royalty starts at 8% of sales, based on an application of the CUT method in which the purported CUTs all involve licenses to manufacture and sell the current generation of P-Cap, and declines to 0% over eight years, declining by 1% each year. Such make-or-sell rights are fundamentally different from use of the P-Cap patent rights to generate a new product. This difference raises the issue of whether the make-or-sell rights are sufficiently comparable to the rights that are the subject of the PCT Payment. See §1.482–4(c). While a royalty rate for make-or-sell rights can form the basis for a reliable determination of an arm's length PCT Payment in the CUT-based implementation of the income method described in paragraph (g)(4) of this section, under that method such royalty rate does not decline to zero. Therefore, the use of a declining royalty rate based on an initial rate for make-or-sell rights further reduces the reliability of the method used by P and S.

(iv) Sales of the next-generation product are not anticipated until after seven years, at which point the royalty rate will have declined to 1%. The temporal mismatch between the period of the royalty rate decline and the period of exploitation raises further concerns about the method's reliability.

(v) For the reasons given in paragraphs (ii) through (iv) of this *Example 4*, the method used by P and S is so unreliable and so contrary to provisions of this section that P and S could not reasonably conclude that they had contracted to make arm's length PCT

Payments as required by paragraphs (b)(1)(ii) and (b)(3) of this section, and thus could not reasonably conclude that their arrangement was a CSA. Accordingly, the Commissioner is not required under paragraph (b)(5)(i) of this section to apply the rules of this section to their arrangement.

(vi) Nevertheless, the arrangement between P and S closely resembles a CSA. If the Commissioner concludes that the rules of this section provide the most reliable measure of an arm's length result for such arrangement, then pursuant to paragraph (b)(5)(ii) of this section, the Commissioner may apply the rules of this section and make any appropriate allocations under paragraph (i) of this section. Alternatively, the Commissioner may conclude that the rules of this section do not provide the most reliable measure of an arm's length result. In such case, the arrangement would be analyzed under the methods under other section 482 regulations to determine whether the arrangement reaches an arm's length result.

(6) *Entity classification of CSAs.* See §301.7701–1(c) of this chapter for the classification of CSAs for purposes of the Internal Revenue Code.

(c) *Platform contributions*—(1) *In general.* A platform contribution is any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost shared intangibles. The determination whether a resource, capability, or right is reasonably anticipated to contribute to developing cost shared intangibles is ongoing and based on the best available information. Therefore, a resource, capability, or right reasonably determined not to be a platform contribution as of an earlier point in time, may be reasonably determined to be a platform contribution at a later point in time. The PCT obligation regarding a resource or capability or right once determined to be a platform contribution does not terminate merely because it may later be determined that such resource or capability or right has not contributed, and no longer is reasonably anticipated to contribute, to developing cost shared intangibles. Notwithstanding the other provisions of this paragraph (c), platform contributions do not include rights in land or depreciable tangible property, and do not include rights in other resources acquired by IDCs. See paragraph (d)(1) of this section.

(2) *Terms of platform contributions*—(i) *Presumed to be exclusive.* For purposes of a PCT, the PCT Payee's provision of a platform contribution is presumed to be exclusive. Thus, it is presumed that the platform resource, capability, or right is not reasonably anticipated to be committed to any business activities other than the CSA Activity, as defined in paragraph (j)(1)(i) of this section, whether carried out by the controlled participants, other controlled taxpayers, or uncontrolled taxpayers.

(ii) *Rebuttal of exclusivity.* The controlled participants may rebut the presumption set forth in paragraph (c)(2)(i) of this section to the satisfaction of the Commissioner. For example, if the platform resource is a research tool, then the controlled participants could rebut the presumption by establishing to the satisfaction of the Commissioner that, as of the date of the PCT, the tool is reasonably anticipated not only to contribute to the CSA Activity but also to be licensed to an uncontrolled taxpayer. In such case, the PCT Payments may need to be prorated as described in paragraph (c)(2)(iii) of this section.

(iii) *Proration of PCT Payments to the extent allocable to other business activities*—(A) *In general.* Some transfer pricing methods employed to determine the arm's length amount of the PCT Payments do so by considering the overall value of the platform contributions as opposed to, for example, the value of the anticipated use of the platform contributions in the CSA Activity. Such a transfer pricing method is consistent with the presumption that the platform contribution is exclusive (that is, that the resources, capabilities or rights that are the subject of a platform contribution are reasonably anticipated to contribute only to the CSA Activity). See paragraph (c)(2)(i) (Terms of platform contributions—Presumed to be exclusive) of this section. The PCT Payments determined under such transfer pricing method may have to be prorated if the controlled participants can rebut the presumption that the platform contribution is exclusive to the satisfaction of the Commissioner as provided in paragraph (c)(2)(ii) of this section. In the case of a platform contribution that also contributes to lines of business of a PCT Payor that are not reasonably anticipated to involve exploitation of the cost shared intangibles, the need for explicit proration may in some cases be avoided through aggregation of transactions. See paragraph (g)(2)(iv) of this section (Aggregation of transactions).

(B) *Determining the proration of PCT Payments.* Proration will be done on a reasonable basis in proportion to the relative economic value, as of the date of the PCT, reasonably anticipated to be derived from the platform contribution by the CSA Activity as compared to the value reasonably anticipated to be derived from the platform contribution by other business activities. In the case of an aggregate valuation done under the principles of paragraph (g)(2)(iv) of this section that addresses payment for resources, capabilities, or rights used for business activities other than the CSA Activity (for example, the right to exploit an existing intangible without further development), the proration of the aggregate payments may have to reflect the economic value attributable to such resources, capabilities, or rights as well. For purposes of the best method rule under §1.482–1(c), the reliability of the analysis under a method that requires proration pursuant to this paragraph is reduced relative to the reliability of an analysis under a method that does not require proration.

(3) *Categorization of the PCT.* For purposes of §1.482–1(b)(2)(ii) and paragraph (a)(2) of this section, a PCT must be identified by the controlled participants as a particular type of transaction (for example, a license for royalty payments). See paragraph (k)(2)(ii)(H) of this section. Such designation must be consistent with the actual conduct of the controlled participants. If the conduct is consistent with different, economically equivalent types of transactions then the controlled participants may designate the PCT as being any of such types of transactions. If the controlled participants fail to make such designation in their documentation, the Commissioner may make a designation consistent with the principles of paragraph (k)(1)(iv) of this section.

(4) *Certain make-or-sell rights excluded*—(i) *In general.* Any right to exploit an existing resource, capability, or right without further development of such item, such as the right to make, replicate, license, or sell existing products, does not constitute a platform contribution to a CSA (and the arm's length compensation for such rights (make-or-sell rights) does not satisfy the compensation obligation under a PCT) unless exploitation without further development of such item is reasonably anticipated to contribute to developing or further developing a cost shared intangible.

(ii) *Examples.* The following examples illustrate the principles of this paragraph (c)(4):

Example 1. P and S, which are members of the same controlled group, execute a CSA. Under the CSA, P and S will bear their RAB shares of IDCs for developing the second generation of ABC, a computer software program. Prior to that arrangement, P had incurred substantial costs and risks to develop ABC. Concurrent with entering into the arrangement, P (as the licensor) executes a license with S (as the licensee) by which S may make and sell copies of the existing ABC. Such make-or-sell rights do not constitute a platform contribution to the CSA. The rules of §§1.482–1 and 1.482–4 through 1.482–6 must be applied to determine the arm's length consideration in connection with the make-or-sell licensing arrangement. In certain circumstances, this determination of the arm's length consideration may be done on an aggregate basis with the evaluation of compensation obligations pursuant to the PCTs entered into by P and S in connection with the CSA. See paragraph (g)(2)(iv) of this section.

Example 2. (i) P, a software company, has developed and currently exploits software program ABC. P and S enter into a CSA to develop future generations of ABC. The ABC source code is the platform on which future generations of ABC will be built and is therefore a platform contribution of P for which compensation is due from S pursuant to a PCT. Concurrent with entering into the CSA, P licenses to S the make-or-sell rights for the current version of ABC. P has entered into similar licenses with uncontrolled parties calling for sales-based royalty payments at a rate of 20%. The current version of ABC has an expected product life of three years. P and S enter into a contingent payment agreement to cover both the PCT Payments due from S for P's platform contribution and payments due from S for the make-or-sell license. Based on the uncontrolled make-or-sell licenses, P and S agree on a sales-based royalty rate of 20% in Year 1 that declines on a straight line basis to 0% over the 3 year product life of ABC.

(ii) The make-or-sell rights for the current version of ABC are not platform contributions, though paragraph (g)(2)(iv) of this section provides for the possibility that the most reliable determination of an arm's length charge for the platform contribution and the make-or-sell license may be one that values the two transactions in the aggregate. A contingent payment schedule based on the uncontrolled make-or-sell licenses may provide an arm's length charge for the separate make-or-sell license between P and S, provided the royalty rates in the uncontrolled licenses similarly decline, but as a measure of the aggregate PCT and licensing payments it does not account for the arm's length value of P's platform contributions which include the rights in the source code and future development rights in ABC.

Example 3. S is a controlled participant that owns Patent Q, which protects S's use of a research tool that is helpful in developing and testing new pharmaceutical compounds. The research tool, which is not itself such a compound, is used in the CSA Activity to develop such compounds. However, the CSA Activity is not anticipated to result in the further development of the research tool or in patents based on Patent Q. Although the right to use Patent Q is not anticipated to result in the further development of Patent Q or the technology that it protects, that right constitutes a platform contribution (as opposed to make-or-sell rights) because it is anticipated to contribute to the research activity to develop cost shared intangibles relating to pharmaceutical compounds covered by the CSA.

(5) *Examples*. The following examples illustrate the principles of this paragraph (c). In each example, Companies P and S are members of the same controlled group, and execute a CSA providing that each will have the exclusive right to exploit cost shared intangibles in its own territory. See paragraph (b)(4)(ii) of this section (Territorial based divisional interests).

Example 1. Company P has developed and currently markets version 1.0 of a new software application XYZ. Company P and Company S execute a CSA under which they will share the IDCs for developing future versions of XYZ. Version 1.0 is reasonably anticipated to contribute to the development of future versions of XYZ and therefore Company P's rights in version 1.0 constitute a platform contribution from Company P that must be compensated by Company S pursuant to a PCT. Pursuant to paragraph (c)(3) of this section, the controlled participants designate the platform contribution as a transfer of intangibles that would otherwise be governed by §1.482–4, if entered into by controlled parties. Accordingly, pursuant to paragraph (a)(2) of this section, the applicable method for determining the arm's length value of the compensation obligation under the PCT between Company P and Company S will be governed by §1.482–4 as supplemented by paragraph (g) of this section. Absent a showing to the contrary by P and S, the platform contribution in this case is presumed to be the exclusive provision of the benefit of all rights in version 1.0, other than the rights described in paragraph (c)(4) of this section (Certain make-or-sell rights excluded). This includes the right to use version 1.0 for purposes of research and the exclusive right in S's territory to exploit any future products that incorporated the technology of version 1.0, and would cover a term extending as long as the controlled participants were to exploit future versions of XYZ or any other product based on the version 1.0 platform. The compensation obligation of Company S pursuant to the PCT will reflect the full value of the platform contribution, as limited by Company S's RAB share.

Example 2. Company P and Company S execute a CSA under which they will share the IDCs for developing Vaccine Z. Company P will commit to the project its research team that has successfully developed a number of other vaccines. The expertise and existing integration of the research team is a unique resource or capability of Company P which is reasonably anticipated to contribute to the development of Vaccine Z. Therefore, P's provision of the capabilities of the research team constitute a platform contribution for which compensation is due from Company S as part of a PCT. Pursuant to paragraph (c)(3) of this section, the controlled parties designate the platform contribution as a provision of services that would otherwise be governed by §1.482–9(a) if entered into by controlled parties. Accordingly, pursuant to paragraph (a)(2) of this section, the applicable method for determining the arm's length value of the compensation obligation under the PCT between Company P and Company S will be governed by §1.482–9(a) as supplemented by paragraph (g) of this section. Absent a showing to the contrary by P and S, the platform contribution in this case is presumed to be the exclusive provision of the benefits by Company P of its research team to the development of Vaccine Z. Because the IDCs include the ongoing compensation of the researchers, the compensation obligation under the PCT is only for the value of the commitment of the research team by Company P to the CSA's development efforts net of such researcher compensation. The value of the compensation obligation of Company S for the PCT will reflect the full value of the provision of services, as limited by Company S's RAB share.

(d) *Intangible development costs*—(1) *Determining whether costs are IDCs*. Costs included in IDCs are determined by reference to the scope of the intangible development activity (IDA).

(i) *Definition and scope of the IDA*. For purposes of this section, the IDA means the activity under the CSA of developing or attempting to develop reasonably anticipated cost shared intangibles. The scope of the IDA includes all of the controlled participants' activities that could reasonably be anticipated to contribute to developing the reasonably anticipated cost shared intangibles. The IDA cannot be described merely by a list of particular resources, capabilities, or rights that will be used in the CSA, because such a list would not identify reasonably anticipated cost shared intangibles. Also, the scope of the IDA may change as the nature or identity of the reasonably anticipated cost shared intangibles changes or the nature of the activities necessary for their development become clearer. For example, the relevance of certain ongoing work to developing reasonably anticipated cost shared intangibles or the need for additional work may only become clear over time.

(ii) *Reasonably anticipated cost shared intangible*. For purposes of this section, *reasonably anticipated cost shared intangible* means any intangible, within the meaning of §1.482–4(b), that, at the applicable point in time, the controlled participants intend to develop under the CSA. Reasonably anticipated cost shared intangibles may change over the course of the CSA. The controlled participants may at any time change the reasonably anticipated cost shared intangibles but must document any such change pursuant to paragraph (k)(2)(ii)(A)(*1*) of this section. Removal of reasonably anticipated cost shared intangibles does not affect the controlled participants' interests in cost shared intangibles already developed under the CSA. In addition, the reasonably anticipated cost shared intangibles automatically expand to include the intended result of any further development of a cost shared intangible already developed under the CSA, or applications of such an intangible. However, the controlled participants may override this automatic expansion in a particular case if they separately remove specified further development of such intangible (or specified applications of such intangible) from the IDA, and document such separate removal pursuant to paragraph (k)(2)(ii)(A)(*3*) of this section.

(iii) *Costs included in IDCs*. For purposes of this section, *IDCs* mean all costs, in cash or in kind (including stock-based compensation, as described in paragraph (d)(3) of this section), but excluding acquisition costs for land or depreciable property, in the ordinary course of business after the formation of a CSA that, based on analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, the IDA. Thus, IDCs include costs incurred in attempting to develop reasonably anticipated cost shared intangibles regardless of whether such costs ultimately lead to development of those intangibles, other intangibles developed unexpectedly, or no intangibles. IDCs shall also include the arm's length rental charge for the use of any land or depreciable tangible property (as determined under §1.482–2(c) (Use of tangible property)) directly identified with, or reasonably allocable to, the IDA. Reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not be conclusive regarding inclusion of costs in IDCs. IDCs do not include interest expense, foreign income taxes (as defined in §1.901–2(a)), or domestic income taxes.

(iv) *Examples*. The following examples illustrate the principles of this paragraph (d)(1):

Example 1. A contract that purports to be a CSA provides that the IDA to which the agreement applies consists of all research and development activity conducted at laboratories A, B, and C but not at other facilities maintained by the controlled participants. The contract does not describe the reasonably anticipated cost shared intangibles with respect to which research and development is to be undertaken. The contract fails to meet the requirements set forth in paragraph (k)(1)(ii)(B) of this section because it fails to adequately describe the scope of the IDA to be undertaken.

Example 2. A contract that purports to be a CSA provides that the IDA to which the agreement applies consists of all research and development activity conducted by any of the controlled participants with the goal of developing a cure for a particular disease. Such a cure is thus a reasonably anticipated cost shared intangible. The contract also contains a provision that the IDA will exclude any activity that builds on the results of the controlled participants' prior research concerning Enzyme X even though such activity could reasonably be anticipated to contribute to developing such cure. The contract fails to meet the requirement set forth in paragraph (d)(1)(i) of this section that the scope of the IDA include all of the controlled participants' activities that could reasonably be anticipated to contribute to developing reasonably anticipated cost shared intangibles.

(2) *Allocation of costs.* If a particular cost is directly identified with, or reasonably allocable to, a function the results of which will benefit both the IDA and other business activities, the cost must be allocated on a reasonable basis between the IDA and such other business activities in proportion to the relative economic value that the IDA and such other business activities are anticipated to derive from such results.

(3) *Stock-based compensation*—(i) *In general.* As used in this section, the term *stock-based compensation* means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) *Identification of stock-based compensation with the IDA.* The determination of whether stock-based compensation is directly identified with, or reasonably allocable to, the IDA is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the CSA and, at date of grant, is directly identified with, or reasonably allocable to, the IDA is included as an IDC under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of a new stock option for purposes of this paragraph (d)(3)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) *Measurement and timing of stock-based compensation IDC*—(A) *In general.* Except as otherwise provided in this paragraph (d)(3)(iii), the cost attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an IDC under this section for the taxable year for which the deduction is allowable.

(*1*) *Transfers to which section 421 applies.* Solely for purposes of this paragraph (d)(3)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

(*2*) *Deductions of foreign controlled participants.* Solely for purposes of this paragraph (d)(3)(iii)(A), an amount is treated as an allowable deduction of a foreign controlled participant to the extent that a deduction would be allowable to a United States taxpayer.

(*3*) *Modification of stock option.* Solely for purposes of this paragraph (d)(3)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(3)(ii) of this section, to constitute the grant of a new stock option not identified with, or reasonably allocable to, the IDA, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(3)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an IDC as of the date of the modification.

(*4*) *Expiration or termination of CSA.* Solely for purposes of this paragraph (d)(3)(iii)(A), if an item of stock-based compensation identified with, or reasonably allocable to, the IDA is not exercised during the term of a CSA, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the CSA, provided that the stock-based compensation is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(3)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an IDC as of the date of the expiration or termination of the CSA.

(B) *Election with respect to options on publicly traded stock*—(*1*) *In general.* With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a CSA may elect to take into account all IDCs attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

(*2*) *Publicly traded stock.* As used in this paragraph (d)(3)(iii)(B), the term *publicly traded stock* means stock that is regularly traded on an established United States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year.

(*3*) *Generally accepted accounting principles.* For purposes of this paragraph (d)(3)(iii)(B), a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that either—

(*i*) The fair value of the stock options under consideration is reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets; or

(*ii*) In the absence of a reconciliation between such other accounting principles and United States generally accepted accounting principles that reflects the fair value of the stock options under consideration, such other accounting principles require that the fair value of the stock options under consideration be reflected as a charge against income in audited financial statements or disclosed in footnotes to such statements.

(*4*) *Time and manner of making the election.* The election described in this paragraph (d)(3)(iii)(B) is made by an explicit reference to the election in the written contract required by paragraph (k)(1) of this section or in a written amendment to the CSA entered into with the consent of the Commissioner pursuant to paragraph (d)(3)(iii)(C) of this section. In the case of a CSA in existence on August 26, 2003, the election by written amendment to the CSA may be made without the consent of the Commissioner if such amendment is entered into not later than the latest due date (with regard to extensions) of a federal income tax return of any controlled participant for the first taxable year beginning after August 26, 2003.

(C) *Consistency.* Generally, all controlled participants in a CSA taking options on publicly traded stock into account under paragraph (d)(3)(ii), (d)(3)(iii)(A), or (d)(3)(iii)(B) of this section must use that same method of identification, measurement and timing for all options on publicly traded stock with respect to that CSA. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner's consent is obtained. All controlled participants in the CSA must join in requests for the Commissioner's consent under this paragraph (d)(3)(iii)(C). Thus, for example, if the controlled participants make the election described in paragraph (d)(3)(iii)(B) of this section upon the formation of the CSA, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained. Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(3)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(3)(iii)(B)(*4*) of this section, the controlled participants may make the election described in paragraph (d)(3)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

(4) *IDC share.* A controlled participant's IDC share for a taxable year is equal to the controlled participant's cost contribution for the taxable year, divided by the sum of all IDCs for the taxable year. A controlled participant's cost contribution for a taxable year means all of the IDCs initially borne by the controlled participant, plus all of the CST Payments that the participant makes to other controlled participants, minus all of the CST Payments that the participant receives from other controlled participants.

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

Example 1. Foreign parent (FP) and its U.S. subsidiary (USS) enter into a CSA to develop a better mousetrap. USS and FP share the costs of FP's R&D facility that will be exclusively dedicated to this research, the salaries of the researchers at the facility, and overhead costs attributable to the project. They also share the cost of a conference facility that is at the disposal of the senior executive management of each company. Based on the facts and circumstances, the cost of the conference facility cannot be directly identified with, and is not reasonably allocable to, the IDA. In this case, the cost of the conference facility must be excluded from the amount of IDCs.

Example 2. U.S. parent (USP) and its foreign subsidiary (FS) enter into a CSA to develop intangibles for producing a new device. USP and FS share the costs of an R&D facility, the salaries of the facility's researchers, and overhead costs attributable to the project. Although USP also incurs costs related to field testing of the device, USP does not include those costs in the IDCs that USP and FS will share under the CSA. The Commissioner may determine, based on the facts and circumstances, that the costs of field testing are IDCs that the controlled participants must share.

Example 3. U.S. parent (USP) and its foreign subsidiary (FS) enter into a CSA to develop a new process patent. USP assigns certain employees to perform solely R&D to develop a new mathematical algorithm to perform certain calculations. That algorithm will be used both to develop the new process patent and to develop a new design patent the development of which is outside the scope of the CSA. During years covered by the CSA, USP compensates such employees with cash salaries, stock-based compensation, or a combination of both. USP and FS anticipate that the economic value attributable to the R&D will be derived from the process patent and the design patent in a relative proportion of 75% and 25%, respectively. Applying the principles of paragraph (d)(2) of this section, 75% of the compensation of such employees must be allocated to the development of the new process patent and, thus, treated as IDCs. With respect to the cash salary compensation, the IDC is 75% of the face value of the cash. With respect to the stock-based compensation, the IDC is 75% of the value of the stock-based compensation as determined under paragraph (d)(3)(iii) of this section.

Example 4. Foreign parent (FP) and its U.S. subsidiary (USS) enter into a CSA to develop a new computer source code. FP has an executive officer who oversees a research facility and employees dedicated solely to the IDA. The executive officer also oversees other research facilities and employees unrelated to the IDA, and performs certain corporate overhead functions. The full amount of the costs of the research facility and employees dedicated solely to the IDA can be directly identified with the IDA and, therefore, are IDCs. In addition, based on the executive officer's records of time worked on various matters, the controlled participants reasonably allocate 20% of the executive officer's compensation to supervision of the facility and employees dedicated to the IDA, 50% of the executive officer's compensation to supervision of the facilities and employees unrelated to the IDA, and 30% of the executive officer's compensation to corporate overhead functions. The controlled participants also reasonably determine that the results of the executive officer's corporate overhead functions yield equal economic benefit to the IDA and the other business activities of FP. Applying the principles of paragraph (d)(1) of this section, the executive officer's compensation allocated to supervising the facility and employees dedicated to the IDA (amounting to 20% of the executive officer's total compensation) must be treated as IDCs. Applying the principles of paragraph (d)(2) of this section, half of the executive officer's compensation allocated to corporate overhead functions (that is, half of 30% of the executive officer's total compensation), must be treated as IDCs. Therefore, a total of 35% (20% plus 15%) of the executive officer's total compensation must be treated as IDCs.

(e) *Reasonably anticipated benefits share*—(1) *Definition*—(i) *In general.* A controlled participant's share of reasonably anticipated benefits is equal to its reasonably anticipated benefits divided by the sum of the reasonably anticipated benefits, as defined in paragraph (j)(1)(i) of this section, of all the controlled participants. RAB shares must be updated to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the CSA. For purposes of determining RAB shares at any given time, reasonably anticipated benefits must be estimated over the entire period, past and future, of exploitation of the cost shared intangibles, and must reflect appropriate updates to take into account the most reliable data regarding past and projected future results available at such time. RAB shares determined for a particular purpose shall not be further updated for that purpose based on information not available at the time that determination needed to be made. For example, RAB shares determined in order to determine IDC shares for a particular taxable year (as set forth in paragraphs (b)(1)(i) and (d)(4) of this section) shall not be recomputed based on information not available at that time. Similarly, RAB shares determined for the purpose of using a particular method such as the acquisition price method (as set forth in paragraph (g)(5)(ii) of this section) to evaluate the arm's length amount charged in a PCT shall not be recomputed based on information not available at the date of that PCT. However, nothing in this paragraph (e)(1)(i) shall limit the Commissioner's use of subsequently available information for purposes of its allocation determinations in accordance with the provisions of paragraph (i) (Allocations by the Commissioner in connection with a CSA) of this section.

(ii) *Reliability.* A controlled participant's RAB share must be determined by using the most reliable estimate. In determining which of two or more available estimates is most reliable, the quality of the data and assumptions used in the analysis must be taken into account, consistent with §1.482–1(c)(2)(ii) (Data and assumptions). Thus, the reliability of an estimate will depend largely on the completeness and accuracy of the data, the soundness of the assumptions, and the relative effects of particular deficiencies in data or assumptions on different estimates. If two estimates are equally reliable, no adjustment should be made based on differences between the estimates. The following factors will be particularly relevant in determining the reliability of an estimate of RAB shares:

(A) The basis used for measuring benefits, as described in paragraph (e)(2)(ii) of this section.

(B) The projections used to estimate benefits, as described in paragraph (e)(2)(iii) of this section.

(iii) *Examples.* The following examples illustrate the principles of this paragraph (e)(1):

Example 1. (i) USP and FS plan to conduct research to develop Product Lines A and B. USP and FS reasonably anticipate respective benefits from Product Line A of 100X and 200X and respective benefits from Product Line B, respectively, of 300X and 400X. USP and FS thus reasonably anticipate combined benefits from Product Lines A and B of 400X and 600X, respectively.

(ii) USP and FS could enter into a separate CSA to develop Product Line A with respective RAB shares of 33⅓ percent and 66⅔ percent (reflecting a ratio of 100X to 200X), and into a separate CSA to develop Product Line B with respective RAB shares of 42$\frac{6}{7}$ percent and 57$\frac{1}{7}$ percent (reflecting a ratio of 300X to 400X). Alternatively, USP and FS could enter into a single CSA to develop both Product Lines A and B with respective RAB shares of 40 percent and 60 percent (in the ratio of 400X to 600X). If the separate CSAs are chosen, then any costs for activities that contribute to developing both Product Line A and Product Line B will constitute IDCs of the respective CSAs as required by paragraphs (d)(1) and (2) of this section.

Example 2. (i) USP, a US company, wholly owns foreign subsidiary, FS. USP and FS enter into a CSA at the start of Year 1. The CSA's total IDCs are $100,000 in each year for Years 1 through 4. In Year 1, USP correctly estimates its RAB share as 50%, based on information available at the time, and therefore correctly computes $50,000 as its cost contribution for Year 1.

(ii) In Year 4, USP correctly estimates its RAB share to be 70%, based on information available at the time and, therefore, correctly computes $70,000 as its cost contribution for Year 4.

(iii) In Year 4, USP also files an amended return for Year 1 in which USP deducts a cost contribution of $70,000, asserting that, for this purpose, it should revise its Year 1 estimated RAB share to 70% based on the information that is now available to it in Year 4. The Commissioner determines that USP is incorrect for two reasons. First, a RAB share determined for a particular purpose (here, to determine USP's IDC shares and thus USP's cost contributions in Year 1) should not be revised based on information not available to USP until Year 4. See paragraph (e)(1)(i) of this section. Second, more generally, USP is not permitted to file an amended return for this purpose under §1.482–1(a)(3). Therefore, for both of these reasons, Commissioner adjusts USP's amended return for Year 1 by disallowing $20,000 of the $70,000 deduction.

(2) *Measure of benefits*—(i) *In general.* In order to estimate a controlled participant's RAB share, the amount of each controlled participant's reasonably anticipated benefits must be measured on a basis that is consistent for all such participants. See paragraph (e)(2)(ii)(E) *Example 9* of this section. If a controlled participant transfers a cost shared intangible to another controlled taxpayer, other than by way of a transfer described in paragraph (f) of this section, that controlled participant's benefits from the transferred intangible must be measured by reference to the transferee's benefits, disregarding any consideration paid by the transferee to the controlled participant (such as a royalty pursuant to a license agreement). Reasonably anticipated benefits are measured either on a direct basis, by reference to estimated benefits to be generated by the use of cost shared intangibles (generally based on additional revenues plus cost savings less any additional costs incurred), or on an indirect basis, by reference to certain measurements that reasonably can be assumed to relate to benefits to be generated. Such indirect bases of measurement of anticipated benefits are described in paragraph (e)(2)(ii) of this section. A controlled participant's reasonably anticipated benefits must be measured on the basis, whether direct or indirect, that most reliably determines RAB shares. In determining which of two bases of measurement is most reliable, the factors set forth in §1.482–1(c)(2)(ii) (Data and assumptions) must be taken into account. It normally will be expected that the basis that provided the most reliable estimate for a particular year will continue to provide the most reliable estimate in subsequent years, absent a material change in the factors that affect the reliability of the estimate. Regardless of whether a direct or indirect basis of measurement is used, adjustments may be required to account for material differences in the activities that controlled participants undertake to exploit their interests in cost shared intangibles. See *Examples 4* and *7* of paragraph (e)(2)(ii)(E) of this section.

(ii) *Indirect bases for measuring anticipated benefits.* Indirect bases for measuring anticipated benefits from participation in a CSA include the following:

(A) *Units used, produced, or sold.* Units of items used, produced, or sold by each controlled participant in the business activities in which cost shared intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will more reliably determine RAB shares to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to the cost shared intangibles per unit of the item or items used, produced, or sold. This circumstance is most likely to arise when the cost shared intangibles are exploited by the controlled participants in the use, production, or sale of substantially uniform items under similar economic conditions.

(B) *Sales.* Sales by each controlled participant in the business activities in which cost shared intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will more reliably determine RAB shares to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to cost shared intangibles per dollar of sales. This circumstance is most likely to arise if the costs of exploiting cost shared intangibles are not substantial relative to the revenues generated, or if the principal effect of using cost shared intangibles is to increase the controlled participants' revenues (for example, through a price premium on the products they sell) without affecting their costs substantially. Sales by each controlled participant are unlikely to provide a reliable basis for measuring RAB shares unless each controlled participant operates at the same market level (for example, manufacturing, distribution, etc.).

(C) *Operating profit*. Operating profit of each controlled participant from the activities in which cost shared intangibles are exploited, as determined before any expense (including amortization) on account of IDCs, may be used as an indirect basis for measuring anticipated benefits. This basis of measurement will more reliably determine RAB shares to the extent that such profit is largely attributable to the use of cost shared intangibles, or if the share of profits attributable to the use of cost shared intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when cost shared intangibles are closely associated with the activity that generates the profit and the activity could not be carried on or would generate little profit without use of those intangibles.

(D) *Other bases for measuring anticipated benefits*. Other bases for measuring anticipated benefits may in some circumstances be appropriate, but only to the extent that there is expected to be a reasonably identifiable relationship between the basis of measurement used and additional revenue generated or net costs saved by the use of cost shared intangibles. For example, a division of costs based on employee compensation would be considered unreliable unless there were a relationship between the amount of compensation and the expected additional revenue generated or net costs saved by the controlled participants from using the cost shared intangibles.

(E) *Examples*. The following examples illustrates this paragraph (e)(2)(ii):

Example 1. Controlled parties A and B enter into a CSA to develop product and process intangibles for already existing Product P. Without such intangibles, A and B would each reasonably anticipate revenue, in present value terms, of $100M from sales of Product P until it becomes obsolete. With the intangibles, A and B each reasonably anticipate selling the same number of units each year, but reasonably anticipate that the price will be higher. Because the particular product intangible is more highly regarded in A's market, A reasonably anticipates an increase of $20M in present value revenue from the product intangible, while B reasonably anticipates an increase of only $10M in present value from the product intangible. Further, A and B each reasonably anticipate spending an additional amount equal to $5M in present value in production costs to include the feature embodying the product intangible. Finally, A and B each reasonably anticipate saving an amount equal to $2M in present value in production costs by using the process intangible. A and B reasonably anticipate no other economic effects from exploiting the cost shared intangibles. A's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue ($20M) plus its reasonably anticipated cost savings ($2M) less its reasonably anticipated increased costs ($5M), which equals $17M. Similarly, B's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue ($10M) plus its reasonably anticipated cost savings ($2M) less its reasonably anticipated increased costs ($5M), which equals $7M. Thus A's reasonably anticipated benefits are $17M and B's reasonably anticipated benefits are $7M.

Example 2. Foreign Parent (FP) and U.S. Subsidiary (USS) both produce a feedstock for the manufacture of various high-performance plastic products. Producing the feedstock requires large amounts of electricity, which accounts for a significant portion of its production cost. FP and USS enter into a CSA to develop a new process that will reduce the amount of electricity required to produce a unit of the feedstock. FP and USS currently both incur an electricity cost of $2 per unit of feedstock produced and rates for each are expected to remain similar in the future. The new process, if it is successful, will reduce the amount of electricity required by each company to produce a unit of the feedstock by 50%. Switching to the new process would not require FP or USS to incur significant investment or other costs. Therefore, the cost savings each company is expected to achieve after implementing the new process are $1 per unit of feedstock produced. Under the CSA, FP and USS divide the costs of developing the new process based on the units of the feedstock each is anticipated to produce in the future. In this case, units produced is the most reliable basis for measuring RAB shares and dividing the IDCs because each controlled participant is expected to have a similar $1 (50% of current charge of $2) decrease in costs per unit of the feedstock produced.

Example 3. The facts are the same as in *Example 2*, except that currently USS pays $3 per unit of feedstock produced for electricity while FP pays $6 per unit of feedstock produced. In this case, units produced is not the most reliable basis for measuring RAB shares and dividing the IDCs because the participants do not expect to have a similar decrease in costs per unit of the feedstock produced. The Commissioner determines that the most reliable measure of RAB shares may be based on units of the feedstock produced if FP's units are weighted relative to USS's units by a factor of 2. This reflects the fact that FP pays twice as much as USS for electricity and, therefore, FP's savings of $3 per unit of the feedstock (50% reduction of current charge of $6) would be twice USS's savings of $1.50 per unit of feedstock (50% reduction of current charge of $3) from any new process eventually developed.

Example 4. The facts are the same as in *Example 3*, except that to supply the particular needs of the U.S. market USS manufactures the feedstock with somewhat different properties than FP's feedstock. This requires USS to employ a somewhat different production process than does FP. Because of this difference, USS would incur significant construction costs in order to adopt any new process that may be developed under the cost sharing agreement. In this case, units produced is not the most reliable basis for measuring RAB shares. In order to reliably determine RAB shares, the Commissioner measures the reasonably anticipated benefits of USS and FP on a direct basis. USS's reasonably anticipated benefits are its reasonably anticipated total savings in electricity costs, less its reasonably anticipated costs of adopting the new process. FS's reasonably anticipated benefits are its reasonably anticipated total savings in electricity costs.

Example 5. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a CSA to develop new anesthetic drugs. USP obtains the right to market any resulting drugs in the United States and FS obtains the right to market any resulting drugs in the rest of the world. USP and FS determine RAB shares on the basis of their respective total anticipated operating profit from all drugs under development. USP anticipates that it will receive a much higher profit than FS per unit sold because the price of the drugs is not regulated in the United States, whereas the price of the drugs is regulated in many non-U.S. jurisdictions. In both controlled participants' territories, the anticipated operating profits are almost entirely attributable to the use of the cost shared intangibles. In this case, the controlled participants' basis for measuring RAB shares is the most reliable.

Example 6. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) manufacture and sell fertilizers. They enter into a CSA to develop a new pellet form of a common agricultural fertilizer that is currently available only in powder form. Under the CSA, USS obtains the rights to produce and sell the new form of fertilizer for the U.S. market while FP obtains the rights to produce and sell the new form of fertilizer in the rest of the world. The costs of developing the new form of fertilizer are divided on the basis of the anticipated sales of fertilizer in the controlled participants' respective markets.

(ii) If the research and development is successful, the pellet form will deliver the fertilizer more efficiently to crops and less fertilizer will be required to achieve the same effect on crop growth. The pellet form of fertilizer can be expected to sell at a price premium over the powder form of fertilizer based on the savings in the amount of fertilizer that needs to be used. This price premium will be a similar premium per dollar of sales in each territory. If the research and development is successful, the costs of producing pellet fertilizer are expected to be approximately the same as the costs of producing powder fertilizer and the same for both FP and USS. Both FP and USS operate at approximately the same market levels, selling their fertilizers largely to independent distributors.

(iii) In this case, the controlled participants' basis for measuring RAB shares is the most reliable.

Example 7. The facts are the same as in *Example 6*, except that FP distributes its fertilizers directly while USS sells to independent distributors. In this case, sales of USS and FP are not the most reliable basis for measuring RAB shares unless adjustments are made to account for the difference in market levels at which the sales occur.

Example 8. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA to develop materials that will be used to train all new entry-level employees. FP and USS determine that the new materials will save approximately ten hours of training time per employee. Because their entry-level employees are paid on differing wage scales, FP and USS decide that they should not measure benefits based on the number of entry-level employees hired by each. Rather, they measure benefits based on compensation paid to the entry-level employees hired by each. In this case, the basis used for measuring RAB shares is the most reliable because there is a direct relationship between compensation paid to new entry-level employees and costs saved by FP and USS from the use of the new training materials.

Example 9. U.S. Parent (USP), Foreign Subsidiary 1 (FS1), and Foreign Subsidiary 2 (FS2) enter into a CSA to develop computer software that each will market and install on customers' computer systems. The controlled participants measure benefits on the basis of projected sales by USP, FS1, and FS2 of the software in their respective geographic areas. However, FS1 plans not only to sell but also to license the software to unrelated customers, and FS1's licensing income (which is a percentage of the licensees' sales) is not counted in the projected benefits. In this case, the basis used for measuring the benefits of each controlled participant is not the most reliable because all of the benefits received by controlled participants are not taken into account. In order to reliably determine RAB shares, FS1's projected benefits from licensing must be included in the measurement on a basis that is the same as that used to measure its own and the other controlled participants' projected benefits from sales (for example, all controlled participants might measure their benefits on the basis of operating profit).

(iii) *Projections used to estimate benefits*—(A) *In general.* The reliability of an estimate of RAB shares also depends upon the reliability of projections used in making the estimate. Projections required for this purpose generally include a determination of the time period between the inception of the research and development activities under the CSA and the receipt of benefits, a projection of the time over which benefits will be received, and a projection of the benefits anticipated for each year in which it is anticipated that the cost shared intangible will generate benefits. A projection of the relevant basis for measuring anticipated benefits may require a projection of the factors that underlie it. For example, a projection of operating profits may require a projection of sales, cost of sales, operating expenses, and other factors that affect operating profits. If it is anticipated that there will be significant variation among controlled participants in the timing of their receipt of benefits, and consequently benefit shares are expected to vary significantly over the years in which benefits will be received, it normally will be necessary to use the present value of the projected benefits to reliably determine RAB shares. See paragraph (g)(2)(v) of this section for best method considerations regarding discount rates used for this purpose. If it is not anticipated that benefit shares will significantly change over time, current annual benefit shares may provide a reliable projection of RAB shares. This circumstance is most likely to occur when the CSA is a long-term arrangement, the arrangement covers a wide variety of intangibles, the composition of the cost shared intangibles is unlikely to change, the cost shared intangibles are unlikely to generate unusual profits, and each controlled participant's share of the market is stable.

(B) *Examples.* The following examples illustrate the principles of this paragraph (e)(2)(iii):

Example 1. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA to develop a new car model. The controlled participants plan to spend four years developing the new model and four years producing and selling the new model. USS and FP project total sales of $4 billion and $2 billion, respectively, over the planned four years of exploitation of the new model. The controlled participants determine RAB shares for each year of 66⅔% for USS and 33⅓% for FP, based on projected total sales.

(ii) USS typically begins producing and selling new car models a year after FP begins producing and selling new car models. In order to reflect USS's one-year lag in introducing new car models, a more reliable projection of each participant's RAB share would be based on a projection of all four years of sales for each participant, discounted to present value.

Example 2. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a CSA to develop new and improved household cleaning products. Both controlled participants have sold household cleaning products for many years and have stable worldwide market shares. The products under development are unlikely to produce unusual profits for either controlled participant. The controlled participants determine RAB shares on the basis of each controlled participant's current sales of household cleaning products. In this case, the controlled participants' RAB shares are reliably projected by current sales of cleaning products.

Example 3. The facts are the same as in *Example 2*, except that FS's market share is rapidly expanding because of the business failure of a competitor in its geographic area. The controlled participants' RAB shares are not reliably projected by current sales of cleaning products. FS's benefit projections should take into account its growth in market share.

Example 4. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA to develop synthetic fertilizers and insecticides. FP and USS share costs on the basis of each controlled participant's current sales of fertilizers and insecticides. The market shares of the controlled participants have been stable for fertilizers, but FP's market share for insecticides has been expanding. The controlled participants' projections of RAB shares are reliable with regard to fertilizers, but not reliable with regard to insecticides; a more reliable projection of RAB shares would take into account the expanding market share for insecticides.

(f) *Changes in participation under a CSA*—(1) *In general.* A change in participation under a CSA occurs when there is either a controlled transfer of interests or a capability variation. A change in participation requires arm's length consideration under paragraph (a)(3)(ii) of this section, and as more fully described in this paragraph (f).

(2) *Controlled transfer of interests.* A controlled transfer of interests occurs when a participant in a CSA transfers all or part of its interests in cost shared intangibles under the CSA in a controlled transaction, and the transferee assumes the associated obligations under the CSA. For example, a change in the territorial based divisional interests or field of use based divisional interests, as described in paragraph (b)(4), is a controlled transfer of interests. After the controlled transfer of interests occurs, the CSA will still exist if at least two controlled participants still have interests in the cost shared intangibles. In such a case, the transferee will be treated as succeeding to the transferor's prior history under the CSA as pertains to the transferred interests, including the transferor's cost contributions, benefits derived, and PCT Payments attributable to such rights or obligations. A transfer that would otherwise constitute a controlled transfer of interests for purposes of this paragraph (f)(2) shall not constitute a controlled transfer of interests if it also constitutes a capability variation for purposes of paragraph (f)(3) of this section.

(3) *Capability variation.* A capability variation occurs when, in a CSA in which interests in cost shared intangibles are divided as described in paragraph (b)(4)(iv) of this section, the controlled participants' division of interests or their relative capabilities or capacities to benefit from the cost shared intangibles are materially altered. For purposes of paragraph (a)(3)(ii) of this section, a capability variation is considered to be a controlled transfer of interests in cost shared intangibles, in which any controlled participant whose RAB share decreases as a result of the capability variation is a transferor, and any controlled participant whose RAB share thus increases is the transferee of the interests in cost shared intangibles.

(4) *Arm's length consideration for a change in participation.* In the event of a change in participation, the arm's length amount of consideration from the transferee, under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6 and paragraph (a)(3)(ii) of this section, will be determined consistent with the reasonably anticipated incremental change in the returns to the transferee and transferor resulting from such change in participation. Such changes in returns will themselves depend on the reasonably anticipated incremental changes in the benefits from exploiting the cost shared intangibles, IDCs borne, and PCT Payments (if any). However, any arm's length consideration required under this paragraph (f)(4) with respect to a capability variation shall be reduced as necessary to prevent duplication of an adjustment already performed under paragraph (i)(2)(ii)(A) of this section that resulted from the same capability variation. If an adjustment has been performed already under this paragraph (f)(4) with respect to a capability variation, then for purposes of any adjustment to be performed under paragraph (i)(2)(ii)(A) of this section, the controlled participants' projected benefit shares referred to in paragraph (i)(2)(ii)(A) of this section shall be considered to be the controlled participants' respective RAB shares after the capability variation occurred.

(5) *Examples.* The following examples illustrate the principles of this paragraph (f):

Example 1. X, Y, and Z are the only controlled participants in a CSA. The CSA divides interests in cost shared intangibles on a territorial basis as described in paragraph (b)(4)(ii) of this section. X is assigned the territories of the Americas, Y is assigned the territory of the UK and Australia, and Z is assigned the rest of the world. When the CSA is formed, X has a platform contribution T. Under the PCTs for T, Y and Z are each obligated to pay X royalties equal to five percent of their respective sales. Aside from T, there are no platform contributions. Two years after the formation of the CSA, Y transfers to Z its interest in cost shared intangibles relating to the UK territory, and the associated obligations, in a controlled transfer of interests described in paragraph (f)(2) of this section. At that time the reasonably anticipated benefits from exploiting cost shared intangibles in the UK have a present value of $11M, the reasonably anticipated IDCs to be borne relating to the UK territory have a present value of $3M, and the reasonably anticipated PCT Payments to be made to X relating to sales in the UK territory have a present value of $2M. As arm's length consideration for the change in participation due to the controlled transfer of interests, Z must pay Y compensation with an anticipated present value of $11M, less $3M, less $2M, which equals $6M.

Example 2. As in *Example 2* of paragraph (b)(4)(v) of this section, companies P and S, both members of the same controlled group, enter into a CSA to develop product Z. P and S agree to divide their interest in product Z based on site of manufacturing. P will have exclusive and perpetual rights in product Z manufactured in facilities owned by P. S will have exclusive and perpetual rights to product Z manufactured in facilities owned by S. P and S agree that neither will license manufacturing rights in product Z to any related or unrelated party. Both P and S maintain books and records that allow production at all sites to be verified. Both own facilities that will manufacture product Z and the relative capacities of these sites are known. All facilities are currently operating at near capacity and are expected to continue to operate at near capacity when product Z enters production so that it will not be feasible to shift production between P's and S's facilities. P and S have no plans to build new facilities and the lead time required to plan and build a manufacturing facility precludes the possibility that P or S will build a new facility during the period for which sales of Product Z are expected. When the CSA is formed, P has a platform contribution T. Under the PCT for T, S is obligated to pay P sales-based royalties according to a certain formula. Aside from T, there are no other platform contributions. Two years after the formation of the CSA, owing to a change in plans not reasonably foreseeable at the time the CSA was entered into, S acquires additional facilities F for the manufacture of Product Z. Such acquisition constitutes a capability variation described in paragraph (f)(3) of this section. Under this capability variation, S's RAB share increases from 50% to 60%. Accordingly, there is a compensable change in participation under paragraph (f)(3) of this section.

(g) *Supplemental guidance on methods applicable to PCTs*—(1) *In general.* This paragraph (g) provides supplemental guidance on applying the methods listed in this paragraph (g)(1) for purposes of evaluating the arm's length amount charged in a PCT. Each method will yield a value for the compensation obligation of each PCT Payor consistent with the product of the combined pre-tax value to all controlled participants of the platform contribution that is the subject of the PCT and the PCT Payor's RAB share. Each method must yield results consistent with measuring the value of a platform contribution by reference to the future income anticipated to be generated by the resulting cost shared intangibles. The methods are—

(i) The comparable uncontrolled transaction method described in §1.482–4(c), or the comparable uncontrolled services price method described in §1.482–9(c), as further described in paragraph (g)(3) of this section;

(ii) The income method, described in paragraph (g)(4) of this section;

(iii) The acquisition price method, described in paragraph (g)(5) of this section;

(iv) The market capitalization method, described in paragraph (g)(6) of this section;

(v) The residual profit split method, described in paragraph (g)(7) of this section; and

(vi) Unspecified methods, described in paragraph (g)(8) of this section.

(2) *Best method analysis applicable for evaluation of a PCT pursuant to a CSA*—(i) *In general.* Each method must be applied in accordance with the provisions of §1.482–1, including the best method rule of §1.482–1(c), the comparability analysis of §1.482–1(d), and the arm's length range of §1.482–1(e), except as

those provisions are modified in this paragraph (g).

(ii) *Consistency with upfront contractual terms and risk allocation—the investor model*—(A) *In general.* Although all of the factors entering into a best method analysis described in §1.482–1(c) and (d) must be considered, specific factors may be particularly relevant in the context of a CSA. In particular, the relative reliability of an application of any method depends on the degree of consistency of the analysis with the applicable contractual terms and allocation of risk under the CSA and this section among the controlled participants as of the date of the PCT, unless a change in such terms or allocation has been made in return for arm's length consideration. In this regard, a CSA involves an upfront division of the risks as to both reasonably anticipated obligations and reasonably anticipated benefits over the reasonably anticipated term of the CSA Activity. Accordingly, the relative reliability of an application of a method also depends on the degree of consistency of the analysis with the assumption that, as of the date of the PCT, each controlled participant's aggregate net investment in the CSA Activity (including platform contributions, operating contributions, as such term is defined in paragraph (j)(1)(i) of this section, operating cost contributions, as such term is defined in paragraph (j)(1)(i) of this section, and cost contributions) is reasonably anticipated to earn a rate of return (which might be reflected in a discount rate used in applying a method) appropriate to the riskiness of the controlled participant's CSA Activity over the entire period of such CSA Activity. If the cost shared intangibles themselves are reasonably anticipated to contribute to developing other intangibles, then the period described in the preceding sentence includes the period, reasonably anticipated as of the date of the PCT, of developing and exploiting such indirectly benefited intangibles.

(B) *Example.* The following example illustrates the principles of this paragraph (g)(2)(ii):

Example. (i) P, a U.S. corporation, has developed a software program, DEF, which applies certain algorithms to reconstruct complete DNA sequences from partially-observed DNA sequences. S is a wholly-owned foreign subsidiary of P. On the first day of Year 1, P and S enter into a CSA to develop a new generation of genetic tests, GHI, based in part on the use of DEF. DEF is therefore a platform contribution of P for which compensation is due from S pursuant to a PCT. S makes no platform contributions to the CSA. Sales of GHI are projected to commence two years after the inception of the CSA and then to continue for eight more years. Based on industry experience, P and S are confident that GHI will be replaced by a new type of genetic testing based on technology unrelated to DEF or GHI and that, at that point, GHI will have no further value. P and S project that that replacement will occur at the end of Year 10.

(ii) For purposes of valuing the PCT for P's platform contribution of DEF to the CSA, P and S apply a type of residual profit split method that is not described in paragraph (g)(7) of this section and which, accordingly, constitutes an unspecified method. See paragraph (g)(7)(i) (last sentence) of this section. The principles of this paragraph (g)(2) apply to any method for valuing a PCT, including the unspecified method used by P and S.

(iii) Under the method employed by P and S, in each year, a portion of the income from sales of GHI in S's territory is allocated to certain routine contributions made by S. The residual of the profit or loss from GHI sales in S's territory after the routine allocation step is divided between P and S pro rata to their capital stocks allocable to S's territory. Each controlled participant's capital stock is computed by capitalizing, applying a capital growth factor to, and amortizing its historical expenditures regarding DEF allocable to S's territory (in the case of P), or its ongoing cost contributions towards developing GHI (in the case of S). The amortization of the capital stocks is effected on a straight-line basis over an assumed four-year life for the relevant expenditures. The capital stocks are grown using an assumed growth factor that P and S consider to be appropriate.

(iv) The assumption that all expenditures amortize on a straight-line basis over four years does not appropriately reflect the principle that as of the date of the PCT regarding DEF, every contribution to the development of GHI, including DEF, is reasonably anticipated to have value throughout the entire period of exploitation of GHI which is projected to continue through Year 10. Under this method as applied by P and S, the share of the residual profit in S's territory that is allocated to P as a PCT Payment from S will decrease every year. After Year 4, P's capital stock in DEF will necessarily be $0, so that P will receive none of the residual profit or loss from GHI sales in S's territory after Year 4 as a PCT Payment.

(v) As a result of this limitation of the PCT Payments to be made by S, the anticipated return to S's aggregate investment in the CSA, over the whole period of S's CSA Activity, is at a rate that is significantly higher than the appropriate rate of return for S's CSA Activity (as determined by a reliable method). This discrepancy is not consistent with the investor model principle that S should anticipate a rate of return to its aggregate investment in the CSA, over the whole period of its CSA Activity, appropriate for the riskiness of its CSA Activity. The inconsistency of the method with the investor model materially lessens its reliability for purposes of a best method analysis. See §1.482–1(c)(2)(ii)(B).

(iii) *Consistency of evaluation with realistic alternatives*—(A) *In general.* The relative reliability of an application of a method also depends on the degree of consistency of the analysis with the assumption that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of the transaction, and only entered into such transaction, if no alternative is preferable. This condition is not met, therefore, where for any controlled participant the total anticipated present value of its income attributable to its entering into the CSA, as of the date of the PCT, is less than the total anticipated present value of its income that could be achieved through an alternative arrangement realistically available to that controlled participant. In principle, this comparison is made on a post-tax basis but, in many cases, a comparison made on a pre-tax basis will yield equivalent results. See also paragraph (g)(2)(v)(B)(*1*) of this section (Discount rate variation between realistic alternatives).

(B) *Examples.* The following examples illustrate the principles of this paragraph (g)(2)(iii):

Example 1. (i) P, a corporation, and S, a wholly-owned subsidiary of P, enter into a CSA to develop a personal transportation device (the product). Under the arrangement, P will undertake all of the R&D, and manufacture and market the product in Country X. S will make CST Payments to P for its appropriate share of P's R&D costs, and manufacture and market the product in the rest of the world. P owns existing patents and trade secrets that are reasonably anticipated to contribute to the development of the product. Therefore the rights in the patents and trade secrets are platform contributions for which compensation is due from S as part of a PCT.

(ii) S's manufacturing and distribution activities under the CSA will be routine in nature, and identical to the activities it would undertake if it alternatively licensed the product from P.

(iii) Reasonably reliable estimates indicate that P could develop the product without assistance from S and license the product outside of Country X for a royalty of 20% of sales. Based on reliable financial projections that include all future development costs and licensing revenue that are allocable to the non-Country X market, and using a discount rate appropriate for the riskiness of P's role as a licensor (see paragraph (g)(2)(v) of this section), the post-tax present value of this licensing alternative to P for the non-Country X market (measured as of the date of the PCT) would be $500 million. Thus, based on this realistic alternative, the anticipated post-tax present value under the CSA to P in the non-Country X market (measured as of the date of the PCT), taking into account anticipated development costs allocable to the non-Country X market, and anticipated CST Payments and PCT Payments from S, and using a discount rate appropriate for the riskiness of P's role as a participant in the CSA, should not be less than $500 million.

Example 2. (i) The facts are the same as in *Example 1*, except that there are no reliable estimates of the value to P from the licensing alternative to the CSA. Further, reasonably reliable estimates indicate that an arm's length return for S's routine manufacturing and distribution activities is a 10% mark-up on total costs of goods sold plus operating expenses related to those activities. Finally, the Commissioner determines that the respective activities undertaken by P and S (other than licensing payments, cost contributions, and PCT Payments) would be identical regardless of whether the arrangement was undertaken as a CSA (cost sharing alternative) or as a long-term licensing arrangement (licensing alternative). In particular, in both alternatives, P would perform all research activities and S would undertake routine manufacturing and distribution activities associated with its territory.

(ii) P undertakes an economic analysis that derives S's cost contributions under the CSA, based on reliable financial projections. Based on this and further economic analysis, P determines S's PCT Payment as a certain lump sum amount to be paid as of the date of the PCT (Date D).

(iii) Based on reliable financial projections that include S's cost contributions and that incorporate S's PCT Payment, as computed by P, and using a discount rate appropriate for the riskiness of S's role as a CSA participant (see paragraphs (g)(2)(v) and (4)(vi)(F) of this section), the anticipated post-tax net present value to S in the cost sharing alternative (measured as of Date D) is $800 million. Further, based on these same reliable projections (but incorporating S's licensing payments instead of S's cost contributions and PCT Payment), and using a discount rate appropriate for the riskiness of S's role as a long-term licensee, the anticipated post-tax net present value to S in the licensing alternative (measured as of Date D) is $100 million. Thus, S's anticipated post-tax net present value is $700 million greater in the cost sharing alternative than in the licensing alternative. This result suggests that P's anticipated post-tax present value must be significantly less under the cost sharing alternative than under the licensing alternative. This means that the reliability of P's analysis as described in paragraph (ii) of this *Example 2* is reduced, because P would not be expected to enter into a CSA if its alternative of being a long-term licensor is preferable.

Example 3. (i) The facts are the same as in paragraphs (i) and (ii) of *Example 2*. In addition, based on reliable financial projections that include S's cost contributions and S's PCT Payment, and using a discount rate appropriate for the riskiness of S's role as a CSA participant, the anticipated post-tax net present value to S under the CSA (measured as of the date of the PCT) is $50 million. Also, instead of entering the CSA, S has the realistic alternative of manufacturing and distributing product Z unrelated to the personal transportation device, with the same anticipated 10% mark-up on total costs that it would anticipate for its routine activities in *Example 2*. Under its realistic alternative, at a discount rate appropriate for the riskiness of S's role with respect to product Z, S anticipates a present value of $100 million.

(ii) Because the lump sum PCT Payment made by S results in S having a considerably lower anticipated net present value than S could achieve through an alternative arrangement realistically available to it, the reliability of P's calculation of the lump sum PCT Payment is reduced.

(iv) *Aggregation of transactions.* The combined effect of multiple contemporaneous transactions, consisting either of multiple PCTs, or of one or more PCT and one or more other transactions in connection with a CSA that are not governed by this section (such as transactions involving cross operating contributions or make-or-sell rights), may require evaluation in accordance with the principles of aggregation described in §1.482–1(f)(2)(i). In such cases, it may be that the multiple transactions are reasonably anticipated, as of the date of the PCT(s), to be so interrelated that the method that provides the most reliable measure of an arm's length charge is a method under this section applied on an aggregate basis for the PCT(s) and other transactions. A section 482 adjustment may be made by comparing the aggregate arm's length charge so determined to the aggregate payments actually made for the multiple transactions. In such a case, it generally will not be necessary to allocate separately the aggregate arm's length charge as between various PCTs or as between PCTs and such other transactions. However, such an allocation may be necessary for other purposes, such as applying paragraph (i)(6) (Periodic adjustments) of this section. An aggregate determination of the arm's length charge for multiple transactions will often yield a payment for a controlled participant that is equal to the aggregate value of the platform contributions and other resources, capabilities, and rights covered by the multiple transactions multiplied by that controlled participant's RAB share. Because RAB shares only include benefits from cost shared intangibles, the reliability of an aggregate determination of payments for multiple transactions may be reduced to the extent that it includes transactions covering resources, capabilities, and rights for which the controlled participants' expected benefit shares differ substantially from their RAB shares.

(v) *Discount rate*—(A) *In general.* The best method analysis in connection with certain methods or forms of payment may depend on a rate or rates of return used to convert projected results of transactions to present value, or to otherwise convert monetary amounts at one or more points in time to equivalent amounts at a different point or points in time. For this purpose, a discount rate or rates should be used that most reliably reflect the market-correlated risks of activities or transactions and should be applied to the best estimates of the relevant projected results, based on all the information potentially available at the time for which the present value calculation is to be performed. Depending on the particular facts and circumstances, the market-correlated risk involved and thus, the discount rate, may differ among a company's various activities or transactions. Normally, discount rates are most reliably determined by reference to market information.

(B) *Considerations in best method analysis of discount rate*—(*1*) *Discount rate variation between realistic alternatives*. Realistic alternatives may involve varying risk exposure and, thus, may be more reliably evaluated using different discount rates. See paragraphs (g)(4)(i)(F) and (vi)(F) of this section. In some circumstances, a party may have less risk as a licensee of intangibles needed in its operations, and so require a lower discount rate, than it would have by entering into a CSA to develop such intangibles, which may involve the party's assumption of additional risk in funding its cost contributions to the IDA. Similarly, self-development of intangibles and licensing out may be riskier for the licensor, and so require a higher discount rate, than entering into a CSA to develop such intangibles, which would relieve the licensor of the obligation to fund a portion of the IDCs of the IDA.

(*2*) *Implied discount rates*. In some circumstances, the particular discount rate or rates used for certain activities or transactions logically imply that certain other activities will have a particular discount rate or set of rates (implied discount rates). To the extent that an implied discount rate is inappropriate in light of the facts and circumstances, which may include reliable direct evidence of the appropriate discount rate applicable for such other activities, the reliability of any method is reduced where such method is based on the discount rates from which such an inappropriate implied discount rate is derived. See paragraphs (g)(4)(vi)(F)(*2*) and (g)(4)(viii), *Example 8* of this section.

(*3*) *Discount rate variation between forms of payment*. Certain forms of payment may involve different risks than others. For example, ordinarily a royalty computed on a profits base would be more volatile, and so require a higher discount rate to discount projected payments to present value, than a royalty computed on a sales base.

(*4*) *Post-tax rate*. In general, discount rate estimates that may be inferred from the operations of the capital markets are post-tax discount rates. Therefore, an analysis would in principle apply post-tax discount rates to income net of expense items including taxes (post-tax income). However, in certain circumstances the result of applying a post-tax discount rate to post-tax income is equivalent to the product of the result of applying a post-tax discount rate to income net of expense items other than taxes (pre-tax income), and the difference of one minus the tax rate (as defined in paragraph (j)(1)(i) of this section). Therefore, in such circumstances, calculation of pre-tax income, rather than post-tax income, may be sufficient. See, for example, paragraph (g)(4)(i)(G) of this section.

(C) *Example*. The following example illustrates the principles of this paragraph (g)(2)(v):

Example. (i) P and S form a CSA to develop intangible X, which will be used in product Y. P will develop X, and S will make CST Payments as its cost contributions. At the start of the CSA, P has a platform contribution, for which S commits to make a PCT Payment of 5% of its sales of product Y. As part of the evaluation of whether that PCT Payment is arm's length, the Commissioner considers whether P had a more favorable realistic alternative (see paragraph (g)(2)(iii) of this section). Specifically, the Commissioner compares P's anticipated post-tax discounted present value of the financial projections under the CSA (taking into account S's PCT payment of 5% of its sale of product Y) with P's anticipated post-tax discounted present value of the financial projections under a reasonably available licensing alternative that consists of developing intangible X on its own and then licensing X to S or to an uncontrolled party similar to S. In undertaking the analysis, the Commissioner determines that, because it would be funding the entire development of the intangible, P undertakes greater risks in the licensing alternative than in the cost sharing alternative (in the cost sharing alternative P would be funding only part of the development of the intangible).

(ii) The Commissioner determines that, as between the two scenarios, all of the components of P's anticipated financial flows are identical, except for the CST and PCT Payments under the CSA, compared to the licensing payments under the licensing alternative. Accordingly, the Commissioner concludes that the differences in market-correlated risks between the two scenarios, and therefore the differences in discount rates between the two scenarios, relate to the differences in these components of the financial projections.

(vi) *Financial projections.* The reliability of an estimate of the value of a platform or operating contribution in connection with a PCT will often depend upon the reliability of projections used in making the estimate. Such projections should reflect the best estimates of the items projected (normally reflecting a probability weighted average of possible outcomes and thus also reflecting non-market-correlated risk). Projections necessary for this purpose may include a projection of sales, IDCs, costs of developing operating contributions, routine operating expenses, and costs of sales. Some method applications directly estimate projections of items attributable to separate development and exploitation by the controlled participants within their respective divisions. Other method applications indirectly estimate projections of items from the perspective of the controlled group as a whole, rather than from the perspective of a particular participant, and then apportion the items so estimated on some assumed basis. For example, in some applications, sales might be directly projected by division, but worldwide projections of other items such as operating expenses might be apportioned among divisions in the same ratio as the divisions' respective sales. Which approach is more reliable depends on which provides the most reliable measure of an arm's length result, considering the competing perspectives under the facts and circumstances in light of the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions. For these purposes, projections that have been prepared for non-tax purposes are generally more reliable than projections that have been prepared solely for purposes of meeting the requirements in this paragraph (g).

(vii) *Accounting principles*—(A) *In general.* Allocations or other valuations done for accounting purposes may provide a useful starting point but will not be conclusive for purposes of the best method analysis in evaluating the arm's length charge in a PCT, particularly where the accounting treatment of an asset is inconsistent with its economic value.

(B) *Examples.* The following examples illustrate the principles of this paragraph (g)(2)(vii):

Example 1. (i) USP, a U.S. corporation and FSub, a wholly-owned foreign subsidiary of USP, enter into a CSA in Year 1 to develop software programs with application in the medical field. Company X is an uncontrolled software company located in the United States that is engaged in developing software programs that could significantly enhance the programs being developed by USP and FSub. Company X is still in a startup phase, so it has no currently exploitable products or marketing intangibles and its workforce consists of a team of software developers. Company X has negligible liabilities and tangible property. In Year 2, USP purchases Company X as part of an uncontrolled transaction in order to acquire its in-process technology and workforce for purposes of the development activities of the CSA. USP files a consolidated return that includes Company X. For accounting purposes, $50 million of the $100 million acquisition price is allocated to the in-process technology and workforce, and the residual $50 million is allocated to goodwill.

(ii) The in-process technology and workforce of Company X acquired by USP are reasonably anticipated to contribute to developing cost shared intangibles and therefore the rights in the in-process technology and workforce of Company X are platform contributions for which FSub must compensate USP as part of a PCT. In determining whether to apply the acquisition price or another method for purposes of evaluating the arm's length charge in the PCT, relevant best method analysis considerations must be weighed in light of the general principles of paragraph (g)(2) of this section. The allocation for accounting purposes raises an issue as to the reliability of using the acquisition price method in this case because it suggests that a significant portion of the value of Company X's nonroutine contributions to USP's business activities is allocable to goodwill, which is often difficult to value reliably and which, depending on the facts and circumstances, might not be attributable to platform contributions that are to be compensated by PCTs. See paragraph (g)(5)(iv)(A) of this section.

(iii) Paragraph (g)(2)(vii)(A) of this section provides that accounting treatment may be a starting point, but is not determinative for purposes of assessing or applying methods to evaluate the arm's length charge in a PCT. The facts here reveal that Company X has nothing of economic value aside from its in-process technology and assembled workforce. The $50 million of the acquisition price allocated to goodwill for accounting purposes, therefore, is economically attributable to either of, or both, the in-process technology and the workforce. That moots the potential issue under the acquisition price method of the reliability of valuation of assets not to be compensated by PCTs, since there are no such assets. Assuming the acquisition price method is otherwise the most reliable method, the aggregate value of Company X's in-process technology and workforce is the full acquisition price of $100 million. Accordingly, the aggregate value of the arm's length PCT Payments due from FSub to USP for the platform contributions consisting of the rights in Company X's in-process technology and workforce will equal $100 million multiplied by FSub's RAB share.

Example 2. (i) The facts are the same as in *Example 1,* except that Company X is a mature software business in the United States with a successful current generation of software that it markets under a recognized trademark, in addition to having the research team and new generation software in process that could significantly enhance the programs being developed under USP's and FSub's CSA. USP continues Company X's existing business and integrates the research team and the in-process technology into the efforts under its CSA with FSub. For accounting purposes, the $100 million price for acquiring Company X is allocated $50 million to existing software and trademark, $25 million to in-process technology and research workforce, and the residual $25 million to goodwill and going concern value.

(ii) In this case an analysis of the facts indicates a likelihood that, consistent with the allocation under the accounting treatment (although not necessarily in the same amount), a significant amount of the nonroutine contributions to the USP's business activities consist of goodwill and going concern value economically attributable to the existing U.S. software business rather than to the platform contributions consisting of the rights in the in-process technology and research workforce. In addition, an analysis of the facts indicates that a significant amount of the nonroutine contributions to USP's business activities consist of the make-or-sell rights under the existing software and trademark, which are not platform contributions and might be difficult to value. Accordingly, further consideration must be given to the extent to which these circumstances reduce the relative reliability of the acquisition price method in comparison to other potentially applicable methods for evaluating the PCT Payment.

Example 3. (i) USP, a U.S. corporation, and FSub, a wholly-owned foreign subsidiary of USP, enter into a CSA in Year 1 to develop Product A. Company Y is an uncontrolled corporation that owns Technology X, which is critical to the development of Product A. Company Y currently markets Product B, which is dependent on Technology X. USP is solely interested in acquiring Technology X, but is only able to do so through the acquisition of Company Y in its entirety for $200 million in an uncontrolled transaction in Year 2. For accounting purposes, the acquisition price is allocated as follows: $120 million to Product B and the underlying Technology X, $30 million to trademark and other marketing intangibles, and the residual $50 million to goodwill and going concern value. After the acquisition of Company Y, Technology X is used to develop Product A. No other part of Company Y is used in any manner. Immediately after the acquisition, product B is discontinued, and, therefore, the accompanying marketing intangibles become worthless. None of the previous employees of Company Y is retained.

(ii) The Technology X of Company Y acquired by USP is reasonably anticipated to contribute to developing cost shared intangibles and is therefore a platform contribution for which FSub must compensate USP as part of a PCT. Although for accounting purposes a significant portion of the acquisition price of Company Y was allocated to items other than Technology X, the facts demonstrate that USP had no intention of using and therefore placed no economic value on any part of Company Y other than Technology X. If USP was willing to pay $200 million for Company Y solely for purposes of acquiring Technology X, then assuming the acquisition price method is otherwise the most reliable method, the value of Technology X is the full $200 million acquisition price. Accordingly, the value of the arm's length PCT Payment due from FSub to USP for the platform contribution consisting of the rights in Technology X will equal the product of $200 million and FSub's RAB share.

(viii) *Valuations of subsequent PCTs*—(A) *Date of subsequent PCT*. The date of a PCT may occur subsequent to the inception of the CSA. For example, an intangible initially developed outside the IDA may only subsequently become a platform contribution because that later time is the earliest date on which it is reasonably anticipated to contribute to developing cost shared intangibles within the IDA. In such case, the date of the PCT, and the analysis of the arm's length amount charged in the subsequent PCT, is as of such later time.

(B) *Best method analysis for subsequent PCT*. In cases where PCTs occur on different dates, the determination of the arm's length amount charged, respectively, in the prior and subsequent PCTs must be coordinated in a manner that provides the most reliable measure of an arm's length result. In some circumstances, a subsequent PCT may be reliably evaluated independently of other PCTs, as may be possible for example, under the acquisition price method. In other circumstances, the results of prior and subsequent PCTs may be interrelated and so a subsequent PCT may be most reliably evaluated under the residual profit split method of paragraph (g)(7) of this section. In those cases, for purposes of allocating the present value of nonroutine residual divisional profit or loss, and so determining the present value of the subsequent PCT Payments, in accordance with paragraph (g)(7)(iii)(C) of this section, the PCT Payor's interest in cost shared intangibles, both already developed and in process, are treated as additional PCT Payor operating contributions as of the date of the subsequent PCT.

(ix) *Arm's length range*—(A) *In general*. The guidance in §1.482–1(e) regarding determination of an arm's length range, as modified by this section, applies in evaluating the arm's length amount charged in a PCT under a transfer pricing method provided in this section (applicable method). Section 1.482–1(e)(2)(i) provides that the arm's length range is ordinarily determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability although use of more than one method may be appropriate for the purposes described in §1.482–1(c)(2)(iii). The rules provided in §1.482–1(e) and this section for determining an arm's length range shall not override the rules provided in paragraph (i)(6) of this section for periodic adjustments by the Commissioner. The provisions in paragraphs (g)(2)(ix)(C) and (D) of this section apply only to applicable methods that are based on two or more input parameters as described in paragraph (g)(2)(ix)(B) of this section. For an example of how the rules of this section for determining an arm's length range of PCT Payments are applied, see paragraph (g)(4)(viii) of this section.

(B) *Methods based on two or more input parameters*. An applicable method may determine PCT Payments based on calculations involving two or more parameters whose values depend on the facts and circumstances of the case (input parameters). For some input parameters (market-based input parameters), the value is most reliably determined by reference to data that derives from uncontrolled transactions (market data). For example, the value of the return to a controlled participant's routine contributions, as such term is defined in paragraph (j)(1)(i) of this section, to the CSA Activity (which value is used as an input parameter in the income method described in paragraph (g)(4) of this section) may in some cases be most reliably determined by reference to the profit level of a company with rights, resources, and capabilities comparable to those routine contributions. See §1.482–5. As another example, the value for the discount rate that reflects the riskiness of a controlled participant's role in the CSA (which value is used as an input parameter in the income method described in paragraph (g)(4) of this section) may in some cases be most reliably determined by reference to the stock beta of a company whose overall risk is comparable to the riskiness of the controlled participant's role in the CSA.

(C) *Variable input parameters*. For some market-based input parameters (variable input parameters), the parameter's value is most reliably determined by considering two or more observations of market data that have, or with adjustment can be brought to, a similar reliability and comparability, as described in §1.482–1(e)(2)(ii) (for example, profit levels or stock betas of two or more companies). See paragraph (g)(2)(ix)(B) of this section.

(D) *Determination of arm's length PCT Payment*. For purposes of applying this paragraph (g)(2)(ix), each input parameter is assigned a single most reliable value, unless it is a variable input parameter as described in paragraph (g)(2)(ix)(C) of this section. The determination of the arm's length payment depends on the number of variable input parameters.

(*1*) *No variable input parameters.* If there are no variable input parameters, the arm's length PCT Payment is a single value determined by using the single most reliable value determined for each input parameter.

(*2*) *One variable input parameter.* If there is exactly one variable input parameter, then under the applicable method, the arm's length range of PCT Payments is the interquartile range, as described in §1.482–1(e)(2)(iii)(C), of the set of PCT Payment values calculated by selecting—

(*i*) Iteratively, the value of the variable input parameter that is based on each observation as described in paragraph (g)(2)(ix)(C) of this section; and

(*ii*) The single most reliable values for each other input parameter.

(*3*) *More than one variable input parameter.* If there are two or more variable input parameters, then under the applicable method, the arm's length range of PCT Payments is the interquartile range, as described in §1.482–1(e)(2)(iii)(C), of the set of PCT Payment values calculated iteratively using every possible combination of permitted choices of values for the input parameters. For input parameters other than a variable input parameter, the only such permitted choice is the single most reliable value. For variable input parameters, such permitted choices include any value that is—

(*i*) Based on one of the observations described in paragraph (g)(2)(ix)(C) of this section; and

(*ii*) Within the interquartile range (as described in §1.482–1(e)(2)(iii)(C)) of the set of all values so based.

(E) *Adjustments.* Section 1.482–1(e)(3), applied as modified by this paragraph (g)(2)(ix), determines when the Commissioner may make an adjustment to a PCT Payment due to the taxpayer's results being outside the arm's length range. Adjustment will be to the median, as defined in §1.482–1(e)(3). Thus, the Commissioner is not required to establish an arm's length range prior to making an allocation under section 482.

(x) *Valuation undertaken on a pre-tax basis.* PCT Payments in general may increase the PCT Payee's tax liability and decrease the PCT Payor's tax liability. The arm's length amount of a PCT Payment determined under the methods in this paragraph (g) is the value of the PCT Payment itself, without regard to such tax effects. Therefore, the methods under this section must be applied, with suitable adjustments if needed, to determine the PCT Payments on a pre-tax basis. See paragraphs (g)(2)(v)(B) and (4)(i)(G) of this section.

(3) *Comparable uncontrolled transaction method.* The comparable uncontrolled transaction (CUT) method described in §1.482–4(c), and the comparable uncontrolled services price (CUSP) method described in §1.482–9(c), may be applied to evaluate whether the amount charged in a PCT is arm's length by reference to the amount charged in a comparable uncontrolled transaction. Although all of the factors entering into a best method analysis described in §1.482–1(c) and (d) must be considered, comparability and reliability under this method are particularly dependent on similarity of contractual terms, degree to which allocation of risks is proportional to reasonably anticipated benefits from exploiting the results of intangible development, similar period of commitment as to the sharing of intangible development risks, and similar scope, uncertainty, and profit potential of the subject intangible development, including a similar allocation of the risks of any existing resources, capabilities, or rights, as well as of the risks of developing other resources, capabilities, or rights that would be reasonably anticipated to contribute to exploitation within the parties' divisions, that is consistent with the actual allocation of risks between the controlled participants as provided in the CSA in accordance with this section. When applied in the manner described in §1.482–4(c) or 1.482–9(c), the CUT or CUSP method will typically yield an arm's length total value for the platform contribution that is the subject of the PCT. That value must then be multiplied by each PCT Payor's respective RAB share in order to determine the arm's

length PCT Payment due from each PCT Payor. The reliability of a CUT or CUSP that yields a value for the platform contribution only in the PCT Payor's division will be reduced to the extent that value is not consistent with the total worldwide value of the platform contribution multiplied by the PCT Payor's RAB share.

(4) *Income method*—(i) *In general*—(A) *Equating cost sharing and licensing alternatives.* The income method evaluates whether the amount charged in a PCT is arm's length by reference to a controlled participant's best realistic alternative to entering into a CSA. Under this method, the arm's length charge for a PCT Payment will be an amount such that a controlled participant's present value, as of the date of the PCT, of its cost sharing alternative of entering into a CSA equals the present value of its best realistic alternative. In general, the best realistic alternative of the PCT Payor to entering into the CSA would be to license intangibles to be developed by an uncontrolled licensor that undertakes the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA. Similarly, the best realistic alternative of the PCT Payee to entering into the CSA would be to undertake the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA and license the resulting intangibles to an uncontrolled licensee. Paragraphs (g)(4)(i)(B) through (vi) of this section describe specific applications of the income method, but do not exclude other possible applications of this method.

(B) *Cost sharing alternative.* The PCT Payor's cost sharing alternative corresponds to the actual CSA in accordance with this section, with the PCT Payor's obligation to make the PCT Payments to be determined and its commitment for the duration of the IDA to bear cost contributions.

(C) *Licensing alternative.* The licensing alternative is derived on the basis of a functional and risk analysis of the cost sharing alternative, but with a shift of the risk of cost contributions to the licensor. Accordingly, the PCT Payor's licensing alternative consists of entering into a license with an uncontrolled party, for a term extending for what would be the duration of the CSA Activity, to license the make-or-sell rights in to-be-developed resources, capabilities, or rights of the licensor. Under such license, the licensor would undertake the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA. Apart from any difference in the allocation of the risks of the IDA, the licensing alternative should assume contractual provisions with regard to non-overlapping divisional intangible interests, and with regard to allocations of other risks, that are consistent with the actual CSA in accordance with this section. For example, the analysis under the licensing alternative should assume a similar allocation of the risks of any existing resources, capabilities, or rights, as well as of the risks of developing other resources, capabilities, or rights that would be reasonably anticipated to contribute to exploitation within the parties' divisions, that is consistent with the actual allocation of risks between the controlled participants as provided in the CSA in accordance with this section. Accordingly, the financial projections associated with the licensing and cost sharing alternatives are necessarily the same except for the licensing payments to be made under the licensing alternative and the cost contributions and PCT Payments to be made under the CSA.

(D) *Only one controlled participant with nonroutine platform contributions.* This method involves only one of the controlled participants providing nonroutine platform contributions as the PCT Payee. For a method under which more than one controlled participant may be a PCT Payee, see the application of the residual profit method pursuant to paragraph (g)(7) of this section.

(E) *Income method payment forms.* The income method may be applied to determine PCT Payments in any form of payment (for example, lump sum, royalty on sales, or royalty on divisional profit). For converting to another form of payment, see generally paragraph (h) (Form of payment rules) of this section.

(F) *Discount rates appropriate to cost sharing and licensing alternatives.* The present value of the cost sharing and licensing alternatives, respectively, should be determined using the appropriate discount rates in accordance with paragraphs (g)(2)(v) and (g)(4)(vi)(F) of this section. See, for example, §1.482–7(g)(2)(v)(B)(*1*) (Discount rate variation between realistic alternatives). In circumstances where the market-correlated risks as between the cost sharing and licensing alternatives are not materially different, a reliable analysis may be possible by using the same discount rate with respect to both alternatives.

(G) *The effect of taxation on determining the arm's length amount.* (*1*) In principle, the present values of the cost sharing and licensing alternatives should be determined by applying post-tax discount rates to post-tax income (including the post-tax value to the controlled participant of the PCT Payments). If such approach is adopted, then the post-tax value of the PCT Payments must be appropriately adjusted in order to determine the arm's length amount of the PCT Payments on a pre-tax basis. See paragraph (g)(2)(x) of this section.

(*2*) In certain circumstances, post-tax income may be derived as the product of the result of applying a post-tax discount rate to pre-tax income, and a factor equal to one minus the tax rate (as defined in (j)(1)(i)). See paragraph (g)(2)(v)(B) of this section.

(*3*) To the extent that a controlled participant's tax rate is not materially affected by whether it enters into the cost sharing or licensing alternative (or reliable adjustments may be made for varying tax rates), the factor (that is, one minus the tax rate) may be cancelled from both sides of the equation of the cost sharing and licensing alternative present values. Accordingly, in such circumstance it is sufficient to apply post-tax discount rates to projections of pre-tax income for the purpose of equating the cost sharing and licensing alternatives. The specific applications of the income method described in paragraphs (g)(4)(ii) through (iv) of this section and the examples set forth in paragraph (g)(4)(viii) of this section assume that a controlled participant's tax rate is not materially affected by whether it enters into the cost sharing or licensing alternative.

(ii) *Evaluation of PCT Payor's cost sharing alternative.* The present value of the PCT Payor's cost sharing alternative is the present value of the stream of the reasonably anticipated residuals over the duration of the CSA Activity of divisional profits or losses, minus operating cost contributions, minus cost contributions, minus PCT Payments.

(iii) *Evaluation of PCT Payor's licensing alternative*—(A) *Evaluation based on CUT.* The present value of the PCT Payor's licensing alternative may be determined using the comparable uncontrolled transaction method, as described in §1.482–4(c)(1) and (2). In this case, the present value of the PCT Payor's licensing alternative is the present value of the stream, over what would be the duration of the CSA Activity under the cost sharing alternative, of the reasonably anticipated residuals of the divisional profits or losses that would be achieved under the cost sharing alternative, minus operating cost contributions that would be made under the cost sharing alternative, minus the licensing payments as determined under the comparable uncontrolled transaction method.

(B) *Evaluation based on CPM.* The present value of the PCT Payor's licensing alternative may be determined using the comparable profits method, as described in §1.482–5. In this case, the present value of the licensing alternative is determined as in paragraph (g)(4)(iii)(A) of this section, except that the PCT Payor's licensing payments, as defined in paragraph (j)(1)(i) of this section, are determined in each period to equal the reasonably anticipated residuals of the divisional profits or losses that would be achieved under the cost sharing alternative, minus operating cost contributions that would be made under the cost sharing alternative, minus market returns for routine contributions, as defined in paragraph (j)(1)(i) of this section. However, treatment of net operating contributions as operating cost contributions shall be coordinated with the treatment of other routine contributions pursuant to this paragraph so as to avoid duplicative market returns to such contributions.

(iv) *Lump sum payment form.* Where the form of PCT Payment is a lump sum as of the date of the PCT, then, based on paragraphs (g)(4)(i) through (iii) of this section, the PCT Payment equals the difference between—

(A) The present value, using the discount rate appropriate for the cost sharing alternative, of the stream of the reasonably anticipated residuals over the duration of the CSA Activity of divisional profits or losses, minus cost contributions and operating cost contributions; and

(B) The present value of the licensing alternative.

(v) *Application of income method using differential income stream.* In some cases, the present value of an arm's length PCT Payment may be determined as the present value, discounted at the appropriate rate, of the PCT Payor's reasonably anticipated stream of additional positive or negative income over the duration of the CSA Activity that would result (before PCT Payments) from undertaking the cost sharing alternative rather than the licensing alternative (differential income stream). See *Example 9* of paragraph (g)(4)(viii) of this section.

(vi) *Best method analysis considerations.* (A) *Coordination with §1.482–1(c).* Whether results derived from this method are the most reliable measure of an arm's length result is determined using the factors described under the best method rule in §1.482–1(c). Thus, comparability and the quality of data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions, must be considered in determining whether this method provides the most reliable measure of an arm's length result.

(B) *Assumptions Concerning Tax Rates.* This method will be more reliable to the extent that the controlled participants' respective tax rates are not materially affected by whether they enter into the cost sharing or licensing alternative. Even if this assumption of invariant tax rates across alternatives does not hold, this method may still be reliable to the extent that reliable adjustments can be made to reflect the variation in tax rates.

(C) *Coordination with §1.482–4(c)(2).* If the licensing alternative is evaluated using the comparable uncontrolled transactions method, as described in paragraph (g)(4)(iii)(A) of this section, any additional comparability and reliability considerations stated in §1.482–4(c)(2) may apply.

(D) *Coordination with §1.482–5(c).* If the licensing alternative is evaluated using the comparable profits method, as described in paragraph (g)(4)(iii)(B) of this section, any additional comparability and reliability considerations stated in §1.482–5(c) may apply.

(E) *Certain Circumstances Concerning PCT Payor.* This method may be used even if the PCT Payor furnishes significant operating contributions, or commits to assume the risk of significant operating cost contributions, to the PCT Payor's division. However, in such a case, any comparable uncontrolled transactions described in paragraph (g)(4)(iii)(A) of this section, and any comparable transactions used under §1.482–5(c) as described in paragraphs (g)(4)(iii)(B) of this section, should be consistent with such contributions (or reliable adjustments must be made for material differences).

(F) *Discount rates—(1) Reflection of similar risk profiles of cost sharing alternative and licensing alternative.* Because the financial projections associated with the licensing and cost sharing alternatives are the same, except for the licensing payments to be made under the licensing alternative and the cost contributions and PCT Payments to be made under the cost sharing alternative, the analysis of the risk profile and financial projections for a realistic alternative to the cost sharing alternative must be closely associated with the risk profile and financial projections associated with the cost sharing alternative, differing only in the treatment of licensing payments, cost contributions, and PCT Payments. When using discount rates in applying the income method, this means that even if different discount rates are warranted for the two alternatives, the risk profiles for the two discount rates are closely related to each other because the discount rate for the licensing alternative and the discount rate for the cost sharing alternative are both derived from the single probability-weighted financial projections associated with the CSA Activity. The difference, if any, in market-correlated risks between the licensing and cost sharing alternatives is due solely to the different effects on risks of the PCT Payor making licensing payments under the licensing alternative, on the one hand, and the PCT Payor making cost contributions and PCT Payments under the cost sharing alternative, on the other hand. That is, the difference in the risk profile between the two scenarios solely reflects the incremental risk, if any, associated with the cost contributions taken on by the PCT Payor in developing the cost shared intangible under the cost sharing alternative, and the difference, if any, in risk associated with the particular payment forms of the licensing payments and the PCT Payments, in light of the fact that the licensing payments in the licensing alternative are partially replaced by cost contributions and partially replaced by PCT Payments in the cost sharing alternative, each with its own payment form. An analysis under the income method that uses a different discount rate for the cost sharing alternative than for the licensing alternative will be more reliable the greater the extent to which the difference, if any, between the two discount rates reflects solely these differences in the risk profiles of these two alternatives. See, for example, paragraph (g)(2)(iii), *Example 2* of this section.

(*2*) *Use of differential income stream as a consideration in assessing the best method*. An analysis under the income method that uses a different discount rate for the cost sharing alternative than for the licensing alternative will be more reliable the greater the extent to which the implied discount rate for the projected present value of the differential income stream is consistent with reliable direct evidence of the appropriate discount rate applicable for activities reasonably anticipated to generate an income stream with a similar risk profile to the differential income stream. Such differential income stream is defined as the stream of the reasonably anticipated residuals of the PCT Payor's licensing payments to be made under the licensing alternative, minus the PCT Payor's cost contributions to be made under the cost sharing alternative. See *Example 8* of paragraph (g)(4)(viii) of this section.

(vii) *Routine platform and operating contributions*. For purposes of this paragraph (g)(4), any routine contributions that are platform or operating contributions, the valuation and PCT Payments for which are determined and made independently of the income method, are treated similarly to cost contributions and operating cost contributions, respectively. Accordingly, wherever used in this paragraph (g)(4), the term ''routine contributions'' shall not include routine platform or operating contributions, and wherever the terms ''cost contributions'' and ''operating cost contributions'' appear in this paragraph, they shall include net routine platform contributions and net routine operating contributions, respectively. Net routine platform contributions are the value of a controlled participant's total reasonably anticipated routine platform contributions, plus its reasonably anticipated PCT Payments to other controlled participants in respect of their routine platform contributions, minus the reasonably anticipated PCT Payments it is to receive from other controlled participants in respect of its routine platform contributions. Net routine operating contributions are the value of a controlled participant's total reasonably anticipated routine operating contributions, plus its reasonably anticipated arm's length compensation to other controlled participants in respect of their routine operating contributions, minus the reasonably anticipated arm's length compensation it is to receive from other controlled participants in respect of its routine operating contributions.

(viii) *Examples*. The following examples illustrate the principles of this paragraph (g)(4):

Example 1. (i) For simplicity of calculation in this *Example 1,* all financial flows are assumed to occur at the beginning of each period. USP, a software company, has developed version 1.0 of a new software application that it is currently marketing. In Year 1 USP enters into a CSA with its wholly-owned foreign subsidiary, FS, to develop future versions of the software application. Under the CSA, USP will have the rights to exploit the future versions in the United States, and FS will have the rights to exploit them in the rest of the world. The future rights in version 1.0, and USP's development team, are reasonably anticipated to contribute to the development of future versions and therefore the rights in version 1.0 and the research and development team are platform contributions for which compensation is due from FS as part of a PCT. USP does not transfer the current exploitation rights in version 1.0 to FS. FS will not perform any research or development activities and does not furnish any platform contributions nor does it control any operating intangibles at the inception of the CSA that would be relevant to the exploitation of version 1.0 or future versions of the software.

(ii) FS undertakes financial projections in its territory of the CSA:

(1) Year	(2) Sales	(3) Operating costs	(4) Cost contributions	(5) Operating income under cost sharing alternative (excluding PCT)
1	0	0	50	−50
2	0	0	50	−50
3	200	100	50	50
4	400	200	50	150
5	600	300	60	240
6	650	325	65	260
7	700	350	70	280
8	750	375	75	300
9	750	375	75	300
10	675	338	68	269
11	608	304	61	243
12	547	273	55	219
13	410	205	41	164
14	308	154	31	123
15	231	115	23	93

FS anticipates that activity on this application will cease after Year 15. The application was derived from software developed by Company Q, an uncontrolled party. FS has a license under Company Q's copyright, but that license expires after Year 15 and will not be renewed.

(iii) In evaluating the cost sharing alternative, FS concludes that the cost sharing alternative represents a riskier alternative for FS than the licensing alternative because, in cost sharing, FS will take on the additional risks associated with cost contributions. Taking this difference into account, FS concludes that the appropriate discount rate to apply in assessing the licensing alternative, based on discount rates of comparable uncontrolled companies undertaking comparable licensing transactions, would be 13% per year, whereas the appropriate discount rate to apply in assessing the cost sharing alternative would be 15% per year. FS determines that the arm's length rate USP would have charged an uncontrolled licensee for a license of future versions of the software (if USP had further developed version 1.0 on its own) is 35% of the sales price, as determined under the CUT method in §1.482–4(c). FS also determines that the tax rate applicable to it will be the same in the licensing alternative as in the CSA. Accordingly, the financial projections associated with the licensing alternative are:

(6) Year	(7) Sales	(8) Operating costs	(9) Licensing payments	(10) Operating income under licensing alternative	(11) Operating income under cost sharing alternative minus operating income under licensing alternative
1	0	0	0	0	−50
2	0	0	0	0	−50
3	200	100	70	30	20

(6) Year	(7) Sales	(8) Operating costs	(9) Licensing payments	(10) Operating income under licensing alternative	(11) Operating income under cost sharing alternative minus operating income under licensing alternative
4	400	200	140	60	90
5	600	300	210	90	150
6	650	325	228	97	163
7	700	350	245	105	175
8	750	375	263	112	188
9	750	375	263	112	188
10	675	338	236	101	168
11	608	304	213	91	152
12	547	273	191	83	136
13	410	205	144	61	103
14	308	154	108	46	77
15	231	115	81	35	58

(iv) Based on these projections and applying the appropriate discount rate, FS determines that under the cost sharing alternative, the present value of the stream of residuals of its anticipated divisional profits, reduced by the anticipated operating cost contributions and cost contributions, but not reduced by any PCT Payments (that is, the stream of anticipated operating income as shown in column 5) would be $889 million. Under the licensing alternative, the present value of the stream of residuals of its anticipated divisional profits and losses minus the operating cost contributions (that is, the stream of anticipated operating income before licensing payments, which is the present value of column 7 reduced by column 8) would be $1.419 billion, and the present value of the licensing payments would be $994 million. Therefore, the total value of the licensing alternative would be $425 million. In order for the present value of the cost sharing alternative to equal the present value of the licensing alternative, the present value of the PCT Payments must equal $464 million. Therefore, the taxpayer makes and reports PCT Payments with a present value of $464 million.

Example 2. Arm's length range. (i) The facts are the same as in *Example 1*. The Commissioner accepts the financial projections undertaken by FS. Further, the Commissioner determines that the licensing discount rate and the CUT licensing rate are most reliably determined by reference to comparable uncontrolled discount rates and license rates, respectively. The observations that are in the interquartile range of the respective input parameters (see paragraph (g)(2)(ix) of this section) are as follows:

Observations that are within interquartile range	Comparable uncontrolled discount rate
1	11%
2	12
3 (Median)	13
4	15
5	17

Observations that are within interquartile range	Comparable uncontrolled licensing rate
1	30%
2	32
3 (Median)	35
4	37
5	40

(ii) Following the principles of paragraph (g)(2)(ix) of this section, the Commissioner undertakes 25 different applications of the income method, using each combination of the discount rate and licensing rate parameters. In undertaking this analysis, the Commissioner assumes that the ratio of the median discount rate for the cost sharing alternative to the median discount rate for the licensing alternative (that is, 15% to 13%) is maintained. The results of the 25 applications of the income method, sorted in ascending order of calculated present value of the PCT Payment, are as follows:

INCOME METHOD APPLICATION NUMBER::	Comparable uncontrolled licensing discount rate	Comparable uncontrolled CSA discount rate	Comparable uncontrolled licensing rate	Calculated lump sum PCT payment	Interquartile range of PCT payments
1	17%	19.6%	30%	217	
2	17	19.6	32	263	
3	15	17.3	30	264	
4	15	17.3	32	315	

INCOME METHOD APPLICATION NUMBER::	Comparable uncontrolled licensing discount rate	Comparable uncontrolled CSA discount rate	Comparable uncontrolled licensing rate	Calculated lump sum PCT payment	Interquartile range of PCT payments
5	13	15	30	321	
6	17	19.6	35	331	
7	12	13.8	30	354	LQ = 354
8	17	19.6	37	376	
9	13	15	32	378	
10	11	12.7	30	391	
11	15	17.3	35	391	
12	12	13.8	32	415	
13	15	17.3	37	442	Median = 442
14	17	19.6	40	444	
15	11	12.7	32	455	
16	13	15	35	464	
17	12	13.8	35	505	
18	15	17.3	40	517	
19	13	15	37	520	UQ = 520
20	11	12.7	35	551	
21	12	13.8	37	566	
22	13	15	40	605	
23	11	12.7	37	615	
24	12	13.8	40	655	
25	11	12.7	40	710	

(iii)Accordingly, the Commissioner determines that a taxpayer will not be subject to adjustment if its initial (ex ante) determination of the present value of PCT Payments is between $354 million and $520 million (the lower and upper quartile results as shown in the last column). Because FS's determination of the present value of the PCT Payments, $464 million, is within the interquartile range, no adjustments are warranted.

Example 3. (i) For simplicity of calculation in this *Example 3,* all financial flows are assumed to occur at the beginning of each period. USP, a U.S. software company, has developed version 1.0 of a new software application, employed to store and retrieve complex data sets in certain types of storage media. Version 1.0 is currently being marketed. In Year 1, USP enters into a CSA with its wholly-owned foreign subsidiary, FS, to develop future versions of the software application. Under the CSA, USP will have the exclusive rights to exploit the future versions in the U.S., and FS will have the exclusive rights to exploit them in the rest of the world. USP's rights in version 1.0, and its development team, are reasonably anticipated to contribute to the development of future versions of the software application and, therefore, the rights in version 1.0 are platform contributions for which compensation is due from FS as part of a PCT. USP also transfers the current exploitation rights in version 1.0 to FS and the arm's length amount of the compensation for such transfer is determined in the aggregate with the arm's length PCT Payments in this *Example 3.* FS does not furnish any platform contributions to the CSA nor does it control any operating intangibles at the inception of the CSA that would be relevant to the exploitation of version 1.0 or future versions of the software. It is reasonably anticipated that FS will have gross sales of $1000X in its territory for 5 years attributable to its exploitation of version 1.0 and the cost shared intangibles, after which time the software application will be rendered obsolete and unmarketable by the obsolescence of the storage medium technology to which it relates. FS's costs reasonably attributable to the CSA, other than cost contributions and operating cost contributions, are anticipated to be $250X per year. Certain operating cost contributions that will be borne by FS are reasonably anticipated to equal $200X per annum for 5 years. In addition, FS is reasonably anticipated to pay cost contributions of $200X per year as a controlled participant in the CSA.

(ii) FS concludes that its realistic alternative would be to license software from an uncontrolled licensor that would undertake the commitment to bear the entire risk of software development. Applying CPM using the profit levels experienced by uncontrolled licensees with contractual provisions and allocations of risk that are comparable to those of FS's licensing alternative, FS determines that it could, as a licensee, reasonably expect a (pre-tax) routine return equal to 14% of gross sales or $140X per year for 5 years. The remaining net revenue would be paid to the uncontrolled licensor as a license fee of $410X per year. FS determines that the discount rate that would be applied to determine the present value of income and costs attributable to its participation in the licensing alternative would be 12.5% as compared to the 15% discount rate that would be applicable in determining the present value of the net income attributable to its participation in the CSA (reflecting the increased risk borne by FS in bearing a share of the R & D costs in the cost sharing alternative). FS also determines that the tax rate applicable to it will be the same in the licensing alternative as in the CSA.

(iii) On these facts, the present value to FS of entering into the cost sharing alternative equals the present value of the annual divisional profits ($1,000X minus $250X) minus operating cost contributions ($200X) minus cost contributions ($200X) minus PCT Payments, determined over 5 years by discounting at a discount rate of 15%. Thus, the present value of the residuals, prior to subtracting the present value of the PCT Payments, is $1349X.

(iv) On these facts, the present value to FS of entering into the licensing alternative would be $561X determined by discounting, over 5 years, annual divisional profits ($1,000X minus $250X) minus operating cost contributions ($200X) and licensing payments ($410X) at a discount rate of 12.5% per annum. The present value of the cost sharing alternative must also equal $561X but equals $1349X prior to subtracting the present value of the PCT Payments. Consequently, the PCT Payments must have a present value of $788X.

Example 4. Pre-tax PCT Payment derived from post-tax information. (i) For simplicity of calculation in this *Example 4*, it is assumed that all payments are made at the end of each year. Domestic controlled participant USP has developed a technology, Z, that it would like to exploit for three years in a CSA. USP enters into a CSA with its wholly-owned foreign subsidiary, FS, that provides for PCT Payments from FS to USP with respect to USP's platform contribution to the CSA of Z in the form of three annual installment payments due from FS to USP on the last day of each of the first three years of the CSA. FS makes no platform contributions to the CSA. Prior to entering into the CSA, FS considers that it has the realistic alternative available to it of licensing Z from USP rather than entering into a CSA with USP to further develop Z for three years.

(ii) FS undertakes financial projections for both the licensing and cost sharing alternatives for exploitation of Z in its territory of the CSA. These projections are set forth in the following tables. The example assumes that there is a reasonably anticipated effective tax rate of 25% in each of years 1 through 3 under both the licensing and cost sharing alternatives. FS determines that the appropriate post-tax discount rate under the licensing alternative is 12.5%, and that the appropriate post-tax discount rate under the cost sharing alternative is 15%.

Licensing alternative	Present value (12.5% DR)	Year 1	Year 2	Year 3
(1) Sales		$1000	$1100	$1210
(2) License Fee		400	440	484
(3) Operating costs		500	550	605
(4) Operating Income	$261	100	110	121
(5) Tax (25%)		25	28	30
(6) Post-tax income	$196	$75	$82	$91
Cost sharing alternative	**Present value (15% DR)**	**Year 1**	**Year 2**	**Year 3**
(7) Sales		$1000	$1100	$1210
(8) Cost Contributions		200	220	242
(9) PCT Payments	D	A	B	C
(10) Operating costs		500	550	605
(11) Operating income excluding PCT	$749	300	330	363
(12) Operating income	H	E	F	G
(13) Tax				
(14) Post-tax income excluding PCT	$562	$225	$248	$272
(15) Post-tax income	L	I	J	K

(iii) Under paragraph (g)(4) of this section, the arm's length charge for a PCT Payment will be an amount such that a controlled participant's present value, as of the date of the PCT of its cost sharing alternative of entering into a CSA equals the present value of its best realistic alternative. This requires that L, the present value of the post-tax income under the CSA, equals the present value of the post-tax income under the licensing alternative, or $196.

(iv) FS determines that PCT Payments for Z should be $196 in Year 1 (A), $215 in Year 2 (B), and $236 in Year 3 (C). By using these amounts for A, B, and C in the table above, FS is able to derive the values of E, F, G, I, J, and K in the table above. Based on these PCT Payments for Z, the post-tax income will be $78 in Year 1 (I), $86 in Year 2 (J), and $95 in Year 3 (K). When this post-tax income stream is discounted at the appropriate rate for the cost sharing alternative (15%), the net present value is $196 (L). The present value of the PCT Payments, when discounted at the appropriate post-tax rate, is $488 (D).

(v) The Commissioner undertakes an audit of the PCT Payments made by FS to USP for Z in Years 1 through 3. The Commissioner concludes that the PCT Payments for Z are arm's length in accordance with this paragraph (g)(4).

Example 5. Pre-tax PCT Payment derived from post-tax information. (i) The facts are the same as in paragraphs (i) and (ii) of *Example 4*. In addition, under this paragraph (g)(4), the arm's length charge for a PCT Payment will be an amount such that a controlled participant's present value, as of the date of the PCT of its cost sharing alternative equals the present value of its best realistic alternative. This requires that L, the present value of the post-tax income under the CSA, equals the present value of the post-tax income under the licensing alternative, or $196.

(ii) FS determines that the post-tax present value of the cost sharing alternative (excluding PCT Payments) is $562. The post-tax present value of the licensing alternative is $196. Accordingly, payments with a post-tax present value of $366 are required.

(iii) The Commissioner undertakes an audit of the PCT Payments made by FS to USP for Z in Years 1 through 3. In correspondence to the Commissioner, USP maintains that the arm's length PCT Payment for Z should have a present value of $366 (D).

(iv) The Commissioner considers that if FS makes PCT Payments for Z with a present value of $366, then the post-tax present value under the CSA (considering the deductibility of the PCT Payments) will be $287, substantially higher than the post-tax present value of the licensing arrangement, $196. The Commissioner determines that, under the specific facts and assumptions of this example, the present value of the post-tax payments may be grossed up by a factor of (one minus the tax rate), resulting in a present value of pre-tax payments of $488. Accordingly, FS must make yearly PCT Payments (A, B, and C) such that the present value of the Payments is $488 (D). (When FS's post-tax income after these PCT Payments for Z is discounted at the appropriate rate for the cost sharing alternative (15%), the net present value is $196 (L), which is equal to the present value of post-tax income under the licensing alternative.) The Commissioner concludes that the calculations that it has made for the PCT Payments for Z are arm's length in accordance with this paragraph (g)(4) and, accordingly, makes the appropriate adjustments to USP's income tax return to account for the gross-up required by paragraph (g)(2)(x) of this section.

Example 6. Pre-tax PCT Payment derived from pre-tax information. (i) The facts are the same as in paragraphs (i) and (ii) of *Example 4*. In addition, under paragraph (g)(4) of this section, the arm's length charge for a PCT Payment will be an amount such that a controlled participant's present value, as of the date of the PCT of its cost sharing alternative of entering into a CSA equals the present value of its best realistic alternative. This requires that "L," the present value of the post-tax income under the CSA, equals the present value of the post-tax income under the licensing alternative, or $196.

(ii) Under the specific facts and assumptions of this *Example 6* (see paragraph (g)(4)(i)(G) of this section), and using the same (post-tax) discount rates as in *Example 4*, the present value of pre-tax income under the licensing alternative (that is, the operating income) is $261, and the present value of pre-tax income under the cost sharing alternative (excluding PCT Payments) is $749. Accordingly, FS determines that its PCT Payments for Z should have a present value equal to the difference between the two, or $488 (D). Such PCT Payments for Z result in a present value of post-tax income under the cost sharing alternative of $196 (L), which is equal to the present value of post-tax income under the licensing alternative.

(iii) The Commissioner undertakes an audit of the PCT Payments for Z made by FS to USP in Years 1 through 3. The Commissioner concludes that the PCT Payments for Z are arm's length in accordance with this paragraph (g)(4).

Example 7. Application of income method with a terminal value calculation. (i) For simplicity of calculation in this *Example 7*, all financial flows are assumed to occur at the beginning of each period. USP's research and development team, Q, has developed a technology, Z, for which it has several applications on the market now and several planned for release at future dates. In Year 1, USP, enters into a CSA with its wholly-owned subsidiary, FS, to develop future applications of Z. Under the CSA, USP will have the rights to further develop and exploit the future applications of Z in the United States, and FS will have the rights to further develop and exploit the future applications of Z in the rest of the world. Both Q and the rights to further develop and exploit future applications of Z are reasonably anticipated to contribute to the development of future applications of Z. Therefore, both Q and the rights to further develop and exploit the future applications of Z are platform contributions for which compensation is due from FS to USP as part of a PCT. USP does not transfer the current exploitation rights for current applications of Z to FS. FS will not perform any research or development activities on Z and does not furnish any platform contributions to the CSA, nor does it control any operating intangibles at the inception of the CSA that would be relevant to the exploitation of either current or future applications of Z.

(ii) At the outset of the CSA, FS undertakes an analysis of the PCTs involving Q and the rights with respect to Z in order to determine the arm's length PCT Payments owing from FS to USP under the CSA. In that evaluation, FS concludes that the cost sharing alternative represents a riskier alternative for FS than the licensing alternative. FS further concludes that the appropriate discount rate to apply in assessing the licensing alternative, based on discount rates of comparable uncontrolled companies undertaking comparable licensing transactions, would be 13% per annum, whereas the appropriate discount rate to apply in assessing the cost sharing alternative would be 14% per annum. FS undertakes financial projections and anticipates making $100 million in sales during the first two years of the CSA in its territory with sales in Years 3 through 8 increasing to $200 million, $400 million, $600 million, $650 million, $700 million, and $750 million, respectively. After Year 8, FS expects its sales of all products based upon exploitation of Z in the rest of the world to grow at 3% per annum for the future. FS and USP do not anticipate cessation of the CSA Activity with respect to Z at any determinable date. FS anticipates that its manufacturing and distribution costs for exploiting Z (including its operating cost contributions), will equal 60% of gross sales of Z from Year 1 onwards, and anticipates its cost contributions will equal $25 million per annum for Years 1 and 2, $50 million per annum for Years 3 and 4, and 10% of gross sales per annum thereafter.

(iii) Based on this analysis, FS determines that the arm's length royalty rate that USP would have charged an uncontrolled licensee for a license of future applications of Z if USP had further developed future applications of Z on its own is 30% of the sales price of the Z-based product, as determined under the comparable uncontrolled transaction method in §1.482–4(c). In light of the expected sales growth and anticipation that the CSA Activity will not cease as of any determinable date, FS's determination includes a terminal value calculation. FS further determines that under the cost sharing alternative, the present value of FS's divisional profits, reduced by the present values of the anticipated operating cost contributions and cost contributions, would be $1,361 million. Under the licensing alternative, the present value of the operating divisional profits and losses, reduced by the operating cost contributions, would be $2,113 million, and the present value of the licensing payments would be $1,585 million. Therefore, the total value of the licensing alternative would be $528 million. In order for the present value of the cost sharing alternative to equal the present value of the licensing alternative, the present value of the PCT Payments must equal $833 million. Accordingly, FS pays USP a lump sum PCT Payment of $833 million in Year 1 for USP's platform contributions of Z and Q.

(iv) The Commissioner undertakes an audit of the PCTs and concludes, based on his own analysis, that this lump sum PCT Payment is within the interquartile range of arm's length results for these platform contributions. The calculations made by FS in determining the PCT Payment in this *Example 7* are set forth in the following tables:

COST SHARING ALTERNATIVE

Time Period (Y = Year, TV = Terminal Value).	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	TV
Discount Period	0	1	2	3	4	5	6	7	7
Items of Income/Expense at Beginning of Year:									
1 Sales	100	100	200	400	600	650	700	750	(3% annual growth in each year from previous year).
2 Routine Cost and Operating Cost Contributions (60% of sales amount in row 1 of relevant year).	60	60	120	240	360	390	420	450	(60% of annual sales in row 1 for each year).
3 Cost Contributions (10% of sales amount in row 1 for relevant year after Year 5).	25	25	50	50	60	65	70	75	(10% of annual sales in row 1 for each year).
4 Profit = amount in row 1 reduced by amounts in rows 2 and 3.	15	15	30	110	180	195	210	225	(row 1 minus rows 2 and 3 for each year).
5 PV (using 14% discount rate).	15	13.2	23.1	74.2	107	101	95.7	89.9	842.
6 TOTAL PV of Cost Sharing Alternative = Sum of all PV amounts in Row 5 for all Time Periods = $1,361 million.									

LICENSING ALTERNATIVE

Time Period (Y = Year, TV = Terminal Value).	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	TV
Discount Period	0	1	2	3	4	5	6	7	7
Items of Income/Expense at Beginning of Year:									
7 Sales	100	100	200	400	600	650	700	750	(3% annual growth in each year from previous year).
8 Routine Cost and Operating Cost Contributions (60% of sales amount in row 7 of relevant year).	60	60	120	240	360	390	420	450	(60% of annual sales in row 7 for each year).
9 Operating Profit = amount in Row 7 reduced by amount in Row 8.	40	40	80	160	240	260	280	300	(Row 7 minus row 8 for each year).
10 PV of row 9 (using 13% discount rate).	40	35.4	62.7	111	147	141	135	128	1313.
11 TOTAL PV FOR ALL AMOUNTS IN ROW 10 = $2,112.7 million									
12 Licensing Payments (30% of sales amount in row 7).	30	30	60	120	180	195	210	225	(30% of amount in row 7 for each year).
13 PV of amount in row 12 (using 13% discount rate).	30	26.5	47	83.2	110	106	101	95.6	985.
14 TOTAL PV FOR ALL AMOUNTS IN ROW 13 = $1,584.5 million.									
15 TOTAL PV of Licensing Alternative = Row 11 minus Row 14 = $528 million.									

CALCULATION OF PCT PAYMENT

16	TOTAL PV OF COST SHARING ALTERNATIVE (FROM ROW 6 ABOVE) =	$1,361 million.
17	TOTAL PV OF LICENSING ALTERNATIVE (FROM ROW 15 ABOVE) =	$528 million.
18	LUMP SUM PCT PAYMENT = ROW 16 − ROW 17 =	$833 million.

Example 8. (i) The facts are the same as in *Example 1*, except that the taxpayer determines that the appropriate discount rate for the cost sharing alternative is 20%. In addition, the taxpayer determines that the appropriate discount rate for the licensing alternative is 10%. Accordingly, the taxpayer determines that the appropriate present value of the PCT Payment is $146 million.

(ii) Based on the best method analysis described in *Example 2*, the Commissioner determines that the taxpayer's calculation of the present value of the PCT Payments is outside of the interquartile range (as shown in the sixth column of *Example 2*), and thus warrants an adjustment. Furthermore, in evaluating the taxpayer's analysis, the Commissioner undertakes an analysis based on the difference in the financial projections between the cost sharing and licensing alternatives (as shown in column 11 of *Example 1*). This column shows the anticipated differential income stream of additional positive or negative income for FS over the duration of the CSA Activity that would result from undertaking the cost sharing alternative (before any PCT Payments) rather than the licensing alternative. This anticipated differential income stream thus reflects the anticipated incremental undiscounted profits to FS from the incremental activity of undertaking the risk of developing the cost shared intangibles and enjoying the value of its divisional interests. Taxpayer's analysis logically implies that the present value of this stream must be $146 million, since only then would FS have the same anticipated value in both the cost sharing and licensing alternatives. A present value of $146 million implies that the discount rate applicable to this stream is 34.4%. Based on a reliable calculation of discount rates applicable to the anticipated income streams of uncontrolled companies whose resources, capabilities, and rights consist primarily of software applications intangibles and research and development teams similar to USP's platform contributions to the CSA, and which income streams, accordingly, may be reasonably anticipated to reflect a similar risk profile to the differential income stream, the Commissioner concludes that an appropriate discount rate for the anticipated income stream associated with USP's platform contributions (that is, the additional positive or negative income over the duration of the CSA

Activity that would result, before PCT Payments, from switching from the licensing alternative to the cost sharing alternative) is 16%, which is significantly less than 34.4%. This conclusion further suggests that Taxpayer's analysis is unreliable. See paragraphs (g)(2)(v)(B)(*2*) and (g)(4)(vi)(F)(*1*) and (*2*) of this section.

(iii) The Commissioner makes an adjustment of $296 million, so that the present value of the PCT Payments is $442 million (the median results as shown in column 6 of *Example 2*).

Example 9. The facts are the same as in *Example 1,* except that additional data on discount rates are available that were not available in *Example 1.* The Commissioner determines the arm's length charge for the PCT Payment by discounting at an appropriate rate the differential income stream associated with the rights contributed by USP in the PCT (that is, the stream of income in column (11) of *Example 1*). Based on an analysis of a set of public companies whose resources, capabilities, and rights consist primarily of resources, capabilities, and rights similar to those contributed by USP in the PCT, the Commissioner determines that 15% to 17% is an appropriate range of discount rates to use to assess the value of the differential income stream associated with the rights contributed by USP in the PCT. The Commissioner determines that applying a discount rate of 17% to the differential income stream associated with the rights contributed by USP in the PCT yields a present value of $446 million, while applying a discount rate of 15% to the differential income stream associated with the rights contributed by USP in the PCT yields a present value of $510 million. Because the taxpayer's result, $464 million, is within the interquartile range determined by the Commissioner, no adjustments are warranted. See paragraphs (g)(2)(v)(B)(*2*), (g)(4)(v), and (g)(4)(vi)(F)(*1*) of this section.

(5) *Acquisition price method*—(i) *In general.* The acquisition price method applies the comparable uncontrolled transaction method of §1.482–4(c), or the comparable uncontrolled services price method described in §1.482–9(c), to evaluate whether the amount charged in a PCT, or group of PCTs, is arm's length by reference to the amount charged (the acquisition price) for the stock or asset purchase of an entire organization or portion thereof (the target) in an uncontrolled transaction. The acquisition price method is ordinarily used where substantially all the target's nonroutine contributions, as such term is defined in paragraph (j)(1)(i) of this section, made to the PCT Payee's business activities are covered by a PCT or group of PCTs.

(ii) *Determination of arm's length charge.* Under this method, the arm's length charge for a PCT or group of PCTs covering resources, capabilities, and rights of the target is equal to the adjusted acquisition price, as divided among the controlled participants according to their respective RAB shares.

(iii) *Adjusted acquisition price.* The adjusted acquisition price is the acquisition price of the target increased by the value of the target's liabilities on the date of the acquisition, other than liabilities not assumed in the case of an asset purchase, and decreased by the value of the target's tangible property on that date and by the value on that date of any other resources, capabilities, and rights not covered by a PCT or group of PCTs.

(iv) *Best method analysis considerations.* The comparability and reliability considerations stated in §1.482–4(c)(2) apply. Consistent with those considerations, the reliability of applying the acquisition price method as a measure of the arm's length charge for the PCT Payment normally is reduced if—

(A) A substantial portion of the target's nonroutine contributions to the PCT Payee's business activities is not required to be covered by a PCT or group of PCTs, and that portion of the nonroutine contributions cannot reliably be valued;

(B) A substantial portion of the target's assets consists of tangible property that cannot reliably be valued; or

(C) The date on which the target is acquired and the date of the PCT are not contemporaneous.

(v) *Example.* The following example illustrates the principles of this paragraph (g)(5):

Example. USP, a U.S. corporation, and its newly incorporated, wholly-owned foreign subsidiary (FS) enter into a CSA at the start of Year 1 to develop Group Z products. Under the CSA, USP and FS will have the exclusive rights to exploit the Group Z products in the U.S. and the rest of the world, respectively. At the start of Year 2, USP acquires Company X for cash consideration worth $110 million. At this time USP's RAB share is 60%, and FS's RAB share is 40% and is not reasonably anticipated to change as a result of this acquisition. Company X joins in the filing of a U.S. consolidated income tax return with USP. Under paragraph (j)(2)(i) of this section, Company X and USP are treated as one taxpayer for purposes of this section. Accordingly, the rights in any of Company X's resources and capabilities that are reasonably anticipated to contribute to the development activities of the CSA will be considered platform contributions furnished by USP. Company X's resources and capabilities consist of its workforce, certain technology intangibles, $15 million of tangible property and other assets and $5 million in liabilities. The technology intangibles, as well as Company X's workforce, are reasonably anticipated to contribute to the development of the Group Z products under the CSA and, therefore, the rights in the technology intangibles and the workforce are platform contributions for which FS must make a PCT Payment to USP. None of Company X's existing intangible assets or any of its workforce are anticipated to contribute to activities outside the CSA. For purposes of this example, it is assumed that no additional adjustment on account of tax liabilities is needed. Applying the acquisition price method, the value of USP's platform contributions is the adjusted acquisition price of $100 million ($110 million acquisition price plus $5 million liabilities less $15 million tangible property and other assets). FS must make a PCT Payment to USP for these platform contributions with a reasonably anticipated present value of $40 million, which is the product of $100 million (the value of the platform contributions) and 40% (FS's RAB share).

(6) *Market capitalization method*—(i) *In general.* The market capitalization method applies the comparable uncontrolled transaction method of §1.482–4(c), or the comparable uncontrolled services price method described in §1.482–9(c), to evaluate whether the amount charged in a PCT, or group of PCTs, is arm's length by reference to the average market capitalization of a controlled participant (PCT Payee) whose stock is regularly traded on an established securities market. The market capitalization method is ordinarily used where substantially all of the PCT Payee's nonroutine contributions to the PCT Payee's business are covered by a PCT or group of PCTs.

(ii) *Determination of arm's length charge.* Under the market capitalization method, the arm's length charge for a PCT or group of PCTs covering resources, capabilities, and rights of the PCT Payee is equal to the adjusted average market capitalization, as divided among the controlled participants according to their respective RAB shares.

(iii) *Average market capitalization.* The average market capitalization is the average of the daily market capitalizations of the PCT Payee over a period of time beginning 60 days before the date of the PCT and ending on the date of the PCT. The daily market capitalization of the PCT Payee is calculated on each day its stock is actively traded as the total number of shares outstanding multiplied by the adjusted closing price of the stock on that day. The adjusted closing price is the daily closing price of the stock, after adjustments for stock-based transactions (dividends and stock splits) and other pending corporate (combination and spin-off) restructuring transactions for which reliable arm's length adjustments can be made.

(iv) *Adjusted average market capitalization.* The adjusted average market capitalization is the average market capitalization of the PCT Payee increased by the value of the PCT Payee's liabilities on the date of the PCT and decreased by the value on such date of the PCT Payee's tangible property and of any other resources, capabilities, or rights of the PCT Payee not covered by a PCT or group of PCTs.

(v) *Best method analysis considerations.* The comparability and reliability considerations stated in §1.482–4(c)(2) apply. Consistent with those considerations, the reliability of applying the comparable uncontrolled transaction method using the adjusted market capitalization of a company as a measure of the arm's length charge for the PCT Payment normally is reduced if—

(A) A substantial portion of the PCT Payee's nonroutine contributions to its business activities is not required to be covered by a PCT or group of PCTs, and that portion of the nonroutine contributions cannot reliably be valued;

(B) A substantial portion of the PCT Payee's assets consists of tangible property that cannot reliably be valued; or

(C) Facts and circumstances demonstrate the likelihood of a material divergence between the average market capitalization of the PCT Payee and the value of its resources, capabilities, and rights for which reliable adjustments cannot be made.

(vi) *Examples.* The following examples illustrate the principles of this paragraph (g)(6):

Example 1. (i) USP, a publicly traded U.S. company, and its newly incorporated wholly-owned foreign subsidiary (FS) enter into a CSA on Date 1 to develop software. At that time USP has in-process software but has no software ready for the market. Under the CSA, USP and FS will have the exclusive rights to exploit the software developed under the CSA in the United States and the rest of the world, respectively. On Date 1, USP's RAB share is 70% and FS's RAB share is 30%. USP's assembled team of researchers and its in-process software are reasonably anticipated to contribute to the development of the software under the CSA. Therefore, the rights in the research team and in-process software are platform contributions for which compensation is due from FS. Further, these rights are not reasonably anticipated to contribute to any business activity other than the CSA Activity.

(ii) On Date 1, USP had an average market capitalization of $205 million, tangible property and other assets that can be reliably valued worth $5 million, and no liabilities. Aside from those assets, USP had no assets other than its research team and in-process software. Applying the market capitalization method, the value of USP's platform contributions is $200 million ($205 million average market capitalization of USP less $5 million of tangible property and other assets). The arm's length value of the PCT Payments FS must make to USP for the platform contributions, before any adjustment on account of tax liability as described in paragraph (g)(2)(ii) of this section, is $60 million, which is the product of $200 million (the value of the platform contributions) and 30% (FS's RAB share on Date 1).

Example 2. Aggregation with make-or-sell rights. (i) The facts are the same as in *Example 1,* except that on Date 1 USP also has existing software ready for the market. USP separately enters into a license agreement with FS for make-or-sell rights for all existing software outside the United States. No marketing has occurred, and USP has no marketing intangibles. This license of current make-or-sell rights is a transaction governed by §1.482–4. However, after analysis, it is determined that the arm's length PCT Payments and the arm's length payments for the make-or-sell license may be most reliably determined in the aggregate using the market capitalization method, under principles described in paragraph (g)(2)(iv) of this section, and it is further determined that those principles are most reliably implemented by computing the aggregate arm's length charge as the product of the aggregate value of the existing and in-process software and FS's RAB share on Date 1.

(ii) Applying the market capitalization method, the aggregate value of USP's platform contributions and the make-or-sell rights in its existing software is $250 million ($255 million average market capitalization of USP less $5 million of tangible property and other assets). The total arm's length value of the PCT Payments and licensing payments FS must make to USP for the platform contributions and current make-or-sell rights, before any adjustment on account of tax liability, if any, is $75 million, which is the product of $250 million (the value of the platform contributions and the make-or-sell rights) and 30% (FS's RAB share on Date 1).

Example 3. Reduced reliability. The facts are the same as in *Example 1* except that USP also has significant nonroutine assets that will be used solely in a nascent business division that is unrelated to the subject of the CSA and that cannot themselves be reliably valued. Those nonroutine contributions are not platform contributions and accordingly are not required to be covered by a PCT. The reliability of using the market capitalization method to determine the value of USP's platform contributions to the CSA is significantly reduced in this case because that method would require adjusting USP's average market capitalization to account for the significant nonroutine contributions that are not required to be covered by a PCT.

(7) *Residual profit split method*—(i) *In general.* The residual profit split method evaluates whether the allocation of combined operating profit or loss attributable to one or more platform contributions subject to a PCT is arm's length by reference to the relative value of each controlled participant's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity (relevant business activity) of the controlled participants for which data are available that include the CSA Activity. The residual profit split method may not be used where only one controlled participant makes significant nonroutine contributions (including platform or operating contributions) to the CSA Activity. The provisions of §1.482–6 shall apply to CSAs only to the extent provided and as modified in this paragraph (g)(7). Any other application to a CSA of a residual profit method not described in

paragraphs (g)(7)(ii) and (iii) of this section will constitute an unspecified method for purposes of sections 482 and 6662(e) and the regulations under those sections.

(ii) *Appropriate share of profits and losses.* The relative value of each controlled participant's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity, consistent with the best method analysis described in §1.482–1(c) and (d). Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled participants engaged in the relevant business activity. The profit allocated to any particular controlled participant is not necessarily limited to the total operating profit of the group from the relevant business activity. For example, in a given year, one controlled participant may earn a profit while another controlled participant incurs a loss. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion.

(iii) *Profit split*—(A) *In general.* Under the residual profit split method, the present value of each controlled participant's residual divisional profit or loss attributable to nonroutine contributions (nonroutine residual divisional profit or loss) is allocated between the controlled participants that each furnish significant nonroutine contributions (including platform or operating contributions) to the relevant business activity in that division.

(B) *Determine nonroutine residual divisional profit or loss.* The present value of each controlled participant's nonroutine residual divisional profit or loss must be determined to reflect the most reliable measure of an arm's length result. The present value of nonroutine residual divisional profit or loss equals the present value of the stream of the reasonably anticipated residuals over the duration of the CSA Activity of divisional profit or loss, minus market returns for routine contributions, minus operating cost contributions, minus cost contributions, using a discount rate appropriate to such residuals in accordance with paragraph (g)(2)(v) of this section. As used in this paragraph (g)(7), the phrase ''market returns for routine contributions'' includes market returns for operating cost contributions and excludes market returns for cost contributions.

(C) *Allocate nonroutine residual divisional profit or loss*—(*1*) *In general.* The present value of nonroutine residual divisional profit or loss in each controlled participant's division must be allocated among all of the controlled participants based upon the relative values, determined as of the date of the PCTs, of the PCT Payor's as compared to the PCT Payee's nonroutine contributions to the PCT Payor's division. For this purpose, the PCT Payor's nonroutine contribution consists of the sum of the PCT Payor's nonroutine operating contributions and the PCT Payor's RAB share of the PCT Payor's nonroutine platform contributions. For this purpose, the PCT Payee's nonroutine contribution consists of the PCT Payor's RAB share of the PCT Payee's nonroutine platform contributions.

(*2*) *Relative value determination.* The relative values of the controlled participants' nonroutine contributions must be determined so as to reflect the most reliable measure of an arm's length result. Relative values may be measured by external market benchmarks that reflect the fair market value of such nonroutine contributions. Alternatively, the relative value of nonroutine contributions may be estimated by the capitalized cost of developing the nonroutine contributions and updates, as appropriately grown or discounted so that all contributions may be valued on a comparable dollar basis as of the same date. If the nonroutine contributions by a controlled participant are also used in other business activities (such as the exploitation of make-or-sell rights described in paragraph (c)(4) of this section), an allocation of the value of the nonroutine contributions must be made on a reasonable basis among all the business activities in which they are used in proportion to the relative economic value that the relevant business activity and such other business activities are anticipated to derive over time as the result of such nonroutine contributions.

(*3*) *Determination of PCT Payments.* Any amount of the present value of a controlled participant's nonroutine residual divisional profit or loss that is allocated to another controlled participant represents the present value of the PCT Payments due to that other controlled participant for its platform contributions to the relevant business activity in the relevant division. For purposes of paragraph (j)(3)(ii) of this section, the present value of a PCT Payor's PCT Payments under this paragraph shall be deemed reduced to the extent of the present value of any PCT Payments owed to it from other controlled participants under this paragraph (g)(7). The resulting remainder may be converted to a fixed or contingent form of payment in accordance with paragraph (h) (Form of payment rules) of this section.

(*4*) *Routine platform and operating contributions.* For purposes of this paragraph (g)(7), any routine platform or operating contributions, the valuation and PCT Payments for which are determined and made independently of the residual profit split method, are treated similarly to cost contributions and operating cost contributions, respectively. Accordingly, wherever used in this paragraph (g)(7), the term ''routine contributions'' shall not include routine platform or operating contributions, and wherever the terms ''cost contributions'' and ''operating cost contributions'' appear in this paragraph (g)(7), they shall include net routine platform contributions and net routine operating contributions, respectively, as defined in paragraph (g)(4)(vii) of this section. However, treatment of net operating contributions as operating cost contributions shall be coordinated with the treatment of other routine contributions pursuant to paragraphs (g)(4)(iii)(B) and (7)(iii)(B) of this section so as to avoid duplicative market returns to such contributions.

(iv) *Best method analysis considerations*—(A) *In general.* Whether results derived from this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule in §1.482–1(c). Thus, comparability and quality of data, reliability of assumptions, and sensitivity of results to possible deficiencies in the data and assumptions, must be considered in determining whether this method provides the most reliable measure of an arm's length result. The application of these factors to the residual profit split in the context of the relevant business activity of developing and exploiting cost shared intangibles is discussed in paragraphs (g)(7)(iv)(B) through (D) of this section.

(B) *Comparability.* The derivation of the present value of nonroutine residual divisional profit or loss includes a carveout on account of market returns for routine contributions. Thus, the comparability considerations that are relevant for that purpose include those that are relevant for the methods that are used to determine market returns for the routine contributions.

(C) *Data and assumptions.* The reliability of the results derived from the residual profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered:

(*1*) The reliability of the allocation of costs, income, and assets between the relevant business activity and the controlled participants' other activities that will affect the reliability of the determination of the divisional profit or loss and its allocation among the controlled participants. See §1.482–6(c)(2)(ii)(C)(*1*).

(*2*) The degree of consistency between the controlled participants and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit or loss affects the reliability of the result. See §1.482–6(c)(2)(ii)(C)(*2*).

(*3*) The reliability of the data used and the assumptions made in estimating the relative value of the nonroutine contributions by the controlled participants. In particular, if capitalized costs of development are used to estimate the relative value of nonroutine contributions, the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate. This is because, in any given case, the costs of developing a nonroutine contribution may not be related to its market value and because the calculation of the capitalized costs of development may require the allocation of indirect costs between the relevant business activity and the controlled participant's other activities, which may affect the reliability of the analysis.

(D) *Other factors affecting reliability.* Like the methods described in §§1.482–3 through 1.482–5 and §1.482–9(c), the carveout on account of market returns for routine contributions relies exclusively on external market benchmarks. As indicated in §1.482–1(c)(2)(i), as the degree of comparability between the controlled participants and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, to the extent the allocation of nonroutine residual divisional profit or loss is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks. Finally, the reliability of the analysis under this method may be enhanced by the fact that all the controlled participants are evaluated under the residual profit split. However, the reliability of the results of an analysis based on information from all the controlled participants is affected by the reliability of the data and the assumptions pertaining to each controlled participant. Thus, if the data and assumptions are significantly more reliable with respect to one of the controlled participants than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(v) *Examples.* The following examples illustrate the principles of this paragraph (g)(7):

Example 1. (i) For simplicity of calculation in this *Example 1,* all financial flows are assumed to occur at the beginning of each period. USP, a U.S. electronic data storage company, has partially developed technology for a type of extremely small compact storage devices (nanodisks) which are expected to provide a significant increase in data storage capacity in various types of portable devices such as cell phones, MP3 players, laptop computers and digital cameras. At the same time, USP's wholly-owned subsidiary, FS, has developed significant marketing intangibles outside the United States in the form of customer lists, ongoing relations with various OEMs, and trademarks that are well recognized by consumers due to a long history of marketing successful data storage devices and other hardware used in various types of consumer electronics. At the beginning of Year 1, USP enters into a CSA with FS to develop nanodisk technologies for eventual commercial exploitation. Under the CSA, USP will have the right to exploit nanodisks in the United States, while FS will have the right to exploit nanodisks in the rest of the world. The partially developed nanodisk technologies owned by USP are reasonably anticipated to contribute to the development of commercially exploitable nanodisks and therefore the rights in the nanodisk technologies constitute platform contributions of USP for which compensation is due under PCTs. FS does not have any platform contributions for the CSA. Due to the fact that nanodisk technologies have yet to be incorporated into any commercially available product, neither USP nor FS transfers rights to make or sell current products in conjunction with the CSA.

(ii) Because only in FS's territory do both controlled participants make significant nonroutine contributions, USP and FS determine that they need to determine the relative value of their respective contributions to residual divisional profit or loss attributable to the CSA Activity only in FS's territory. FS anticipates making no nanodisk sales during the first year of the CSA in its territory with revenues in Year 2 reaching $200 million. Revenues through Year 5 are reasonably anticipated to increase by 50% per year. The annual growth rate for revenues is then expected to decline to 30% per annum in Years 6 and 7, 20% per annum in Years 8 and 9 and 10% per annum in Year 10. Revenues are then expected to decline 10% in Year 11 and 5% per annum, thereafter. The routine costs (defined here as costs other than cost contributions, routine platform and operating contributions, and nonroutine contributions) that are allocable to this revenue in calculating FS's divisional profit or loss, are anticipated to equal $40 million for the first year of the CSA and $130 for the second year and $200 and $250 million in Years 3 and 4. Total operating expenses attributable to product exploitation (including operating cost contributions) equal 52% of sales per year. FS undertakes routine distribution activities in its markets that constitute routine contributions to the relevant business activity of exploiting nanodisk technologies. USP and FS estimate that the total market return on these routine contributions will amount to 6% of the routine costs. FS expects its cost contributions to be $60 million in Year 1, rise to $100 million in Years 2 and 3, and then decline again to $60 million in Year 4. Thereafter, FS's cost contributions are expected to equal 10% of revenues.

(iii) USP and FS determine the present value of the stream of the reasonably anticipated residuals in FS's territory over the duration of the CSA Activity of the divisional profit or loss (revenues minus routine costs), minus the market returns for routine contributions, the operating cost contributions, and the cost contributions. USP and FS determine, based on the considerations discussed in paragraph (g)(2)(v) of this section, that the appropriate discount rate is 17.5% per annum. Therefore, the present value of the nonroutine residual divisional profit is $1,395 million.

(iv) After analysis, USP and FS determine that the relative value of the nanodisk technologies contributed by USP to CSA (giving effect only to its value in FS's territory) is roughly 150% of the value of FS's marketing intangibles (which only have value in FS's territory). Consequently, 60% of the nonroutine residual divisional profit is attributable to USP's platform contribution. Therefore, FS's PCT Payments should have an expected present value equal to $837 million (.6 × $1,395 million).

(v) The calculations for this *Example 1* are displayed in the following table:

Time Period (Y = Year) (TV = Terminal Value)	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10	Y11	TV
Discount Period	0	1	2	3	4	5	6	7	8	9	10	10
[1] Sales	0	200	300	450	675	878	1141	1369	1643	1807	1626	
[2] Growth Rate	....	....	50%	50%	50%	30%	30%	20%	20%	10%	−10%	
[3] Exploitation Costs and Operating Cost Contributions (52% of Sales [1])	40	130	200	250	351	456	593	712	854	940	846	
[4] Return on [3] (6% of [3])	2.4	8	12	15	21	27	36	43	51	56	51	
[5] Cost Contributions (10% of Sales [1] after Year 5)	60	100	100	60	68	88	114	137	164	181	163	
[6] Residual Profit = [1] minus {[3] + [4] + [5]}	−102	−38	−12	125	235	306	398	477	573	630	567	2395
[7] Residual Profit [6] Discounted at 17.5% discount rate	−102	−32	−9	77	124	137	151	154	158	148	113	477
[8] Sum of all amounts in [7] for all time periods = $1,395 million												
[9] Relative value in FS's division of USP's nanotechnology to FS's marketing intangibles = 150%												
[10] Profit Split (USP)	60% = 1.5 × [11]											
[11] Profit Split (FS)	40%											

[12] FS's PCT Payments	[8] × [10] = $1,395 million × 60% = $837 million

Example 2. (i) For simplicity of calculation in this *Example 2*, all financial flows are assumed to occur at the beginning of each period. USP is a U.S. automobile manufacturing company that has completed significant research on the development of diesel-electric hybrid engines that, if they could be successfully manufactured, would result in providing a significant increased fuel economy for a wide variety of motor vehicles. Successful commercialization of the diesel-electric hybrid engine will require the development of a new class of advanced battery that will be light, relatively cheap to manufacture and yet capable of holding a substantial electric charge. FS, a foreign subsidiary of USP, has completed significant research on developing lithium-ion batteries that appear likely to have the requisite characteristics. At the beginning of Year 1, USP enters into a CSA with FS to further develop diesel-electric hybrid engines and lithium-ion battery technologies for eventual commercial exploitation. Under the CSA, USP will have the right to exploit the diesel-electric hybrid engine and lithium-ion battery technologies in the United States, while FS will have the right to exploit such technologies in the rest of the world. The partially developed diesel-electric hybrid engine and lithium-ion battery technologies owned by USP and FS, respectively, are reasonably anticipated to contribute to the development of commercially exploitable automobile engines and therefore the rights in both these technologies constitute platform contributions of USP and of FS for which compensation is due under PCTs. At the time of inception of the CSA, USP owns operating intangibles in the form of self-developed marketing intangibles which have significant value in the United States, but not in the rest of the world, and that are relevant to exploiting the cost shared intangibles. Similarly, FS owns self-developed marketing intangibles which have significant value in the rest of the world, but not in the United States, and that are relevant to exploiting the cost shared intangibles. Although the new class of diesel-electric hybrid engine using lithium-ion batteries is not yet ready for commercial exploitation, components based on this technology are beginning to be incorporated in current-generation gasoline-electric hybrid engines and the rights to make and sell such products are transferred from USP to FS and vice-versa in conjunction with the inception of the CSA, following the same territorial division as in the CSA.

(ii) USP's estimated RAB share is 66.7%. During Year 1, it is anticipated that sales in USP's territory will be $1000X in Year 1. Sales in FS's territory are anticipated to be $500X. Thereafter, as revenue from the use of components in gasoline-electric hybrids is supplemented by revenues from the production of complete diesel-electric hybrid engines using lithium-ion battery technology, anticipated sales in both territories will increase rapidly at a rate of 50% per annum through Year 4. Anticipated sales are then anticipated to increase at a rate of 40% per annum for another 4 years. Sales are then anticipated to increase at a rate of 30% per annum through Year 10. Thereafter, sales are anticipated to decrease at a rate of 5% per annum for the foreseeable future as new automotive drivetrain technologies displace diesel-electric hybrid engines and lithium-ion batteries. Total operating expenses attributable to product exploitation (including operating cost contributions) equal 40% of sales per year for both USP and FS. USP and FS estimate that the total market return on these routine contributions to the CSA will amount to 6% of these operating expenses. USP is expected to bear ⅔ of the total cost contributions for the foreseeable future. Cost contributions are expected to total $375X in Year 1 (of which $250X are borne by USP) and increase at a rate of 25% per annum through Year 6. In Years 7 through 10, cost contributions are expected to increase 10% a year. Thereafter, cost contributions are expected to decrease by 5% a year for the foreseeable future.

(iii) USP and FS determine the present value of the stream of FS's reasonably anticipated residual divisional profit, which is the stream of FS's reasonably anticipated divisional profit or loss, minus the market returns for routine contributions, minus operating cost contributions, minus cost contributions. USP and FS determine, based on the considerations discussed in paragraph (g)(2)(v) of this section, that the appropriate discount rate is 12% per year. Therefore, the present value of the nonroutine residual divisional profit in USP's territory is $41,727X and in CFC's territory is $20,864X.

(iv) After analysis, USP and FS determine that, in the United States the relative value of the technologies contributed by USP and FS to the CSA and of the operating intangibles used by USP in the exploitation of the cost shared intangibles (reported as equaling 100 in total), equals: USP's platform contribution (59.5); FS's platform contribution (25.5); and USP's operating intangibles (15). Consequently, the present value of the arm's length amount of the PCT Payments that USP should pay to FS for FS's platform contribution is $10,640X (.255 × $41,727X). Similarly, USP and FS determine that, in the rest of the world, the relative value of the technologies contributed by USP and FS to the CSA and of the operating intangibles used by FS in the exploitation of the cost shared intangibles can be divided as follows: USP's platform contribution (63); FS's platform contribution (27); and FS's operating intangibles (10). Consequently, the present value of the arm's length amount of the PCT Payments that FS should pay to USP for USP's platform contribution is $13,144X (.63 × $20,864X). Therefore, FS is required to make a net payment to USP with a present value of $2,504X ($13,144X − 10,640X).

(v) The calculations for this *Example 2* are displayed in the following tables:

CALCULATION OF USP'S PCT PAYMENT TO FS

Time Period (Y = Year) (TV = Terminal Value)	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10	TV
Discount Period	0	1	2	3	4	5	6	7	8	9	9
[1] Sales	1000	1500	2250	3375	4725	6615	9261	12965	16855	21912	
[2] Growth Rate	....	50%	50%	50%	40%	40%	40%	40%	30%	30%	
[3] Exploitation Costs and Operating Cost Contributions (40% of Sales [1])	400	600	900	1350	1890	2646	3704	5186	6742	8765	
[4] Return on [3] = 6% of [3]	24	36	54	81	113	159	222	311	405	526	
[5] Cost Contributions	250	313	391	488	610	763	839	923	1015	1117	
[6] Residual Profit = [1] minus {[3] + [4] + [5]}	326	552	905	1456	2111	3047	4495	6545	8693	11504	64287
[7] Residual Profit [6] Discounted at 12% discount rate	326	492	722	1036	1342	1729	2277	2961	3511	4148	23183

[8] Sum of all amounts in [7] for all time periods = $41,727X

Profit Split for Calculation of USP's PCT Payment to FS: [Total of US contributions = 74.5%]
[9] USP's Platform Contribution = 59.5%
[10] FS's Platform Contribution = 25.5%
[11] USP's Operating Intangibles = 15%

[12] USP's PCT Payment to FS = [8] × [10] = $41,727X multiplied by 25.5% = $10,640X

CALCULATION OF FS'S NET PCT PAYMENT TO USF

Time Period (Y = Year) (TV = Terminal Value)	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10	TV
Discount Period	0	1	2	3	4	5	6	7	8	9	9
[13] Sales	500	750	1125	1688	2363	3308	4631	6483	8428	10956	
[14] Growth Rate	....	50%	50%	50%	40%	40%	40%	40%	30%	30%	
[15] Exploitation Costs and Operating Cost Contributions (40% of Sales [13])	200	300	450	675	945	1323	1852	2593	3371	4382	
[16] Return on [15] = 6% of [15]	12	18	27	41	57	79	111	156	202	263	
[17] Cost Contributions	125	156	195	244	305	381	420	462	508	559	
[18] Residual Profit = [13] minus {[15] + [16] + [17]}	163	276	453	728	1056	1524	2248	3272	4347	5752	32144
[19] Residual Profit [18] Discounted at 12% discount rate	163	246	361	518	671	865	1139	1480	1755	2074	11591

[20] Sum of all amounts in [19] for all time periods = $20,864X

Profit Split for Calculation of FS's PCT Payment to USP: [Total of FS's contributions = 37%]
[21] USP's Platform Contribution = 63%
[22] FS's Platform Contribution = 27%

CALCULATION OF FS'S NET PCT PAYMENT TO USF—Continued

[23] FS's Operating Intangibles = 10%
[24] FS's PCT Payment to USP = [20] × [21] = $20,864X multiplied by 63% = $13,144X
[25] FS's Net PCT Payment to USP = [24] minus [12] = $13,144X minus $10,640X = $2,504X

(8) *Unspecified methods.* Methods not specified in paragraphs (g)(3) through (7) of this section may be used to evaluate whether the amount charged for a PCT is arm's length. Any method used under this paragraph (g)(8) must be applied in accordance with the provisions of §1.482–1 and of paragraph (g)(2) of this section. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. Therefore, in establishing whether a PCT achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled participant could have realized by choosing a realistic alternative to the CSA. See paragraph (k)(2)(ii)(J) of this section. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See §1.482–1(c) (Best method rule). In accordance with §1.482–1(d) (Comparability), to the extent that an unspecified method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(h) *Form of payment rules*—(1) *CST Payments.* CST Payments may not be paid in shares of stock in the payor (or stock in any member of the controlled group that includes the controlled participants).

(2) *PCT Payments*—(i) *In general.* The consideration under a PCT for a platform contribution may take one or a combination of both of the following forms:

(A) Payments of a fixed amount (fixed payments), either paid in a lump sum payment or in installment payments spread over a specified period, with interest calculated in accordance with §1.482–2(a) (Loans or advances).

(B) Payments contingent on the exploitation of cost shared intangibles by the PCT Payor (contingent payments). Accordingly, controlled participants have flexibility to adopt a form and period of payment, provided that such form and period of payment are consistent with an arm's length charge as of the date of the PCT. See also paragraphs (h)(2)(iv) and (3) of this section.

(ii) *No PCT Payor Stock.* PCT Payments may not be paid in shares of stock in the PCT Payor (or stock in any member of the controlled group that includes the controlled participants).

(iii) *Specified form of payment*—(A) *In general.* The form of payment selected (subject to the rules of this paragraph (h)) for any PCT, including, in the case of contingent payments, the contingent base and structure of the payments as set forth in paragraph (h)(2)(iii)(B) of this section, must be specified no later than the due date of the applicable tax return (including extensions) for the later of the taxable year of the PCT Payor or PCT Payee that includes the date of that PCT.

(B) *Contingent payments.* In accordance with paragraph (k)(1)(iv)(A) of this section, a provision of a written contract described in paragraph (k)(1) of this section, or of the additional documentation described in paragraph (k)(2) of this section, that provides for payments for a PCT (or group of PCTs) to be contingent on the exploitation of cost shared intangibles will be respected as consistent with economic substance only if the allocation between the controlled participants of the risks attendant on such form of payment is determinable before the outcomes of such allocation that would have materially affected the PCT pricing are known or reasonably knowable. A contingent payment provision must clearly and unambiguously specify the basis on which the contingent payment obligations are to be determined. In particular, the contingent payment provision must clearly and unambiguously specify the events that give rise to an obligation to make PCT Payments, the royalty base (such as sales or revenues), and the computation used to determine the PCT Payments. The royalty base specified must be one that permits verification of its proper use by reference to books and records maintained by the controlled participants in the normal course of business (for example, books and records maintained for financial accounting or business management purposes).

(C) *Examples.* The following examples illustrate the principles of this paragraph (h)(2).

Example 1. A CSA provides that PCT Payments with respect to a particular platform contribution shall be contingent payments equal to 15% of the revenues from sales of products that incorporate cost shared intangibles. The terms further permit (but do not require) the controlled participants to adjust such contingent payments in accordance with a formula set forth in the arrangement so that the 15% rate is subject to adjustment by the controlled participants at their discretion on an after-the-fact, uncompensated basis. The Commissioner may impute payment terms that are consistent with economic substance with respect to the platform contribution because the contingent payment provision does not specify the computation used to determine the PCT Payments.

Example 2. Taxpayer, an automobile manufacturer, is a controlled participant in a CSA that involves research and development to perfect certain manufacturing techniques necessary to the actual manufacture of a state-of-the-art, hybrid fuel injection system known as DRL337. The arrangement involves the platform contribution of a design patent covering DRL337. Pursuant to paragraph (h)(2)(iii)(B) of this section, the CSA provides for PCT Payments with respect to the platform contribution of the patent in the form of royalties contingent on sales of automobiles that contain the DRL337 system. However, Taxpayer's system of book- and record-keeping does not enable Taxpayer to track which automobile sales involve automobiles that contain the DRL337 system. Because Taxpayer has not complied with paragraph (h)(2)(iii)(B) of this section, the Commissioner may impute payment terms that are consistent with economic substance and susceptible to verification by the Commissioner.

Example 3. (i) Controlled participants A and B enter into a CSA that provides for PCT Payments from A to B with respect to B's platform contribution, Z, in the form of three annual installment payments due from A to B on the last day of each of the first three years of the CSA.

(ii) On audit, based on all the facts and circumstances, the Commissioner determines that the installment PCT Payments are consistent with an arm's length charge as of the date of the PCT. Accordingly, the Commissioner does not make an adjustment with respect to the PCT Payments in any year.

Example 4. (i) The facts are the same as in *Example 3* except that the CSA contains an additional term with respect to the PCT Payments. Under this provision, A and B further agreed that, if the present value (as of the CSA Start Date) of A's actual divisional operating profit or loss during the three-year period is less than the present value (as of the CSA Start Date) of the divisional operating profit or loss that the parties projected for A upon formation of the CSA for that period, then the third installment payment shall be subject to a compensating adjustment in the amount necessary to reduce the present value (as of the CSA Start Date) of the aggregate PCT Payments for those three years to the amount that would have been calculated if the actual results had been used for the calculation instead of the projected results.

(ii) This provision further specifies that A will pay B an additional amount, $Q, in the first year of the CSA to compensate B for taking on additional downside risk through the contingent payment term described in paragraph (i) of this *Example 4*.

(iii) During the first two years, A pays B installment payments as agreed, as well as the additional amount, $Q. In the third year, A and B determine that the present value (as of the CSA Start Date) of A's actual divisional operating profit or loss during the three-year period is less than the present value (as of the CSA Start Date) of the divisional operating profit or loss that the parties projected for A upon formation of the CSA for that period. A reduces the PCT Payment to B in the third year in the amount necessary to reduce the present value (as of the CSA Start Date) of the aggregate PCT Payments for those three years to the amount that would have been calculated if the actual results had been used for the calculation instead of the projected results.

(iv) On audit, based on all the facts and circumstances, the Commissioner determines that the installment PCT Payments agreed to be paid by A to B were consistent with an arm's length charge as of the date of the

PCT. The Commissioner further determines that the contingency was sufficiently specified such that its occurrence or nonoccurrence was unambiguous and determinable; that the projections were reliable; and that the contingency did, in fact, occur. Finally, the Commissioner determines, based on all the facts and circumstances, that $Q was within the arm's length range for the additional allocation of risk to B. Accordingly, no adjustment is made with respect to the installment PCT Payments, or the additional PCT Payment for the contingent payment term, in any year.

Example 5. (i) The facts are the same as in *Example 4* except that the CSA states the amount that A will pay B for the contingent payment term is $X, an amount that is less than $Q, and A pays B $X in the first year of the CSA.

(ii) On audit, based on all the facts and circumstances, the Commissioner determines that the installment PCT Payments agreed to be paid by A to B were consistent with an arm's length charge as of the date of the PCT. The Commissioner further determines that the contingency was sufficiently specified such that its occurrence or nonoccurrence was unambiguous and determinable; that the projections were reliable; and that the contingency did, in fact, occur. However, the Commissioner also determines, based on all the facts and circumstances, that the additional PCT Payment of $X from A to B for the contingent payment term was not an arm's length charge for the additional allocation of risk as of the CSA Start Date in connection with the contingent payment term. Accordingly, the Commissioner makes an adjustment to B's results equal to the difference between $X and the median of the arm's length range of charges for the contingent payment term.

Example 6. (i) The facts are the same as in *Example 3* except that A and B further agreed that, if the present value (as of the CSA Start Date) of A's actual divisional operating profit or loss during the three-year period is either less or greater than the present value (as of the CSA Start Date) of the divisional operating profit or loss that the parties projected for A upon formation of the CSA for that period, then A may make a compensating adjustment to the third installment payment in the amount necessary to reduce (if actual divisional operating profit or loss is less than the projections) or increase (if actual divisional operating profit or loss exceeds the projections) the present value (as of the CSA Start Date) of the aggregate PCT Payments for those three years to the amount that would have been calculated if the actual results had been used for the calculation instead of the projected results.

(ii) On audit, the Commissioner determines that the contingent payment term lacks economic substance under §§1.482–1(d)(3)(iii)(B) and 1.482–7(h)(2)(iii)(B). It lacks economic substance because the allocation of the risks between A and B was indeterminate as of the CSA Start Date due to the elective nature of the potential compensating adjustments. Specifically, the parties agreed upfront only that A might make compensating adjustments to the installment payments. By the terms of the agreement, A could decide whether to make such adjustments after the outcome of the risks was known or reasonably knowable. Even though the contingency and potential compensating adjustments were clearly defined in the CSA, no compensating adjustments were required by the CSA regardless of the occurrence or nonoccurrence of the contingency. As a result, the contingent payment terms did not clearly and unambiguously specify the events that give rise to an obligation to make PCT Payments, and, accordingly, the obligation to make compensating adjustments pursuant to the contingency was indeterminate. The contingent payment term allows the taxpayer to make adjustments that are favorable to its overall tax position in those years where the agreement allows it to make such adjustments, but decline to exercise its right to make any adjustment in those years in which such an adjustment would be unfavorable to its overall tax position. Such terms do not reflect a substantive upfront allocation of risk. In addition, the vagueness of the agreement makes it impossible to determine whether such contingent payment term warrants an additional arm's length charge and, if so, how much.

(iii) Accordingly, the Commissioner may disregard the contingent payment term under §§1.482–1(d)(3)(ii)(B)(*1*) and 1.482–7(k)(1)(iv) and may impute other contractual terms in its place consistent with the economic substance of the CSA.

Example 7. (i) The facts are the same as in *Example 6* except that the contingent payment term provides that, if the present value (as of the CSA Start Date) of A's actual divisional operating profit or loss during the three-year period is either less or greater than the present value (as of the CSA Start Date) of the divisional operating profit or loss that the parties projected for A upon formation of the CSA for that period, then A will make a compensating adjustment to the third installment payment. The CSA does not specify the amount of (or a formula for) any such compensating adjustments.

(ii) On audit, the Commissioner determines that the contingent payment term lacks economic substance under §§1.482–1(d)(3)(iii)(B) and 1.482–7(h)(2)(iii)(B). It lacks economic substance because the allocation of the risks between A and B was indeterminate as of the CSA Start Date due to the failure to specify the amount of (or a formula for) the compensating adjustments that must be made if a contingency occurs. The basis on which the compensating adjustments were to be determined was neither clear nor unambiguous. Even though the contingency was clearly defined in the CSA and the requirement of a compensating adjustment in the event of a contingency was clearly specified in the CSA, the parties had no agreement regarding the amount of such compensating adjustments. As a result, the computation used to determine the PCT Payments was indeterminate. The parties could choose to make a small positive compensating adjustment if the actual results turned out to be much greater than the projections, and could choose to make a significant negative compensating adjustment if the actual results turned out to be less than the projections. Such terms do not reflect a substantive upfront allocation of risk. In addition, the vagueness of the agreement makes it impossible to determine whether such contingent payment term warrants an additional arm's length charge and, if so, how much.

(iii) Accordingly, the Commissioner may disregard the contingent price term under §§1.482–1(d)(3)(ii)(B)(*1*) and 1.482–7(k)(1)(iv) and may impute other contractual terms in its place consistent with economic substance of the CSA.

(iv) *Conversion from fixed to contingent form of payment.* With regard to a conversion of a fixed present value to a contingent form of payment, see paragraphs (g)(2)(v) (Discount rate) and (vi) (Financial projections) of this section.

(3) *Coordination of best method rule and form of payment.* A method described in paragraph (g)(1) of this section evaluates the arm's length amount charged in a PCT in terms of a form of payment (method payment form). For example, the method payment form for the acquisition price method described in paragraph (g)(5) of this section, and for the market capitalization method described in paragraph (g)(6) of this section, is fixed payment. Applications of the income method provide different method payment forms. See paragraphs (g)(4)(i)(E) and (iv) of this section. The method payment form may not necessarily correspond to the form of payment specified pursuant to paragraphs (h)(2)(iii) and (k)(2)(ii)(l) of this section (specified payment form). The determination under §1.482–1(c) of the method that provides the most reliable measure of an arm's length result is to be made without regard to whether the respective method payment forms under the competing methods correspond to the specified payment form. If the method payment form of the method determined under §1.482–1(c) to provide the most reliable measure of an arm's length result differs from the specified payment form, then the conversion from such method payment form to such specified payment form will be made to the satisfaction of the Commissioner.

(i) *Allocations by the Commissioner in connection with a CSA*—(1) *In general.* The Commissioner may make allocations to adjust the results of a controlled transaction in connection with a CSA so that the results are consistent with an arm's length result, in accordance with the provisions of this paragraph (i).

(2) *CST allocations*—(i) *In general.* The Commissioner may make allocations to adjust the results of a CST so that the results are consistent with an arm's length result, including any allocations to make each controlled participant's IDC share, as determined under paragraph (d)(4) of this section, equal to that participant's RAB share, as determined under paragraph (e)(1) of this section. Such allocations may result from, for purposes of CST determinations, adjustments to—

(A) Redetermine IDCs by adding any costs (or cost categories) that are directly identified with, or are reasonably allocable to, the IDA, or by removing any costs (or cost categories) that are not IDCs;

(B) Reallocate costs between the IDA and other business activities;

(C) Improve the reliability of the selection or application of the basis used for measuring benefits for purposes of estimating a controlled participant's RAB share;

(D) Improve the reliability of the projections used to estimate RAB shares, including adjustments described in paragraph (i)(2)(ii) of this section; and

(E) Allocate among the controlled participants any unallocated interests in cost shared intangibles.

(ii) *Adjustments to improve the reliability of projections used to estimate RAB shares*—(A) *Unreliable projections.* A significant divergence between projected benefit shares and benefit shares adjusted to take into account any available actual benefits to date (adjusted benefit shares) may indicate that the projections were not reliable for purposes of estimating RAB shares. In such a case, the Commissioner may use adjusted benefit shares as the most reliable measure of RAB shares and adjust IDC shares accordingly. The projected benefit shares will not be considered unreliable, as applied in a given taxable year, based on a divergence from adjusted benefit shares for every controlled participant that is less than or equal to 20% of the participant's projected benefits share. Further, the Commissioner will not make an allocation based on such divergence if the difference is due to an extraordinary event, beyond the control of the controlled participants, which could not reasonably have been anticipated at the time that costs were shared. The Commissioner generally may adjust projections of benefits used to calculate benefit shares in accordance with the provisions of §1.482–1. In particular, if benefits are projected over a period of years, and the projections for initial years of the period prove to be unreliable, this may indicate that the projections for the remaining years of the period are also unreliable and thus should be adjusted. For purposes of this paragraph (i)(2)(ii)(A), all controlled participants that are not U.S. persons are treated as a single controlled participant. Therefore, an adjustment based on an unreliable projection of RAB shares will be made to the IDC shares of foreign controlled participants only if there is a matching adjustment to the IDC shares of controlled participants that are U.S. persons. Nothing in this paragraph (i)(2)(ii)(A) prevents the Commissioner from making an allocation if a taxpayer did not use the most reliable basis for measuring anticipated benefits. For example, if the taxpayer measures its anticipated benefits based on units sold, and the Commissioner determines that another basis is more reliable for measuring anticipated benefits, then the fact that actual units sold were within 20% of the projected unit sales will not preclude an allocation under this section.

(B) *Foreign-to-foreign adjustments*. Adjustments to IDC shares based on an unreliable projection also may be made among foreign controlled participants if the variation between actual and projected benefits has the effect of substantially reducing U.S. tax.

(C) *Correlative adjustments to PCTs*. Correlative adjustments will be made to any PCT Payments of a fixed amount that were determined based on RAB shares that are subsequently adjusted on a finding that they were based on unreliable projections. No correlative adjustments will be made to contingent PCT Payments regardless of whether RAB shares were used as a parameter in the valuation of those payments.

(D) *Examples*. The following examples illustrate the principles of this paragraph (i)(2)(ii):

Example 1. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a CSA to develop new food products, dividing costs on the basis of projected sales two years in the future. In Year 1, USP and FS project that their sales in Year 3 will be equal, and they divide costs accordingly. In Year 3, the Commissioner examines the controlled participants' method for dividing costs. USP and FS actually accounted for 42% and 58% of total sales, respectively. The Commissioner agrees that sales two years in the future provide a reliable basis for estimating benefit shares. Because the differences between USP's and FS's adjusted and projected benefit shares are less than 20% of their projected benefit shares, the projection of future benefits for Year 3 is reliable.

Example 2. The facts are the same as in *Example 1*, except that in Year 3 USP and FS actually accounted for 35% and 65% of total sales, respectively. The divergence between USP's projected and adjusted benefit shares is greater than 20% of USP's projected benefit share and is not due to an extraordinary event beyond the control of the controlled participants. The Commissioner concludes that the projected benefit shares were unreliable, and uses adjusted benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

Example 3. U.S. Parent (USP), a U.S. corporation, and its foreign subsidiary (FS) enter into a CSA in Year 1. They project that they will begin to receive benefits from cost shared intangibles in Years 4 through 6, and that USP will receive 60% of total benefits and FS 40% of total benefits. In Years 4 through 6, USP and FS actually receive 50% each of the total benefits. In evaluating the reliability of the controlled participants' projections, the Commissioner compares the adjusted benefit shares to the projected benefit shares. Although USP's adjusted benefit share (50%) is within 20% of its projected benefit share (60%), FS's adjusted benefit share (50%) is not within 20% of its projected benefit share (40%). Based on this discrepancy, the Commissioner may conclude that the controlled participants' projections were unreliable and may use adjusted benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

Example 4. Three controlled taxpayers, USP, FS1, and FS2 enter into a CSA. FS1 and FS2 are foreign. USP is a domestic corporation that controls all the stock of FS1 and FS2. The controlled participants project that they will share the total benefits of the cost shared intangibles in the following percentages: USP 50%; FS1 30%; and FS2 20%. Adjusted benefit shares are as follows: USP 45%; FS1 25%; and FS2 30%. In evaluating the reliability of the controlled participants' projections, the Commissioner compares these adjusted benefit shares to the projected benefit shares. For this purpose, FS1 and FS2 are treated as a single controlled participant. The adjusted benefit share received by USP (45%) is within 20% of its projected benefit share (50%). In addition, the non-US controlled participant's adjusted benefit share (55%) is also within 20% of their projected benefit share (50%). Therefore, the Commissioner concludes that the controlled participant's projections of future benefits were reliable, despite the fact that FS2's adjusted benefit share (30%) is not within 20% of its projected benefit share (20%).

Example 5. The facts are the same as in *Example 4*. In addition, the Commissioner determines that FS2 has significant operating losses and has no earnings and profits, and that FS1 is profitable and has earnings and profits. Based on all the evidence, the Commissioner concludes that the controlled participants arranged that FS1 would bear a larger cost share than appropriate in order to reduce FS1's earnings and profits and thereby reduce inclusions USP otherwise would be deemed to have on account of FS1 under subpart F. Pursuant to paragraph (i)(2)(ii)(B) of this section, the Commissioner may make an adjustment solely to the cost shares borne by FS1 and FS2 because FS2's projection of future benefits was unreliable and the variation between adjusted and projected benefits had the effect of substantially reducing USP's U.S. income tax liability (on account of FS1 subpart F income).

Example 6. (i)(A) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA in 1996 to develop a new treatment for baldness. USS's interest in any treatment developed is the right to produce and sell the treatment in the U.S. market while FP retains rights to produce and sell the treatment in the rest of the world. USS and FP measure their anticipated benefits from the CSA based on their respective projected future sales of the baldness treatment. The following sales projections are used:

SALES

[In millions of dollars]

Year	USS	FP
1	5	10
2	20	20
3	30	30
4	40	40
5	40	40
6	40	40
7	40	40
8	20	20
9	10	10
10	5	5

(B) In Year 1, the first year of sales, USS is projected to have lower sales than FP due to lags in U.S. regulatory approval for the baldness treatment. In each subsequent year, USS and FP are projected to have equal sales. Sales are projected to build over the first three years of the period, level off for several years, and then decline over the final years of the period as new and improved baldness treatments reach the market.

(ii) To account for USS's lag in sales in the Year 1, the present discounted value of sales over the period is used as the basis for measuring benefits. Based on the risk associated with this venture, a discount rate of 10 percent is selected. The present discounted value of projected sales is determined to be approximately $154.4 million for USS and $158.9 million for FP. On this basis USS and FP are projected to obtain approximately 49.3% and 50.7% of the benefit, respectively, and the costs of developing the baldness treatment are shared accordingly.

(iii)(A) In Year 6, the Commissioner examines the CSA. USS and FP have obtained the following sales results through Year 5:

SALES

[In millions of dollars]

Year	USS	FP
1	0	17
2	17	35
3	25	35
4	38	41
5	39	41

(B) USS's sales initially grew more slowly than projected while FP's sales grew more quickly. In each of the first three years of the period, the share of total sales of at least one of the parties diverged by over 20% from its projected share of sales. However, by Year 5 both parties' sales had leveled off at approximately their projected values. Taking into account this leveling off of sales and all the facts and circumstances, the Commissioner determines that it is appropriate to use the original projections for the remaining years of sales. Combining the actual results through Year 5 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $141.6 million for USS and $187.3 million for FP. This result implies that USS and FP obtain approximately 43.1% and 56.9%, respectively, of the anticipated benefits from the baldness treatment. Because these adjusted benefit shares are within 20% of the benefit shares calculated based on the original sales projections, the Commissioner determines that, based on the difference between adjusted and projected benefit shares, the original projections were not unreliable. No adjustment is made based on the difference between adjusted and projected benefit shares.

Example 7. (i) The facts are the same as in *Example 6*, except that the actual sales results through Year 5 are as follows:

SALES

[In millions of dollars]

Year	USS	FP
1	0	17
2	17	35
3	25	44
4	34	54
5	36	55

(ii) Based on the discrepancy between the projections and the actual results and on consideration of all the facts, the Commissioner determines that for the remaining years the following sales projections are more reliable than the original projections:

SALES

[In millions of dollars]

Year	USS	FP
6	36	55
7	36	55
8	18	28
9	9	14
10	4.5	7

(iii) Combining the actual results through Year 5 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $131.2 million for USS and $229.4 million for FP. This result implies that USS and FP obtain approximately 35.4% and 63.6%, respectively, of the anticipated benefits from the baldness treatment. These adjusted benefit shares diverge by greater than 20% from the benefit shares calculated based on the original sales projections, and the Commissioner determines that, based on the difference between adjusted and projected benefit shares, the original projections were unreliable. The Commissioner adjusts cost shares for each of the taxable years under examination to conform them to the recalculated shares of anticipated benefits.

(iii) *Timing of CST allocations.* If the Commissioner makes an allocation to adjust the results of a CST, the allocation must be reflected for tax purposes in the year in which the IDCs were incurred. When a CST payment is owed by one controlled participant to another controlled participant, the Commissioner may make appropriate allocations to reflect an arm's length rate of interest for the time value of money, consistent with the provisions of §1.482–2(a) (Loans or advances).

(3) *PCT allocations.* The Commissioner may make allocations to adjust the results of a PCT so that the results are consistent with an arm's length result in accordance with the provisions of the applicable sections of the regulations under section 482, as determined pursuant to paragraph (a)(2) of this section.

(4) *Allocations regarding changes in participation under a CSA.* The Commissioner may make allocations to adjust the results of any controlled transaction described in paragraph (f) of this section if the controlled participants do not reflect arm's length results in relation to any such transaction.

(5) *Allocations when CSTs are consistently and materially disproportionate to RAB shares.* If a controlled participant bears IDC shares that are consistently and materially greater or lesser than its RAB share, then the Commissioner may conclude that the economic substance of the arrangement between the controlled participants is inconsistent with the terms of the CSA. In such a case, the Commissioner may disregard such terms and impute an agreement that is consistent with the controlled participants' course of conduct, under which a controlled participant that bore a disproportionately greater IDC share received additional interests in the cost shared intangibles. See §§1.482–1(d)(3)(ii)(B) (Identifying contractual terms) and 1.482–4(f)(3)(ii) (Identification of owner). Such additional interests will consist of partial undivided interests in the other controlled participant's interest in the cost shared intangible. Accordingly,

that controlled participant must receive arm's length consideration from any controlled participant whose IDC share is less than its RAB share over time, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6 to provide compensation for the latter controlled participants' use of such partial undivided interest.

(6) *Periodic adjustments*—(i) *In general.* Subject to the exceptions in paragraph (i)(6)(vi) of this section, the Commissioner may make periodic adjustments for an open taxable year (the Adjustment Year) and for all subsequent taxable years for the duration of the CSA Activity with respect to all PCT Payments, if the Commissioner determines that, for a particular PCT (the Trigger PCT), a particular controlled participant that owes or owed a PCT Payment relating to that PCT (such controlled participant being referred to as the PCT Payor for purposes of this paragraph (i)(6)) has realized an Actually Experienced Return Ratio (AERR) that is outside the Periodic Return Ratio Range (PRRR). The satisfaction of the condition stated in the preceding sentence is referred to as a Periodic Trigger. See paragraphs (i)(6)(ii) through (vi) of this section regarding the PRRR, the AERR, and periodic adjustments. In determining whether to make such adjustments, the Commissioner may consider whether the outcome as adjusted more reliably reflects an arm's length result under all the relevant facts and circumstances, including any information known as of the Determination Date. The Determination Date is the date of the relevant determination by the Commissioner. The failure of the Commissioner to determine for an earlier taxable year that a PCT Payment was not arm's length will not preclude the Commissioner from making a periodic adjustment for a subsequent year. A periodic adjustment under this paragraph (i)(6) may be made without regard to whether the taxable year of the Trigger PCT or any other PCT remains open for statute of limitations purposes or whether a periodic adjustment has previously been made with respect to any PCT Payment.

(ii) *PRRR.* Except as provided in the next sentence, the *PRRR* will consist of return ratios that are not less than .667 nor more than 1.5. Alternatively, if the controlled participants have not substantially complied with the documentation requirements referenced in paragraph (k) of this section, as modified, if applicable, by paragraphs (m)(2) and (3) of this section, the PRRR will consist of return ratios that are not less than .8 nor more than 1.25.

(iii) *AERR*—(A) *In general.* The *AERR* is the present value of total profits (PVTP) divided by the present value of investment (PVI). In computing PVTP and PVI, present values are computed using the applicable discount rate (ADR), and all information available as of the Determination Date is taken into account.

(B) *PVTP.* The *PVTP* is the present value, as of the CSA Start Date, as defined in section (j)(1)(i) of this section, of the PCT Payor's actually experienced divisional profits or losses from the CSA Start Date through the end of the Adjustment Year.

(C) *PVI.* The *PVI* is the present value, as of the CSA Start Date, of the PCT Payor's investment associated with the CSA Activity, defined as the sum of its cost contributions and its PCT Payments, from the CSA Start Date through the end of the Adjustment Year. For purposes of computing the PVI, PCT Payments means all PCT Payments due from a PCT Payor before netting against PCT Payments due from other controlled participants pursuant to paragraph (j)(3)(ii) of this section.

(iv) *ADR*—(A) *In general.* Except as provided in paragraph (i)(6)(iv)(B) of this section, the ADR is the discount rate pursuant to paragraph (g)(2)(v) of this section, subject to such adjustments as the Commissioner determines appropriate.

(B) *Publicly traded companies.* If the PCT Payor meets the conditions of paragraph (i)(6)(iv)(C) of this section, the ADR is the PCT Payor WACC as of the date of the Trigger PCT. However, if the Commissioner determines, or the controlled participants establish to the satisfaction of the Commissioner, that a discount rate other than the PCT Payor WACC better reflects the degree of risk of the CSA Activity as of such date, the ADR is such other discount rate.

(C) *Publicly traded.* A PCT Payor meets the conditions of this paragraph (i)(6)(iv)(C) if—

(*1*) Stock of the PCT Payor is publicly traded; or

(*2*) Stock of the PCT Payor is not publicly traded, provided the PCT Payor is included in a group of companies for which consolidated financial statements are prepared; and a publicly traded company in such group owns, directly or indirectly, stock in PCT Payor. Stock of a company is publicly traded within the meaning of this paragraph (i)(6)(iv)(C) if such stock is regularly traded on an established United States securities market and the company issues financial statements prepared in accordance with United States generally accepted accounting principles for the taxable year.

(D) *PCT Payor WACC.* The *PCT Payor WACC* is the WACC, as defined in paragraph (j)(1)(i) of this section, of the PCT Payor or the publicly traded company described in paragraph (i)(6)(iv)(C)(*2*)(*ii*) of this section, as the case may be.

(E) *Generally accepted accounting principles.* For purposes of paragraph (i)(6)(iv)(C) of this section, a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that the amounts of debt, equity, and interest expense are reflected in any reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets.

(v) *Determination of periodic adjustments.* In the event of a Periodic Trigger, subject to paragraph (i)(6)(vi) of this section, the Commissioner may make periodic adjustments with respect to all PCT Payments between all PCT Payors and PCT Payees for the Adjustment Year and all subsequent years for the duration of the CSA Activity pursuant to the residual profit split method as provided in paragraph (g)(7) of this section, subject to the further modifications in this paragraph (i)(6)(v). A periodic adjustment may be made for a particular taxable year without regard to whether the taxable years of the Trigger PCT or other PCTs remain open for statute of limitation purposes.

(A) *In general.* Periodic adjustments are determined by the following steps:

(*1*) First, determine the present value, as of the date of the Trigger PCT, of the PCT Payments under paragraph (g)(7)(iii)(C)(*3*) of this section pursuant to the Adjusted RPSM as defined in paragraph (i)(6)(v)(B) of this section (first step result).

(*2*) Second, convert the first step result into a stream of contingent payments on a base of reasonably anticipated divisional profits or losses over the entire duration of the CSA Activity, using a level royalty rate (second step rate). See paragraph (h)(2)(iv) of this section (Conversion from fixed to contingent form of payment). This conversion is made based on all information known as of the Determination Date.

(*3*) Third, apply the second step rate to the actual divisional profit or loss for taxable years preceding and including the Adjustment Year to yield a stream of contingent payments for such years, and convert such stream to a present value as of the CSA Start Date under the principles of paragraph (g)(2)(v) of this section (third step result). For this purpose, the second step rate applied to a loss for a particular year will yield a negative contingent payment for that year.

(*4*) Fourth, convert any actual PCT Payments up through the Adjustment Year to a present value as of the CSA Start Date under the principles of paragraph (g)(2)(v) of this section. Then subtract such amount from the third step result. Determine the nominal amount in the Adjustment Year that would have a present value as of the CSA Start Date equal to the present value determined in the previous sentence to determine the periodic adjustment in the Adjustment Year.

(*5*) Fifth, apply the second step rate to the actual divisional profit or loss for each taxable year after the Adjustment Year up to and including the taxable year that includes the Determination Date to yield a stream of contingent payments for such years. For this purpose, the second step rate applied to a loss will yield a negative contingent payment for that year. Then subtract from each such payment any actual PCT Payment made for the same year to determine the periodic adjustment for such taxable year.

(*6*) For each taxable year subsequent to the year that includes the Determination Date, the periodic adjustment for such taxable year (which is in lieu of any PCT Payment that would otherwise be payable for that year under the taxpayer's position) equals the second step rate applied to the actual divisional profit or loss for that year. For this purpose, the second step rate applied to a loss for a particular year will yield a negative contingent payment for that year.

(*7*) If the periodic adjustment for any taxable year is a positive amount, then it is an additional PCT Payment owed from the PCT Payor to the PCT Payee for such year. If the periodic adjustment for any taxable year is a negative amount, then it is an additional PCT Payment owed by the PCT Payee to the PCT Payor for such year.

(B) *Adjusted RPSM as of Determination Date.* The Adjusted RPSM is the residual profit split method pursuant to paragraph (g)(7) of this section applied to determine the present value, as of the date of the Trigger PCT, of the PCT Payments under paragraph (g)(7)(iii)(C)(*3*) of this section, with the following modifications.

(*1*) Actual results up through the Determination Date shall be substituted for what otherwise were the projected results over such period, as reasonably anticipated as of the date of the Trigger PCT.

(*2*) Projected results for the balance of the CSA Activity after the Determination Date, as reasonably anticipated as of the Determination Date, shall be substituted for what otherwise were the projected results over such period, as reasonably anticipated as of the date of the Trigger PCT.

(*3*) The requirement in paragraph (g)(7)(i) of this section, that at least two controlled participants make significant nonroutine contributions, does not apply.

(vi) *Exceptions to periodic adjustments*—(A) *Controlled participants establish periodic adjustment not warranted.* No periodic adjustment will be made under paragraphs (i)(6)(i) and (v) of this section if the controlled participants establish to the satisfaction of the Commissioner that all the conditions described in one of paragraphs (i)(6)(vi)(A)(*1*) through (*4*) of this section apply with respect to the Trigger PCT.

(*1*) *Transactions involving the same platform contribution as in the Trigger PCT.*

(*i*) The same platform contribution is furnished to an uncontrolled taxpayer under substantially the same circumstances as those of the relevant Trigger PCT and with a similar form of payment as the Trigger PCT;

(*ii*) This transaction serves as the basis for the application of the comparable uncontrolled transaction method described in paragraph (g)(3) of this section, in the first year and all subsequent years in which substantial PCT Payments relating to the Trigger PCT were required to be paid; and

(*iii*) The amount of those PCT Payments in that first year was arm's length.

(*2*) *Results not reasonably anticipated.* The differential between the AERR and the nearest bound of the PRRR is due to extraordinary events beyond the control of the controlled participants that could not reasonably have been anticipated as of the date of the Trigger PCT.

(*3*) *Reduced AERR does not cause Periodic Trigger.* The Periodic Trigger would not have occurred had the PCT Payor's divisional profits or losses used to calculate its PVTP both taken into account expenses on account of operating cost contributions and routine platform contributions, and excluded those profits or losses attributable to the PCT Payor's routine contributions to its exploitation of cost shared intangibles, nonroutine contributions to the

CSA Activity, operating cost contributions, and routine platform contributions.

(*4*) *Increased AERR does not cause Periodic Trigger*—(*i*) The Periodic Trigger would not have occurred had the divisional profits or losses of the PCT Payor used to calculate its PVTP included its reasonably anticipated divisional profits or losses after the Adjustment Year from the CSA Activity, including from its routine contributions, its operating cost contributions, and its nonroutine contributions to that activity, and had the cost contributions and PCT Payments of the PCT Payor used to calculate its PVI included its reasonably anticipated cost contributions and PCT Payments after the Adjustment Year. The reasonably anticipated amounts in the previous sentence are determined based on all information available as of the Determination Date.

(*ii*) For purposes of this paragraph (i)(6)(vi)(A)(*4*), the controlled participants may, if they wish, assume that the average yearly divisional profits or losses for all taxable years prior to and including the Adjustment Year, in which there has been substantial exploitation of cost shared intangibles resulting from the CSA (exploitation years), will continue to be earned in each year over a period of years equal to 15 minus the number of exploitation years prior to and including the Determination Date.

(B) *Circumstances in which Periodic Trigger deemed not to occur*. No Periodic Trigger will be deemed to have occurred at the times and in the circumstances described in paragraph (i)(6)(vi)(B)(*1*) or (*2*) of this section.

(*1*) *10-year period*. In any year subsequent to the 10-year period beginning with the first taxable year in which there is substantial exploitation of cost shared intangibles resulting from the CSA, if the AERR determined is within the PRRR for each year of such 10-year period.

(*2*) *5-year period*. In any year of the 5-year period beginning with the first taxable year in which there is substantial exploitation of cost shared intangibles resulting from the CSA, if the AERR falls below the lower bound of the PRRR.

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

Example 1. (i) For simplicity of calculation in this *Example 1*, all financial flows are assumed to occur at the beginning of the year. At the beginning of Year 1, USP, a publicly traded U.S. company, and FS, its wholly-owned foreign subsidiary, enter into a CSA to develop new technology for cell phones. USP has a platform contribution, the rights for an in-process technology that when developed will improve the clarity of calls, for which compensation is due from FS. FS has no platform contributions to the CSA, no operating contributions, and no operating cost contributions. USP and FS agree to fixed PCT payments of $40 million in Year 1 and $10 million per year for Years 2 through 10. At the beginning of Year 1, the weighted average cost of capital of the controlled group that includes USP and FS is 15%. In Year 9, the Commissioner audits Years 5 through 7 of the CSA and considers whether any periodic adjustments should be made. USP and FS have substantially complied with the documentation requirements of paragraph (k) of this section.

(ii) FS experiences the results reported in the following table from its participation in the CSA through Year 7. In the table, all present values (PV) are reported as of the CSA Start Date, which is the same as the date of the PCT (and reflect a 15% discount rate as discussed in paragraph (iii) of this *Example 1*). Thus, in any year the present value of the cumulative investment is PVI and of the cumulative divisional profit or loss is PVTP. All amounts in this table and the tables that follow are reported in millions of dollars and cost contributions are referred to as ‘‘CCs’’ (for simplicity of calculation in this *Example 1*, all financial flows are assumed to occur at the beginning of the year).

a	b	c	d	e	f	g	h
Year	Sales	Non CC costs	CCs	PCT payments	Investment (d + e)	Divisional profit or loss (b-c)	AERR (PVTP/PVI) (g/f)
1	0	0	15	40	55	0	
2	0	0	17	10	27	0	
3	0	0	18	10	28	0	
4	705	662	20	10	30	46	
5	886	718	22	10	32	168	

a	b	c	d	e	f	g	h
Year	Sales	Non CC costs	CCs	PCT payments	Investment (d + e)	Divisional profit or loss (b-c)	AERR (PVTP/ PVI) (g/f)
6	1,113	680	24	10	34	433	
7	1,179	747	27	10	37	432	
PV through Year 5	970	846	69	69	138	124	0.90
PV through Year 6	1,523	1,184	81	74	155	340	2.20
PV through Year 7	2,033	1,507	93	78	171	526	3.09

(iii) Because USP is publicly traded in the United States and is a member of the controlled group to which FS (the PCT Payor) belongs, for purposes of calculating the AERR for FS, the present values of its PVTP and PVI are determined using an ADR of 15%, the weighted average cost of capital of the controlled group. (It is assumed that no other rate was determined or established, under paragraph (i)(6)(iv)(B) of this section, to better reflect the relevant degree of risk.) At a 15% discount rate, the PVTP, calculated as of Year 1, and based on actual profits realized by FS through Year 7 from exploiting the new cell phone technology developed by the CSA, is $526 million. The PVI, based on FS's cost contributions and its PCT Payments, is $171 million. The AERR for FS is equal to its PVTP divided by its PVI, $526 million/$171 million, or 3.09. There is a Periodic Trigger because FS's AERR of 3.09 falls outside the PRRR of .67 to 1.5, the applicable PRRR for controlled participants complying with the documentation requirements of this section.

(iv) At the time of the Determination Date, it is determined that the first Adjustment Year in which a Periodic Trigger occurred was Year 6, when the AERR of FS was determined to be 2.20. It is also determined that for Year 6 none of the exceptions to periodic adjustments described in paragraph (i)(6)(vi) of this section applies. The Commissioner exercises its discretion under paragraph (i)(6)(i) of this section to make periodic adjustments using Year 6 as the Adjustment Year. Therefore, the arm's length PCT Payments from FS to USP shall be determined for each taxable year using the adjusted residual profit split method described in paragraphs (g)(7) and (i)(6)(v)(B) of this section. Periodic adjustments will be made for each year to the extent the PCT Payments actually made by FS differ from the PCT Payment calculation under the adjusted residual profit split method.

(v) It is determined, as of the Determination Date, that the cost shared intangibles will be exploited through Year 10. FS's return for routine contributions (determined by the Commissioner, based on the return for comparable functions undertaken by comparable uncontrolled companies, to be 8% of non-CC costs), and its actual and projected results, are described in the following table.

a	b	c	d	e	f	g
Year	Sales	Non-CC costs	Divisional profit or loss (b-c)	CCs	Routing return	Residual proift (d-e-f)
1	0	0	0	15	0	−15
2	0	0	0	17	0	−17
3	0	0	0	18	0	−18
4	705	662	43	20	53	−30
5	886	718	168	22	57	89
6	1,113	680	433	24	54	355
7	1,179	747	432	27	60	345
8	1,238	822	416	29	66	321
9	1,300	894	406	32	72	302
10	1,365	974	391	35	78	278
Cumulative PV through Year 10 as of CSA Start Date	3,312	2,385	927	124	191	612

(vi) The periodic adjustments are calculated in a series of steps set out in paragraph (i)(6)(v)(A) of this section. First, a lump sum for the PCT Payment is determined using the adjusted residual profit split method. Under the method, based on the considerations discussed in paragraph (g)(2)(v) of this section, the appropriate discount rate is 15% per year. The nonroutine residual divisional profit or loss described in paragraph (g)(7)(iii)(B) of this section is $612 million. Further, under paragraph (g)(7)(iii)(C) of this section, the entire nonroutine residual divisional profit constitutes the PCT Payment because only USP has nonroutine contributions.

(vii) In step two, the first step result ($612 million) is converted into a level royalty rate based on the reasonably anticipated divisional profit or losses of the CSA Activity, the PV of which is reported in the table above (net PV of divisional profit or loss for Years 1 through 10 is $927 million). Consequently, the step two result is a level royalty rate of 66.0% ($612/$927) of the divisional profit in Years 1 through 10.

(viii) In step three, the Commissioner calculates the PCT Payments due through Year 6 by applying the step two royalty rate to the actual divisional profits for each year and then determines the aggregate PV of these PCT Payments as of the CSA Start Date ($224 million as reported in the following table). In step four, the PCT Payments actually made through Year 6 are similarly converted to PV as of the CSA Start Date ($74 million) and subtracted from the amount determined in step three ($224 million—$74 million = $150 million). That difference of $150 million, representing a net PV as of the CSA Start Date, is then converted to a nominal amount, as of the Adjustment Year, of equivalent present value (again using a discount rate of 15%). That nominal amount is $302 million (not shown in the table), and is the periodic adjustment in Year 6.

a	b	c	d	e
Year	Divisional profit	Royalty rate	Nominal royalty due under adjusted RPSM (b*c)	Nominal payments made
Year 1	0	66.0	$0	$40
Year 2	0	66.0	0	10
Year 3	0	66.0	0	10
Year 4	43	66.0	28	10
Year 5	168	66.0	111	10
Year 6	433	66.0	286	10
Cumulative PV as of Year 1			224	74

(ix) Under step five, the royalties due from FS to USP for Year 7 (the year after the Adjustment Year) through Year 9 (the year including the Determination Date) are determined. (These determinations are made for Years 8 and 9 after the divisional profit for those years becomes available.) For each year, the periodic adjustment is a PCT Payment due in addition to the $10 million PCT Payment that must otherwise be paid under the CSA as described in paragraph (i) of this *Example 1*. That periodic adjustment is calculated as the product of the step two royalty rate and the divisional profit, minus the $10 million that was otherwise paid for that year. The calculations are shown in the following table:

a	b	c	d	e	f
Year	Divisional profit	Royalty rate	Royalty due (b*c)	PCT Payments otherwise paid	Periodic adjustment d-e)
7	432	66.0%	$285	$10	$275
8	416	66.0	275	10	265
9	406	66.0	268	10	258

(x) Under step six, the periodic adjustment for Year 10 (the only exploitation year after the year containing the Determination Date) will be determined by applying the step two royalty rate to the divisional profit. This periodic adjustment is a PCT Payment payable from FS to USP, and is in lieu of the $10 payment otherwise due. The calculations are shown in the following table, based on a divisional profit of $391 million. USP and FS experienced the following results in Year 10.

Year	Divisional profit	Royalty rate	Royalty due	PCT payment called for under original agreement but not made	Periodic adjustment
10	391	66.0%	$258	$10 (not paid)	$258

Example 2. The facts are the same as in paragraphs (i) through (iii) of *Example 1.* At the time of the Determination Date, it is determined that the first Adjustment Year in which a Periodic Trigger occurred was Year 6, when the AERR of FS was determined to be 2.73. Upon further investigation as to what may have caused the high return in FS's market, the Commissioner learns that, in Years 4 through 6, USP's leading competitors experienced severe, unforeseen disruptions in their supply chains resulting in a significant increase in USP's and FS's market share for cell phones. Further analysis determines that without this unforeseen occurrence the Periodic Trigger would not have occurred. Based on paragraph (i)(6)(vi)(A)(*2*) of this section, the Commissioner determines to his satisfaction that no adjustments are warranted.

Example 3. (i) USP, a U.S. corporation, and its wholly-owned foreign subsidiaries FS1, FS2, and FS3 enter into a CSA at the start of Year 1 to develop version 2.0 of a computer program. USP makes a platform contribution, version 1.0 of the program (upon which version 2.0 will be based), for which compensation is due from FS1, FS2, and FS3. None of the foreign subsidiaries makes any platform contributions.

(ii) In Year 6, the Commissioner audits Years 3 through 5 of the CSA and considers whether any periodic adjustments should be made. At the time of the Determination Date, the Commissioner determines that the first Adjustment Year in which a Periodic Trigger occurred was Year 3, and further determines that none of the exceptions to periodic adjustments described in paragraph (i)(6)(vi) of this section applies. The Commissioner exercises his discretion under paragraph (i)(6)(i) of this section to make periodic adjustments using Year 3 as the Adjustment Year. Therefore, the arm's length PCT Payments from FS1, FS2, and FS3 to USP shall be determined using the adjusted residual profit split method described in paragraphs (g)(7)(v)(B) and (i)(6)(v)(B) of this section. Periodic adjustments will be made for each year to the extent the PCT Payments actually made by FS1, FS2, and FS3 differ from the PCT Payment calculation under the adjusted residual profit split method.

(iii) The periodic adjustments are calculated in a series of steps set out in paragraph (i)(6)(v)(A) of this section. First, a lump sum for the PCT Payments is determined using the adjusted residual profit split method. The following results are calculated (based on actual results for years for which actual results are available and projected results for all years thereafter) in order to apply the adjusted residual profit split method (it is determined that the cost shared intangibles will be exploited through Year 7, so the results reported in the following table are cumulative values through Year 7):

Participant	Divisional profits (cumulative PV through year 7 as of the CSA start date)	Residual profits (cumulative PV through year 7 as of the CSA start date)
FS1	$667	$314
FS2	271	159
FS3	592	295

Because only USP had nonroutine contributions, under paragraph (g)(7)(iii)(C) of this section, the entire nonroutine residual divisional profit constitutes the PCT Payment owed to USP. Therefore, the present values (as of the CSA Start Date) of the PCT Payments owed are as follows:

PCT Payment owed from FS1 to USP: $314 million

PCT Payment owed from FS2 to USP: $159 million

PCT Payment owed from FS3 to USP: $295 million

Pursuant to paragraph (i)(6)(v)(A) of this section, the steps in paragraphs (i)(6)(v)(A)(*2*) through (*7*) of this section are performed separately for the PCT Payments that are owed to USP by each of FS1, FS2, and FS3.

(iv) First, the steps are performed with respect to FS1. In step two, the first step result ($314 million) is converted into a level royalty rate based on FS1's reasonably anticipated divisional profits or losses through Year 7 (the PV of which is $667 million). Consequently, the step two result is a level royalty rate of 47.1% ($314/$667) of the divisional profits in Years 1 through 7. In step three, the Commissioner calculates the PCT Payments due through Year 3 (the Adjustment Year) by applying the step two royalty rate (47.1%) to FS1's actual divisional profits for each year up to and including Year 3 and then determining the aggregate PV of these PCT Payments as of Year 3. In step four, the PCT Payments actually made by FS1 to USP through Year 3 are similarly converted to a PV as of Year 3 and subtracted from the amount determined in step three. That difference is the periodic adjustment in Year 3 with respect to the PCT Payments made for Years 1 through 3 from FS1 to USP. Under step five, the royalties due from FS1 to USP for Year 4 (the year after the Adjustment Year) through Year 6 (the year including the Determination Date) are determined. The periodic adjustment for each of these years is calculated as the product of the step two royalty rate and the divisional profit for that year, minus any actual PCT Payment made by FS1 to USP in that year. The periodic adjustment for each such year is a PCT Payment due in addition to the PCT Payment from FS1 to USP that was already made under the CSA. Under step six, the periodic adjustment for Year 7 (the only exploitation year after the year containing the Determination Date) will be determined by applying the step two royalty rate to FS1's divisional profit for that year. This periodic adjustment for Year 7 is a PCT Payment payable from FS1 to USP and is in lieu of any PCT Payment from FS1 to USP otherwise due.

(v) Next, the steps in paragraphs (i)(6)(v)(A)(*2*) through (*7*) of this section are performed with respect to FS2. In step two, the first step result ($159 million) is converted into a level royalty rate based on FS2's reasonably anticipated divisional profits or losses through Year 7 (the PV of which is $271 million). Consequently, the step two result is a level royalty rate of 58.7% ($159/$271) of the divisional profits in Years 1 through 7. In step three, the Commissioner calculates the PCT Payments due through Year 3 (the Adjustment Year) by applying the step two royalty rate (58.7%) to FS2's actual divisional profits for each year up to and including Year 3 and then determining the aggregate PV of these PCT Payments as of Year 3. In step four, the PCT Payments actually made by FS2 to USP through Year 3 are similarly converted to a PV as of Year 3 and subtracted from the amount determined in step three. That difference is the periodic adjustment in Year 3 with respect to the PCT Payments made for Years 1 through 3 from FS2 to USP. Under step five, the royalties due from FS2 to USP for Year 4 (the year after the Adjustment Year) through Year 6 (the year including the Determination Date) are determined. The periodic adjustment for each of these years is calculated as the product of the step two royalty rate and the divisional profit for that year, minus any actual PCT Payment made by FS2 to USP in that year. The periodic adjustment for each such year is a PCT Payment due in addition to the PCT Payment from FS2 to USP that was already made under the CSA. Under step six, the periodic adjustment for Year 7 (the only exploitation year after the year containing the Determination Date) will be determined by applying the step two royalty rate to FS2's divisional profit for that year. This periodic adjustment for Year 7 is a PCT Payment payable from FS2 to USP and is in lieu of any PCT Payment from FS2 to USP otherwise due.

(vi) Finally, the steps in paragraphs (i)(6)(v)(A)(*2*) through (*7*) of this section are performed with respect to FS3. In step two, the first step result ($295 million) is converted into a level royalty rate based on FS3's reasonably anticipated divisional profits or losses through Year 7 (the PV of which is $592 million). Consequently, the step two result is a level royalty rate of 49.8% ($295/$592) of the divisional profits in Years 1 through 7. In step three, the Commissioner calculates the PCT Payments due through Year 3 (the Adjustment Year) by applying the step two royalty rate (49.8%) to FS3's actual divisional profits for each year up to and including Year 3 and then determining the aggregate PV of these PCT Payments as of Year 3. In step four, the PCT Payments actually made by FS3 to USP through Year 3 are similarly converted to a PV as of Year 3 and subtracted from the amount determined in step three. That difference is the periodic adjustment in Year 3 with respect to the PCT Payments made for Years 1 through 3 from FS3 to USP. Under step five, the royalties due from FS3 to USP for Year 4 (the year after the Adjustment Year) through Year 6 (the year including the Determination Date) are determined. The periodic adjustment for each of these years is calculated as the product of the step two royalty rate and the divisional profit for that year, minus any actual PCT Payment made by FS3 to USP in that year. The periodic adjustment for each such year is a PCT Payment due in addition to the PCT Payment from FS3 to USP that was already made under the CSA. Under step six, the periodic adjustment for Year 7 (the only exploitation year after the year containing the Determination Date) will be determined by applying the step two royalty rate to FS3's divisional profit for that year. This periodic adjustment for Year 7 is a PCT Payment payable from FS3 to USP and is in lieu of any PCT Payment from FS3 to USP otherwise due.

(j) *Definitions and special rules*—(1) *Definitions*—(i) *In general.* For purposes of this section—

Term	Definition	Main cross references
Acquisition price		§ 1.482–7(g)(5)(i).
Adjusted acquisition price		§ 1.482–7(g)(5)(iii).
Adjusted average market capitalization		§ 1.482–7(g)(6)(iv).
Adjusted benefit shares		§ 1.482–7(i)(2)(ii)(A).
Adjusted RPSM		§ 1.482–7(i)(6)(v)(B).
Adjustment Year		§ 1.482–7(i)(6)(i).
ADR		§ 1.482–7(i)(6)(iv).
AERR		§ 1.482–7(i)(6)(iii).

Term	Definition	Main cross references
Applicable Method		§ 1.482–7(g)(2)(ix)(A).
Average market capitalization		§ 1.482–7(g)(6)(iii).
Benefits	*Benefits* mean the sum of additional revenue generated, plus cost savings, minus any cost increases from exploiting cost shared intangibles.	§ 1.482–7(e)(1)(i).
Capability variation		§ 1.482–7(f)(3).
Change in participation under a CSA		§ 1.482–7(f).
Consolidated group		§ 1.482–7(j)(2)(i).
Contingent payments		§ 1.482–7(h)(2)(i)(B).
Controlled participant	*Controlled participant* means a controlled taxpayer, as defined under § 1.482–1(i)(5), that is a party to the contractual agreement that underlies the CSA, and that reasonably anticipates that it will derive benefits, as defined in paragraph (e)(1)(i) of this section, from exploiting one or more cost shared intangibles.	§ 1.482–7(a)(1).
Controlled transfer of interests		§ 1.482–7(f)(2).
Cost contribution		§ 1.482–7(d)(4).
Cost shared intangible	*Cost shared intangible* means any intangible, within the meaning of § 1.482–4(b), that is developed by the IDA, including any portion of such intangible that reflects a platform contribution. Therefore, an intangible developed by the IDA is a cost shared intangible even though the intangible was not always or was never a reasonably anticipated cost shared intangible.	§ 1.482–7(b).
Cost sharing alternative		§ 1.482–7(g)(4)(i)(B).
Cost sharing arrangement or CSA		§ 1.482–7(a), (b).
Cost sharing transactions or CSTs		§ 1.482–7(a)(1), (b)(1)(i).
Cross operating contributions	A cross operating contribution is any resource or capability or right, other than a platform contribution, that a controlled participant has developed, maintained, or acquired prior to the CSA Start Date, or subsequent to the CSA start date by means other than operating cost contributions or cost contributions, that is reasonably anticipated to contribute to the CSA Activity within another controlled participant's division.	§ 1.482–7(a)(3)(iii), (g)(2)(iv).
CSA Activity	*CSA Activity* is the activity of developing and exploiting cost shared intangibles.	§ 1.482–7(c)(2)(i).
CSA Start Date	The *CSA Start Date* is the earlier of the date of the CSA contract or the first occurrence of any IDC to which the CSA applies, in accordance with § 1.482–7(k)(1)(iii).	§ 1.482–7(i)(6)(iii)(B) and (k)(1)(ii) and (iii).
CST Payments		§ 1.482–7(b)(1).
Date of PCT		§ 1.482–7(b)(3).
Determination Date		§ 1.482–7(i)(6)(i).
Differential income stream		§ 1.482–7(g)(4)(vi)(F)(*2*).
Division	*Division* means the territory or other division that serves as the basis of the division of interests under the CSA in the cost shared intangibles pursuant to § 1.482–7(b)(4).	See definitions of divisional profit or loss, operating contribution, and operating cost contribution.
Divisional interest		§ 1.482–7(b)(1)(iii), (b)(4).
Divisional profit or loss	*Divisional profit or loss* means the operating profit or loss as separately earned by each controlled participant in its division from the CSA Activity, determined before any expense (including amortization) on account of cost contributions, operating cost contributions, routine platform and operating contributions, nonroutine contributions (including platform and operating contributions), and tax.	§ 1.482–7(g)(4)(iii).

Term	Definition	Main cross references
Fixed payments		§ 1.482–7(h)(2)(i)(A).
Implied discount rate		§ 1.482–7(g)(2)(v)(B)(*2*).
IDC share		§ 1.482–7(d)(4).
Input parameters		§ 1.482–7(g)(2)(ix)(B).
Intangible development activity or IDA		§ 1.482–7(d)(1).
Intangible development costs or IDCs		§ 1.482–7(a)(1), (d)(1).
Licensing alternative		§ 1.482–7(g)(4)(i)(C).
Licensing payments	*Licensing payments* means payments pursuant to the licensing obligations under the licensing alternative.	§ 1.482–7(g)(4)(iii).
Make-or-sell rights		§ 1.482–7(c)(4), (g)(2)(iv).
Market-based input parameter		§ 1.482–7(g)(2)(ix)(B).
Market returns for routine contributions	*Market returns for routine contributions* means returns determined by reference to the returns achieved by uncontrolled taxpayers engaged in activities similar to the relevant business activity in the controlled participant's division, consistent with the methods described in §§ 1.482–3, 1.482–4, 1.482–5, or § 1.482–9(c).	§ 1.482–7(g)(4), (g)(7).
Method payment form		§ 1.482–7(h)(3).
Nonroutine contributions	*Nonroutine contributions* means a controlled participant's contributions to the relevant business activities that are not routine contributions. Nonroutine contributions ordinarily include both nonroutine platform contributions and nonroutine operating contributions used by controlled participants in the commercial exploitation of their interests in the cost shared intangibles (for example, marketing intangibles used by a controlled participant in its division to sell products that are based on the cost shared intangible).	§ 1.482–7(g).
Nonroutine residual divisional profit or loss.		§ 1.482–7(g)(7)(iii).
Operating contributions	An *operating contribution* is any resource or capability or right, other than a platform contribution, that a controlled participant has developed, maintained, or acquired prior to the CSA Start Date, or subsequent to the CSA Start Date by means other than operating cost contributions or cost contributions, that is reasonably anticipated to contribute to the CSA Activity within the controlled participant's division.	§ 1.482–7(g)(2)(ii), (g)(4)(vi)(E), (g)(7)(iii)(A) and (C).
Operating cost contributions	*Operating cost contributions* means all costs in the ordinary course of business on or after the CSA Start Date that, based on analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, developing resources, capabilities, or rights (other than reasonably anticipated cost shared intangibles) that are reasonably anticipated to contribute to the CSA Activity within the controlled participant's division.	§ 1.482–7(g)(2)(ii), (g)(4)(iii), (g)(7)(iii)(B).
PCT Payee		§ 1.482–7(b)(1)(ii).
PCT Payment		§ 1.482–7(b)(1)(ii).
PCT Payor		§ 1.482–7(b)(1)(ii), (i)(6)(i).
PCT Payor WACC		§ 1.482–7(i)(6)(iv)(D).
Periodic adjustments		§ 1.482–7(i)(6)(i).
Periodic Trigger		§ 1.482–7(i)(6)(i).
Platform contribution transaction or PCT		§ 1.482–7(a)(2), (b)(1)(ii).
Platform contributions		§ 1.482–7(c)(1).
Post-tax income		§ 1.482–7(g)(2)(v)(B)(*4*), (g)(4)(i)(G).
Pre-tax income		§ 1.482–7(g)(2)(v)(B)(*4*), (g)(4)(i)(G).
Projected benefit shares		§ 1.482–7(i)(2)(ii)(A).
PRRR		§ 1.482–7(i)(6)(ii).

Term	Definition	Main cross references
PVI		§ 1.482–7(i)(6)(iii)(C).
PVTP		§ 1.482–7(i)(6)(iii)(B).
Reasonably anticipated benefits	A controlled participant's *reasonably anticipated benefits* mean the benefits that reasonably may be anticipated to be derived from exploiting cost shared intangibles. For purposes of this definition, benefits mean the sum of additional revenue generated, plus cost savings, minus any cost increases from exploiting cost shared intangibles.	§ 1.482–7(e)(1).
Reasonably anticipated benefits or RAB shares.		§ 1.482–7(a)(1), (e)(1).
Reasonably anticipated cost shared intangible.		§ 1.482–7(d)(1)(ii).
Relevant business activity		§ 1.482–7(g)(7)(i).
Routine contributions	*Routine contributions* means a controlled participant's contributions to the relevant business activities that are of the same or similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled participants.	§ 1.482–7(g)(4), (g)(7).
Routine platform and operating contributions, and net routine platform and operating contributions.		§ 1.482–7(g)(4)(vii), 1.482–7(g)(7)(iii)(C)(*4*).
Specified payment form		§ 1.482–7(h)(3).
Stock-based compensation		§ 1.482–7(d)(3).
Stock options		§ 1.482–7(d)(3)(i).
Subsequent PCT		§ 1.482–7(g)(2)(viii).
Target		§ 1.482–7(g)(5)(i).
Tax rate	Reasonably anticipated effective tax rate with respect to the pre-tax income to which the tax rate is being applied. For example, under the income method, this rate would be the reasonably anticipated effective tax rate of the PCT Payor or PCT Payee under the cost sharing alternative or the licensing alternative, as appropriate.	§ 1.482–7(g)(2)(v)(B)(*4*)(*ii*), (g)(4)(i)(G).
Trigger PCT		§ 1.482–7(i)(6)(i).
Variable input parameter		§ 1.482–7(g)(2)(ix)(C).
WACC	*WACC* means weighted average cost of capital.	§ 1.482–7(i)(6)(iv)(D).

(ii) *Examples.* The following examples illustrate certain definitions in paragraph (j)(1)(i) of this section:

Example 1. Controlled participant. Foreign Parent (FP) is a foreign corporation engaged in the extraction of a natural resource. FP has a U.S. subsidiary (USS) to which FP sells supplies of this resource for sale in the United States. FP enters into a CSA with USS to develop a new machine to extract the natural resource. The machine uses a new extraction process that will be patented in the United States and in other countries. The CSA provides that USS will receive the rights to exploit the machine in the extraction of the natural resource in the United States, and FP will receive the rights in the rest of the world. This resource does not, however, exist in the United States. Despite the fact that USS has received the right to exploit this process in the United States, USS is not a controlled participant because it will not derive a benefit from exploiting the intangible developed under the CSA.

Example 2. Controlled participants. (i) U.S. Parent (USP), one foreign subsidiary (FS), and a second foreign subsidiary constituting the group's research arm (R + D) enter into a CSA to develop manufacturing intangibles for a new product line A. USP and FS are assigned the exclusive rights to exploit the intangibles respectively in the United States and the rest of the world, where each presently manufactures and sells various existing product lines. R + D is not assigned any rights to exploit the intangibles. R + D's activity consists solely in carrying out research for the group. It is reliably projected that the RAB shares of USP and FS will be 66⅔% and 33⅓%, respectively, and the parties' agreement provides that USP and FS will reimburse 66⅔% and 33⅓%, respectively, of the IDCs incurred by R + D with respect to the new intangible.

(ii) R + D does not qualify as a controlled participant within the meaning of paragraph (j)(1)(i) of this section, because it will not derive any benefits from exploiting cost shared intangibles. Therefore, R + D is treated as a service provider for purposes of this section and must receive arm's length consideration for the assistance it is deemed to provide to USP and FS, under the rules of paragraph (a)(3) of this section and §§ 1.482–4(f)(3)(iii) and (4), and 1.482–9, as appropriate. Such consideration must be treated as IDCs incurred by USP and FS in proportion to their RAB shares (that is, 66⅔% and 33⅓%, respectively). R + D will not be considered to bear any share of the IDCs under the arrangement.

Example 3. Cost shared intangible, reasonably anticipated cost shared intangible. U.S. Parent (USP) has developed and currently exploits an antihistamine, XY, which is manufactured in tablet form. USP enters into a CSA with its wholly-owned foreign subsidiary (FS) to develop XYZ, a new improved version of XY that will be manufactured as a nasal spray. Work under the CSA is fully devoted to developing XYZ, and XYZ is developed. During the development period, XYZ is a reasonably anticipated cost shared intangible under the CSA. Once developed, XYZ is a cost shared intangible under the CSA.

Example 4. Cost shared intangible. The facts are the same as in *Example 3*, except that in the course of developing XYZ, the controlled participants by accident discover ABC, a cure for disease D. ABC is a cost shared intangible under the CSA.

Example 5. Reasonably anticipated benefits. Controlled parties A and B enter into a cost sharing arrangement to develop product and process intangibles for an already existing Product P. Without such intangibles, A and B would each reasonably anticipate revenue, in present value terms, of $100M from sales of Product P until it became obsolete. With the intangibles, A and B each reasonably anticipate selling the same number of units each year, but reasonably anticipate that the price will be higher. Because the particular product intangible is more highly regarded in A's market, A reasonably anticipates an increase of $20M in present value revenue from the product intangible, while B reasonably anticipates only an increase of $10M. Further, A and B each reasonably anticipate spending an extra $5M present value in production costs to include the feature embodying the product intangible. Finally, A and B each reasonably anticipate saving $2M present value in production costs by using the process intangible. A and B reasonably anticipate no other economic effects from exploiting the cost shared intangibles. A's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue ($20M) plus its reasonably anticipated cost savings ($2M) minus its reasonably anticipated increased costs ($5M), which equals $17M. Similarly, B's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue ($10M) plus its reasonably anticipated cost savings ($2M) minus its reasonably anticipated increased costs ($5M), which equals $7M. Thus A's reasonably anticipated benefits are $17M and B's reasonably anticipated benefits are $7M.

(2) *Special rules*—(i) *Consolidated group*. For purposes of this section, all members of the same consolidated group shall be treated as one taxpayer. For these purposes, the term *consolidated group* means all members of a group of controlled entities created or organized within a single country and subjected to an income tax by such country on the basis of their combined income.

(ii) *Trade or business*. A participant that is a foreign corporation or nonresident alien individual will not be treated as engaged in a trade or business within the United States solely by reason of its participation in a CSA. See generally § 1.864–2(a).

(iii) *Partnership*. A CSA, or an arrangement to which the Commissioner applies the rules of this section, will not be treated as a partnership to which the rules of subchapter K of the Internal Revenue Code apply. See § 301.7701–1(c) of this chapter.

(3) *Character*—(i) *CST Payments*. CST Payments generally will be considered

the payor's costs of developing intangibles at the location where such development is conducted. For these purposes, IDCs borne directly by a controlled participant that are deductible are deemed to be reduced to the extent of any CST Payments owed to it by other controlled participants pursuant to the CSA. Each cost sharing payment received by a payee will be treated as coming pro rata from payments made by all payors and will be applied pro rata against the deductions for the taxable year that the payee is allowed in connection with the IDCs. Payments received in excess of such deductions will be treated as in consideration for use of the land and tangible property furnished for purposes of the CSA by the payee. For purposes of the research credit determined under section 41, CST Payments among controlled participants will be treated as provided for intra-group transactions in §1.41–6(i). Any payment made or received by a taxpayer pursuant to an arrangement that the Commissioner determines not to be a CSA will be subject to the provisions of §§1.482–1 through 1.482–6 and 1.482–9. Any payment that in substance constitutes a cost sharing payment will be treated as such for purposes of this section, regardless of its characterization under foreign law.

(ii) *PCT Payments*. A PCT Payor's payment required under paragraph (b)(1)(ii) of this section is deemed to be reduced to the extent of any payments owed to it under such paragraph from other controlled participants. Each PCT Payment received by a PCT Payee will be treated as coming pro rata out of payments made by all PCT Payors. PCT Payments will be characterized consistently with the designation of the type of transaction pursuant to paragraphs (c)(3) and (k)(2)(ii)(H) of this section. Depending on such designation, such payments will be treated as either consideration for a transfer of an interest in intangible property or for services.

(iii) *Examples*. The following examples illustrate this paragraph (j)(3):

Example 1. U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) form a CSA to develop a miniature widget, the Small R. Based on RAB shares, USP agrees to bear 40% and FS to bear 60% of the costs incurred during the term of the agreement. The principal IDCs are operating costs incurred by FS in Country Z of 100X annually, and costs incurred by USP in the United States also of 100X annually. Of the total costs of 200X, USP's share is 80X and FS's share is 120X so that FS must make a payment to USP of 20X. The payment will be treated as a reimbursement of 20X of USP's costs in the United States. Accordingly, USP's Form 1120 will reflect an 80X deduction on account of activities performed in the United States for purposes of allocation and apportionment of the deduction to source. The Form 5471 "Information Return of U.S. Persons With Respect to Certain Foreign Corporations" for FS will reflect a 100X deduction on account of activities performed in Country Z and a 20X deduction on account of activities performed in the United States.

Example 2. The facts are the same as in *Example 1*, except that the 100X of costs borne by USP consist of 5X of costs incurred by USP in the United States and 95X of arm's length rental charge, as described in paragraph (d)(1)(iii) of this section, for the use of a facility in the United States. The depreciation deduction attributable to the U.S. facility is 7X. The 20X net payment by FS to USP will first be applied in reduction pro rata of the 5X deduction for costs and the 7X depreciation deduction attributable to the U.S. facility. The 8X remainder will be treated as rent for the U.S. facility.

Example 3. (i) Four members (A, B, C, and D) of a controlled group form a CSA to develop the next generation technology for their business. Based on RAB shares, the participants agree to bear shares of the costs incurred during the term of the agreement in the following percentages: A 40%; B 15%; C 25%; and D 20%. The arm's length values of the platform contributions they respectively own are in the following amounts for the taxable year: A 80X; B 40X; C 30X; and D 30X. The provisional (before offsets) and final PCT Payments among A, B, C, and D are shown in the table as follows:

(All amounts stated in X's)

	A	B	C	D
Payments	<40>	<21>	<37.5>	<30>
Receipts	48	34	22.5	24
Final	8	13	<15>	<6>

(ii) The first row/first column shows A's provisional PCT Payment equal to the product of 100X (sum of 40X, 30X, and 30X) and A's RAB share of 40%. The second row/first column shows A's provisional PCT receipts equal to the sum of the products of 80X and B's, C's, and D's RAB shares (15%, 25%, and 20%, respectively). The other entries in the first two rows of the table are similarly computed. The last row shows the final PCT receipts/payments after offsets. Thus, for the taxable year, A and B are treated as receiving the 8X and 13X, respectively, pro rata out of payments by C and D of 15X and 6X, respectively.

(k) *CSA administrative requirements.* A controlled participant meets the requirements of this paragraph if it substantially complies, respectively, with the CSA contractual, documentation, accounting, and reporting requirements of paragraphs (k)(1) through (4) of this section.

(1) *CSA contractual requirements*—(i) *In general.* A CSA must be recorded in writing in a contract that is contemporaneous with the formation (and any revision) of the CSA and that includes the contractual provisions described in this paragraph (k)(1).

(ii) *Contractual provisions.* The written contract described in this paragraph (k)(1) must include provisions that—

(A) List the controlled participants and any other members of the controlled group that are reasonably anticipated to benefit from the use of the cost shared intangibles, including the address of each domestic entity and the country of organization of each foreign entity;

(B) Describe the scope of the IDA to be undertaken and each reasonably anticipated cost shared intangible or class of reasonably anticipated cost shared intangibles;

(C) Specify the functions and risks that each controlled participant will undertake in connection with the CSA;

(D) Divide among the controlled participants all divisional interests in cost shared intangibles and specify each controlled participant's divisional interest in the cost shared intangibles, as described in paragraphs (b)(1)(iii) and (4) of this section, that it will own and exploit without any further obligation to compensate any other controlled participant for such interest;

(E) Provide a method to calculate the controlled participants' RAB shares, based on factors that can reasonably be expected to reflect the participants' shares of anticipated benefits, and require that such RAB shares must be updated, as described in paragraph (e)(1) of this section (see also paragraph (k)(2)(ii)(F) of this section);

(F) Enumerate all categories of IDCs to be shared under the CSA;

(G) Specify that the controlled participant must use a consistent method of accounting to determine IDCs and RAB shares, as described in paragraphs (d) and (e) of this section, respectively, and must translate foreign currencies on a consistent basis;

(H) Require the controlled participant to enter into CSTs covering all IDCs, as described in paragraph (b)(1)(i) of this section, in connection with the CSA;

(I) Require the controlled participants to enter into PCTs covering all platform contributions, as described in paragraph (b)(1)(ii) of this section, in connection with the CSA;

(J) Specify the form of payment due under each PCT (or group of PCTs) in existence at the formation (and any revision) of the CSA, including information and explanation that reasonably supports an analysis of applicable provisions of paragraph (h) of this section; and

(K) Specify the date on which the CSA is entered into (CSA Start Date) and the duration of the CSA, the conditions under which the CSA may be modified or terminated, and the consequences of a modification or termination (including consequences described under the rules of paragraph (f) of this section).

(iii) *Meaning of contemporaneous*—(A) *In general.* For purposes of this paragraph (k)(1), a written contractual agreement is contemporaneous with the formation (or revision) of a CSA if, and only if, the controlled participants record the CSA, in its entirety, in a document that they sign and date no later than 60 days after the first occurrence of any IDC described in paragraph (d) of this section to which such agreement (or revision) is to apply.

(B) *Example.* The following example illustrates the principles of this paragraph (k)(1)(iii):

Example. Companies A and B, both of which are members of the same controlled group, commence an IDA on March 1, Year 1. Company A pays the first IDCs in relation to the IDA, as cash salaries to A's research staff, for the staff's work during the first week of March, Year 1. A and B, however, do not sign and date any written contractual agreement until August 1, Year 1, whereupon they execute a "Cost Sharing Agreement" that purports to be "effective as of" March 1 of Year 1. The arrangement fails the requirement that the participants record their arrangement in a written contractual agreement that is contemporaneous with the formation of a CSA. The arrangement has failed to meet the requirements set forth in paragraph (b)(2) of this section and, pursuant to paragraph (b) of this section, cannot be a CSA.

(iv) *Interpretation of contractual provisions*—(A) *In general*. The provisions of a written contract described in this paragraph (k)(1) and of the additional documentation described in paragraph (k)(2) of this section must be clear and unambiguous. The provisions will be interpreted by reference to the economic substance of the transaction and the actual conduct of the controlled participants. See §1.482–1(d)(3)(ii)(B) (Identifying contractual terms). Accordingly, the Commissioner may impute contractual terms in a CSA consistent with the economic substance of the CSA and may disregard contractual terms that lack economic substance. An allocation of risk between controlled participants after the outcome of such risk is known or reasonably knowable lacks economic substance. See §1.482–1(d)(3)(iii)(B) (Identification of taxpayer that bears risk). A contractual term that is disregarded due to a lack of economic substance does not satisfy a contractual requirement set forth in this paragraph (k)(1) or documentation requirement set forth in paragraph (k)(2) of this section. See paragraph (b)(5) of this section for the treatment of an arrangement among controlled taxpayers that fails to comply with the requirements of this section.

(B) *Examples*. The following examples illustrate the principles of this paragraph (k)(1)(iv). In each example, it is assumed that the Commissioner will exercise the discretion granted pursuant to paragraph (b)(5)(ii) of this section to apply the provisions of this section to the arrangement that purports to be a CSA.

Example 1. The contractual provisions recorded upon formation of an arrangement that purports to be a CSA provide that PCT Payments with respect to a particular platform contribution will consist of payments contingent on sales. Contrary to the contractual provisions, the PCT Payments actually made are contingent on profits. Because the controlled participants' actual conduct is different from the contractual terms, the Commissioner may determine, based on the facts and circumstances, that—

(i) The actual payments have economic substance and, therefore, impute payment terms in the CSA consistent with the actual payments; or

(ii) The contract terms reflect the economic substance of the arrangement and, therefore, the actual payments must be adjusted to conform to the terms.

Example 2. An arrangement that purports to be a CSA provides that PCT Payments with respect to a particular platform contribution shall be contingent payments equal to 10% of sales of products that incorporate cost shared intangibles. The contract terms further provide that the controlled participants must adjust such contingent payments in accordance with a formula set forth in the terms. During the first three years of the arrangement, the controlled participants fail to make the adjustments required by the terms with respect to the PCT Payments. The Commissioner may determine, based on the facts and circumstances, that—

(i) The contingent payment terms with respect to the platform contribution do not have economic substance because the controlled participants did not act in accordance with their upfront risk allocation; or

(ii) The contract terms reflect the economic substance of the arrangement and, therefore, the actual payments must be adjusted to conform to the terms.

(2) *CSA documentation requirements*—(i) *In general*. The controlled participants must timely update and maintain sufficient documentation to establish that the participants have met the CSA contractual requirements of paragraph (k)(1) of this section and the additional CSA documentation requirements of this paragraph (k)(2).

(ii) *Additional CSA documentation requirements*. The controlled participants to a CSA must timely update and maintain documentation sufficient to—

(A) Describe the current scope of the IDA and identify—

(*1*) Any additions or subtractions from the list of reasonably anticipated cost shared intangibles reported pursuant to paragraph (k)(1)(ii)(B) of this section;

(*2*) Any cost shared intangible, together with each controlled participant's interest therein; and

(*3*) Any further development of intangibles already developed under the CSA or of specified applications of such intangible which has been removed from the IDA (see paragraphs (d)(1)(ii) and (j)(1)(i) of this section for the definitions of reasonably anticipated cost shared intangible and cost shared intangible) and the steps (including any accounting classifications and allocations) taken to implement such removal;

(B) Establish that each controlled participant reasonably anticipates that it will derive benefits from exploiting cost shared intangibles;

(C) Describe the functions and risks that each controlled participant has undertaken during the term of the CSA;

(D) Provide an overview of each controlled participant's business segments, including an analysis of the economic and legal factors that affect CST and PCT pricing;

(E) Establish the amount of each controlled participant's IDCs for each taxable year under the CSA, including all IDCs attributable to stock-based compensation, as described in paragraph (d)(3) of this section (including the method of measurement and timing used in determining such IDCs, and the data, as of the date of grant, used to identify stock-based compensation with the IDA);

(F) Describe the method used to estimate each controlled participant's RAB share for each year during the course of the CSA, including—

(*1*) All projections used to estimate benefits;

(*2*) All updates of the RAB shares in accordance with paragraph (e)(1) of this section; and

(*3*) An explanation of why that method was selected and why the method provides the most reliable measure for estimating RAB shares;

(G) Describe all platform contributions;

(H) Designate the type of transaction involved for each PCT or group of PCTs;

(I) Specify, within the time period provided in paragraph (h)(2)(iii) of this section, the form of payment due under each PCT or group of PCTs, including information and explanation that reasonably supports an analysis of applicable provisions of paragraph (h) of this section;

(J) Describe and explain the method selected to determine the arm's length payment due under each PCT, including—

(*1*) An explanation of why the method selected constitutes the best method, as described in §1.482–1(c)(2), for measuring an arm's length result;

(*2*) The economic analyses, data, and projections relied upon in developing and selecting the best method, including the source of the data and projections used;

(*3*) Each alternative method that was considered, and the reason or reasons that the alternative method was not selected;

(*4*) Any data that the controlled participant obtains, after the CSA takes effect, that would help determine if the controlled participant's method selected has been applied in a reasonable manner;

(*5*) The discount rate or rates, where applicable, used for purposes of evaluating PCT Payments, including information and explanation that reasonably supports an analysis of applicable provisions of paragraph (g)(2)(v) of this section;

(*6*) The estimated arm's length values of any platform contributions as of the dates of the relevant PCTs, in accordance with paragraph (g)(2)(ii) of this section;

(*7*) A discussion, where applicable, of why transactions were or were not aggregated under the principles of paragraph (g)(2)(iv) of this section;

(*8*) The method payment form and any conversion made from the method payment form to the specified payment form, as described in paragraph (h)(3) of this section; and

(*9*) If applicable under paragraph (i)(6)(iv) of this section, the WACC of the parent of the controlled group that includes the controlled participants.

(iii) *Coordination rules and production of documents*—(A) *Coordination with penalty regulations*. See §1.6662–6(d)(2)(iii)(D) regarding coordination of the rules of this paragraph (k) with the documentation requirements for purposes of the accuracy-related penalty under section 6662(e) and (h).

(B) *Production of documentation.* Each controlled participant must provide to the Commissioner, within 30 days of a request, the items described in this paragraph (k)(2) and paragraph (k)(3) of this section. The time for compliance described in this paragraph (k)(2)(iii)(B) may be extended at the discretion of the Commissioner.

(3) *CSA accounting requirements*—(i) *In general.* The controlled participants must maintain books and records (and related or underlying data and information) that are sufficient to—

(A) Establish that the controlled participants have used (and are using) a consistent method of accounting to measure costs and benefits;

(B) Permit verification that the amount of any contingent PCT Payments due have been (and are being) properly determined;

(C) Translate foreign currencies on a consistent basis; and

(D) To the extent that the method of accounting used materially differs from U.S. generally accepted accounting principles, explain any such material differences.

(ii) *Reliance on financial accounting.* For purposes of this section, the controlled participants may not rely solely upon financial accounting to establish satisfaction of the accounting requirements of this paragraph (k)(3). Rather, the method of accounting must clearly reflect income. *Thor Power Tools Co.* v. *Commissioner*, 439 U.S. 522 (1979).

(4) *CSA reporting requirements*—(i) *CSA Statement.* Each controlled participant must file with the Internal Revenue Service, in the manner described in this paragraph (k)(4), a ''Statement of Controlled Participant to §1.482–7 Cost Sharing Arrangement'' (CSA Statement) that complies with the requirements of this paragraph (k)(4).

(ii) *Content of CSA Statement.* The CSA Statement of each controlled participant must—

(A) State that the participant is a controlled participant in a CSA;

(B) Provide the controlled participant's taxpayer identification number;

(C) List the other controlled participants in the CSA, the country of organization of each such participant, and the taxpayer identification number of each such participant;

(D) Specify the earliest date that any IDC described in paragraph (d)(1) of this section occurred; and

(E) Indicate the date on which the controlled participants formed (or revised) the CSA and, if different from such date, the date on which the controlled participants recorded the CSA (or any revision) contemporaneously in accordance with paragraphs (k)(1)(i) and (iii) of this section.

(iii) *Time for filing CSA Statement*—(A) *90-day rule.* Each controlled participant must file its original CSA Statement with the Internal Revenue Service Ogden Campus (addressed as follows: ''Attn: CSA Statements, Mail Stop 4912, Internal Revenue Service, 1973 North Rulon White Blvd., Ogden, Utah 84404–0040''), no later than 90 days after the first occurrence of an IDC to which the newly-formed CSA applies, as described in paragraph (k)(1)(iii)(A) of this section, or, in the case of a taxpayer that became a controlled participant after the formation of the CSA, no later than 90 days after such taxpayer became a controlled participant. A CSA Statement filed in accordance with this paragraph (k)(4)(iii)(A) must be dated and signed, under penalties of perjury, by an officer of the controlled participant who is duly authorized (under local law) to sign the statement on behalf of the controlled participant.

(B) *Annual return requirement*—(*1*) *In general.* Each controlled participant must attach to its U.S. income tax return, for each taxable year for the duration of the CSA, a copy of the original CSA Statement that the controlled participant filed in accordance with the 90-day rule of paragraph (k)(4)(iii)(A) of this section. In addition, the controlled participant must update the information reflected on the original CSA Statement annually by attaching a schedule that documents changes in such information over time.

(*2*) *Special filing rule for annual return requirement.* If a controlled participant is not required to file a U.S. income tax return, the participant must ensure that the copy or copies of the CSA Statement and any updates are attached to Schedule M of any Form 5471, any Form 5472 ''Information Return of a Foreign Owned Corporation,'' or any Form 8865 ''Return of U.S. Persons With Respect to Certain Foreign Partnerships,'' filed with respect to that participant.

(iv) *Examples*. The following examples illustrate this paragraph (k)(4). In each example, Companies A and B are members of the same controlled group.

Example 1. A and B, both of which file U.S. tax returns, agree to share the costs of developing a new chemical formula in accordance with the provisions of this section. On March 30, Year 1, A and B record their agreement in a written contract styled, ''Cost Sharing Agreement.'' The contract applies by its terms to IDCs occurring after March 1, Year 1. The first IDCs to which the CSA applies occurred on March 15, Year 1. To comply with paragraph (k)(4)(iii)(A) of this section, A and B individually must file separate CSA Statements no later than 90 days after March 15, Year 1 (June 13, Year 1). Further, to comply with paragraph (k)(4)(iii)(B) of this section, A and B must attach copies of their respective CSA Statements to their respective Year 1 U.S. income tax returns.

Example 2. The facts are the same as in *Example 1*, except that a year has passed and C, which files a U.S. tax return, joined the CSA on May 9, Year 2. To comply with the annual filing requirement described in paragraph (k)(4)(iii)(B) of this section, A and B must each attach copies of their respective CSA Statements (as filed for Year 1) to their respective Year 2 income tax returns, along with a schedule updated appropriately to reflect the changes in information described in paragraph (k)(4)(ii) of this section resulting from the addition of C to the CSA. To comply with both the 90-day rule described in paragraph (k)(4)(iii)(A) of this section and the annual filing requirement described in paragraph (k)(4)(iii)(B) of this section, C must file a CSA Statement no later than 90 days after May 9, Year 2 (August 7, Year 2), and must attach a copy of such CSA Statement to its Year 2 income tax return.

(l) *Effective/applicability dates*. Except as otherwise provided in this paragraph (l), this section applies on December 16, 2011. Paragraphs (g)(2)(v)(B)(*2*), (g)(4)(vi)(F)(*2*), and (g)(4)(viii), *Example 8* of this section apply to taxable years beginning on or after December 19, 2011. Paragraphs (g)(4)(v) and (g)(4)(viii), *Example 9* apply to taxable years beginning on or after August 27, 2013.

(m) *Transition rule*—(1) *In general*. An arrangement in existence on January 5, 2009, will be considered a CSA, as described under paragraph (b) of this section, if, prior to such date, it was a qualified cost sharing arrangement under the provisions of §1.482–7 (as contained in the 26 CFR part 1 edition revised as of January 1, 1996, hereafter referred to as ''former §1.482–7''), but only if the written contract, as described in paragraph (k)(1) of this section, is amended, if necessary, to conform with, and only if the activities of the controlled participants substantially comply with, the provisions of this section, as modified by paragraphs (m)(2) and (m)(3) of this section, by July 6, 2009.

(2) *Transitional modification of applicable provisions*. For purposes of this paragraph (m), conformity and substantial compliance with the provisions of this section shall be determined with the following modifications:

(i) CSTs and PCTs occurring prior to January 5, 2009, shall be subject to the provisions of former §1.482–7 rather than this section.

(ii) Except to the extent provided in paragraph (m)(3) of this section, PCTs that occur under a CSA that was a qualified cost sharing arrangement under the provisions of former §1.482–7 and remained in effect on January 5, 2009, shall be subject to the periodic adjustment rules of §1.482–4(f)(2) rather than the rules of paragraph (i)(6) of this section.

(iii) Paragraphs (b)(1)(iii) and (b)(4) of this section shall not apply.

(iv) Paragraph (k)(1)(ii)(D) of this section shall not apply.

(v) Paragraphs (k)(1)(ii)(H) and (I) of this section shall be construed as applying only to transactions entered into on or after January 5, 2009.

(vi) The deadline for recordation of the revised written contractual agreement pursuant to paragraph (k)(1)(iii) of this section shall be no later than July 6, 2009.

(vii) Paragraphs (k)(2)(ii)(G) through (J) of this section shall be construed as applying only with reference to PCTs entered into on or after January 5, 2009.

(viii) Paragraph (k)(4)(iii)(A) of this section shall be construed as requiring a CSA Statement with respect to the revised written contractual agreement described in paragraph (m)(2)(vi) of this section no later than September 2, 2009.

(ix) Paragraph (k)(4)(iii)(B) of this section shall be construed as only applying for taxable years ending after the filing of the CSA Statement described in paragraph (m)(2)(viii) of this section.

(3) *Special rule for certain periodic adjustments.* The periodic adjustment rules in paragraph (i)(6) of this section (rather than the rules of §1.482–4(f)(2)) shall apply to PCTs that occur on or after the date of a material change in the scope of the CSA from its scope as of January 5, 2009. A material change in scope would include a material expansion of the activities undertaken beyond the scope of the intangible development area, as described in former §1.482–7(b)(4)(iv). For this purpose, a contraction of the scope of a CSA, absent a material expansion into one or more lines of research and development beyond the scope of the intangible development area, does not constitute a material change in scope of the CSA. Whether a material change in scope has occurred is determined on a cumulative basis. Therefore, a series of expansions, any one of which is not a material expansion by itself, may collectively constitute a material expansion.

[T.D. 9568, 76 FR 80090, Dec. 22, 2011, as amended by T.D. 9569, 76 FR 80250, Dec. 23, 2011; 77 FR 3606, Jan. 25, 2012, 77 FR 8814, Feb. 14, 2012; T.D. 9630, 78 FR 52855, Aug. 27, 2013; 78 FR 62426, Oct. 22, 2013]

§ 1.482–8 Examples of the best method rule.

(a) *Introduction.* In accordance with the best method rule of §1.482–1(c), a method may be applied in a particular case only if the comparability, quality of data, and reliability of assumptions under that method make it more reliable than any other available measure of the arm's length result. The following examples illustrate the comparative analysis required to apply this rule. As with all of the examples in these regulations, these examples are based on simplified facts, are provided solely for purposes of illustrating the type of analysis required under the relevant rule, and do not provide rules of general application. Thus, conclusions reached in these examples as to the relative reliability of methods are based on the assumed facts of the examples, and are not general conclusions concerning the relative reliability of any method.

(b) *Examples.*

Example 1. Preference for comparable uncontrolled price method. Company A is the U.S. distribution subsidiary of Company B, a foreign manufacturer of consumer electrical appliances. Company A purchases toaster ovens from Company B for resale in the U.S. market. To exploit other outlets for its toaster ovens, Company B also sells its toaster ovens to Company C, an unrelated U.S. distributor of toaster ovens. The products sold to Company A and Company C are identical in every respect and there are no material differences between the transactions. In this case application of the CUP method, using the sales of toaster ovens to Company C, generally will provide a more reliable measure of an arm's length result for the controlled sale of toaster ovens to Company A than the application of any other method. See §§1.482–1(c)(2)(i) and –3(b)(2)(ii)(A).

Example 2. Resale price method preferred to comparable uncontrolled price method. The facts are the same as in Example 1, except that the toaster ovens sold to Company A are of substantially higher quality than those sold to Company C and the effect on price of such quality differences cannot be accurately determined. In addition, in order to round out its line of consumer appliances Company A purchases blenders from unrelated parties for resale in the United States. The blenders are resold to substantially the same customers as the toaster ovens, have a similar resale value to the toaster ovens, and are purchased under similar terms and in similar volumes. The distribution functions performed by Company A appear to be similar for toaster ovens and blenders. Given the product differences between the toaster ovens, application of the resale price method using the purchases and resales of blenders as the uncontrolled comparables is likely to provide a more reliable measure of an arm's length result than application of the comparable uncontrolled price method using Company B's sales of toaster ovens to Company C.

Example 3. Resale price method preferred to comparable profits method. (i) The facts are the same as in *Example 2* except that Company A purchases all its products from Company B and Company B makes no uncontrolled sales into the United States. However, six uncontrolled U.S. distributors are identified that purchase a similar line of products from unrelated parties. The uncontrolled distributors purchase toaster ovens from unrelated parties, but there are significant differences in the characteristics of the toaster ovens, including the brandnames under which they are sold.

(ii) Under the facts of this case, reliable adjustments for the effect of the different brandnames cannot be made. Except for some differences in payment terms and inventory levels, the purchases and resales of toaster ovens by the three uncontrolled distributors are closely similar to the controlled purchases in terms of the markets in which they occur, the volume of the transactions, the marketing activities undertaken by the distributor, inventory levels, warranties, allocation of currency risk, and other relevant functions and risks. Reliable adjustments can be made for the differences in payment terms and inventory levels. In addition, sufficiently detailed accounting information is available to permit adjustments to be made for differences in accounting methods or in reporting of costs between cost of goods sold and operating expenses. There are no other material differences between the controlled and uncontrolled transactions.

(iii) Because reliable adjustments for the differences between the toaster ovens, including the trademarks under which they are sold, cannot be made, these uncontrolled transactions will not serve as reliable measures of an arm's length result under the comparable uncontrolled price method. There is, however, close functional similarity between the controlled and uncontrolled transactions and reliable adjustments have been made for material differences that would be likely to affect gross profit. Under these circumstances, the gross profit margins derived under the resale price method are less likely to be susceptible to any unidentified differences than the operating profit measures used under the comparable profits method. Therefore, given the close functional comparability between the controlled and uncontrolled transactions, and the high quality of the data, the resale price method achieves a higher degree of comparability and will provide a more reliable measure of an arm's length result. See §1.482–1(c) (Best method rule).

Example 4. Comparable profits method preferred to resale price method. The facts are the same as in *Example 3,* except that the accounting information available for the uncontrolled comparables is not sufficiently detailed to ensure consistent reporting between cost of goods sold and operating expenses of material items such as discounts, insurance, warranty costs, and supervisory, general and administrative expenses. These expenses are significant in amount. Therefore, whether these expenses are treated as costs of goods sold or operating expenses would have a significant effect on gross margins. Because in this case reliable adjustments can not be made for such accounting differences, the reliability of the resale price method is significantly reduced. There is, however, close functional similarity between the controlled and uncontrolled transactions and reliable adjustments have been made for all material differences other than the potential accounting differences. Because the comparable profits method is not adversely affected by the potential accounting differences, under these circumstances the comparable profits method is likely to produce a more reliable measure of an arm's length result than the resale price method. See §1.482–1(c) (Best method rule).

Example 5. Cost plus method preferred to comparable profits method. (i) USS is a U.S. company that manufactures machine tool parts and sells them to its foreign parent corporation, FP. Four U.S. companies are identified that also manufacture various types of machine tool parts but sell them to uncontrolled purchasers.

(ii) Except for some differences in payment terms, the manufacture and sales of machine tool parts by the four uncontrolled companies are closely similar to the controlled transactions in terms of the functions performed and risks assumed. Reliable adjustments can be made for the differences in payment terms. In addition, sufficiently detailed accounting information is available to permit adjustments to be made for differences between the controlled transaction and the uncontrolled comparables in accounting methods and in the reporting of costs between cost of goods sold and operating expenses.

(iii) There is close functional similarity between the controlled and uncontrolled transactions and reliable adjustments can be made for material differences that would be likely to affect gross profit. Under these circumstances, the gross profit markups derived under the cost plus method are less likely to be susceptible to any unidentified differences than the operating profit measures used under the comparable profits method. Therefore, given the close functional comparability between the controlled and uncontrolled transactions, and the high quality of the data, the cost plus method achieves a higher degree of comparability and will provide a more reliable measure of an arm's length result. See §1.482–1(c) (Best method rule).

Example 6. Comparable profits method preferred to cost plus method. The facts are the same as in *Example 5,* except that there are significant differences between the controlled and uncontrolled transactions in terms of the types of parts and components manufactured and the complexity of the manufacturing process. The resulting functional differences are likely to materially affect gross profit margins, but it is not possible to identify the specific differences and reliably adjust for their effect on gross profit. Because these functional differences would be reflected in differences in operating expenses, the operating profit measures used under the comparable profits method implicitly reflect to some extent these functional differences. Therefore, because in this case the comparable profits method is less sensitive than the cost plus method to the potentially significant functional differences between the controlled and uncontrolled transactions, the comparable profits method is likely to produce a more reliable measure of an arm's length result than the cost plus method. See §1.482–1(c) (Best method rule).

Example 7. Preference for comparable uncontrolled transaction method. (i) USpharm, a U.S. pharmaceutical company, develops a new drug Z that is a safe and effective treatment for the disease zeezee. USpharm has obtained patents covering drug Z in the United States and in various foreign countries. USpharm has also obtained the regulatory authorizations necessary to market drug Z in the United States and in foreign countries.

(ii) USpharm licenses its subsidiary in country X, Xpharm, to produce and sell drug Z in country X. At the same time, it licenses an unrelated company, Ydrug, to produce and sell drug Z in country Y, a neighboring country. Prior to licensing the drug, USpharm had obtained patent protection and regulatory approvals in both countries and both countries provide similar protection for intellectual property rights. Country X and country Y are similar countries in terms of population, per capita income and the incidence of disease zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, costs of producing drug Z in each country are expected to be approximately the same.

(iii) USpharm and Xpharm establish terms for the license of drug Z that are identical in every material respect, including royalty rate, to the terms established between USpharm and Ydrug. In this case the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm's length royalty rate for the Xpharm license agreement. Given that the same property is transferred in the controlled and uncontrolled transactions, and that the circumstances under which the transactions occurred are substantially the same, in this case the comparable uncontrolled transaction method is likely to provide a more reliable measure of an arm's length result than any other method. See §1.482–4(c)(2)(ii).

Example 8. Residual profit split method preferred to other methods. (i) USC is a U.S. company that develops, manufactures and sells communications equipment. EC is the European subsidiary of USC. EC is an established company that carries out extensive research and development activities and develops, manufactures and sells communications equipment in Europe. There are extensive transactions between USC and EC. USC licenses valuable technology it has developed to EC for use in the European market but EC also licenses valuable technology it has developed to USC. Each company uses components manufactured by the other in some of its products and purchases products from the other for resale in its own market.

(ii) Detailed accounting information is available for both USC and EC and adjustments can be made to achieve a high degree of consistency in accounting practices between them. Relatively reliable allocations of costs, income and assets can be made between the business activities that are related to the controlled transactions and those that are not. Relevant marketing and research and development expenditures can be identified and reasonable estimates of the useful life of the related intangibles are available so that the capitalized value of the intangible development expenses of USC and EC can be calculated. In this case there is no reason to believe that the relative value of these capitalized expenses is substantially different from the relative value of the intangible property of USC and EC. Furthermore, comparables are identified that could be used to estimate a market return for the routine contributions of USC and EC. Based on these facts, the residual profit split could provide a reliable measure of an arm's length result.

(iii) There are no uncontrolled transactions involving property that is sufficiently comparable to much of the tangible and intangible property transferred between USC and EC to permit use of the comparable uncontrolled price method or the comparable uncontrolled transaction method. Uncontrolled companies are identified in Europe and the United States that perform somewhat similar activities to USC and EC; however, the activities of none of these companies are as complex as those of USC and EC and they do not use similar levels of highly valuable intangible property that they have developed themselves. Under these circumstances, the uncontrolled companies may be useful in determining a market return for the routine contributions of USC and EC, but that return would not reflect the value of the intangible property employed by USC and EC. Thus, none of the uncontrolled companies is sufficiently similar so that reliable results would be obtained using the resale price, cost plus, or comparable profits methods. Moreover, no uncontrolled companies can be identified that engaged in sufficiently similar activities and transactions with each other to employ the comparable profit split method.

(iv) Given the difficulties in applying the other methods, the reliability of the internal data on USC and EC, and the fact that acceptable comparables are available for deriving a market return for the routine contributions of USC and EC, the residual profit split method is likely to provide the most reliable measure of an arm's length result in this case.

Example 9. Comparable profits method preferred to profit split. (i) Company X is a large, complex U.S. company that carries out extensive research and development activities and manufactures and markets a variety of products. Company X has developed a new process by which compact disks can be fabricated at a fraction of the cost previously required. The process is expected to prove highly profitable, since there is a large market for compact disks. Company X establishes a new foreign subsidiary, Company Y, and licenses it the rights to use the process to fabricate compact disks for the foreign market as well as continuing technical support and improvements to the process. Company Y uses the process to fabricate compact disks which it supplies to related and unrelated parties.

(ii) The process licensed to Company Y is unique and highly valuable and no uncontrolled transfers of intangible property can be found that are sufficiently comparable to permit reliable application of the comparable uncontrolled transaction method. Company X is a large, complex company engaged in a variety of activities that owns unique and highly valuable intangible property. Consequently, no uncontrolled companies can be found that are similar to Company X. Furthermore, application of the profit split method in this case would involve the difficult and problematic tasks of allocating Company X's costs and assets between the relevant business activity and other activities and assigning a value to Company X's intangible contributions. On the other hand, Company Y performs relatively routine manufacturing and marketing activities and there are a number of similar uncontrolled companies. Thus, application of the comparable profits method using Company Y as the tested party is likely to produce a more reliable measure of an arm's length result than a profit split in this case.

Example 10. Cost of services plus method preferred to other methods. (i) FP designs and manufactures consumer electronic devices that incorporate advanced technology. In year 1, FP introduces Product X, an entertainment device targeted primarily at the youth market. FP's wholly-owned, exclusive U.S. distributor, USSub, sells Product X in the U.S. market. USSub hires an independent marketing firm, Agency A, to promote Product X in the U.S. market. Agency A has successfully promoted other electronic products on behalf of other uncontrolled parties. USSub executes a one-year, renewable contract with Agency A that requires it to develop the market for Product X, within an annual budget set by USSub. In years 1 through 3, Agency A develops advertising, buys media, and sponsors events featuring Product X. Agency A receives a markup of 25% on all expenses of promoting Product X, with the exception of media buys, which are reimbursed at cost. During year 3, sales of Product X decrease sharply, as Product X is displaced by competitors' products. At the end of year 3, sales of Product X are discontinued.

(ii) Prior to the start of year 4, FP develops a new entertainment device, Product Y. Like Product X, Product Y is intended for sale to the youth market, but it is marketed under a new trademark distinct from that used for Product X. USSub decides to perform all U.S. market promotion for Product Y. USSub hires key Agency A staff members who handled the successful Product X campaign. To promote Product Y, USSub intends to use methods similar to those used successfully by Agency A to promote Product X (print advertising, media, event sponsorship, *etc.*). FP and USSub enter into a one-year, renewable agreement concerning promotion of Product Y in the U.S. market. Under the agreement, FP compensates USSub for promoting Product Y, based on a cost of services plus markup of A%. Third-party media buys by USSub in connection with Product Y are reimbursed at cost.

(iii) Assume that under the contractual arrangements between FP and USSub, the arm's length consideration for Product Y and the trademark or other intangible property may be determined reliably under one or more transfer pricing methods. At issue in this example is the separate evaluation of the arm's length compensation for the year 4 promotional activities performed by USSub pursuant to its contract with FP.

(iv) USSub's accounting records contain reliable data that separately state the costs incurred to promote Product Y. A functional analysis indicates that USSub's activities to promote Product Y in year 4 are similar to activities performed by Agency A during years 1 through 3 under the contract with USSub. In other respects, no material differences exist in the market conditions or the promotional activities performed in year 4, as compared to those in years 1 through 3.

(v) It is possible to identify uncontrolled distributors or licensees of electronic products that perform, as one component of their business activities, promotional activities similar to those performed by USSub. However, it is unlikely that publicly available accounting data from these companies would allow computation of the comparable transactional costs or total services costs associated with the marketing or promotional activities that these entities perform, as one component of business activities. If that were possible, the comparable profits method for services might provide a reliable measure of an arm's length result. The functional analysis of the marketing activities performed by USSub in year 4 indicates that they are similar to the activities performed by Agency A in years 1 through 3 for Product X. Because reliable information is available concerning the markup on costs charged in a comparable uncontrolled transaction, the most reliable measure of an arm's length price is the cost of services plus method in §1.482–9(e).

Example 11. CPM for services preferred to other methods. (i) FP manufactures furniture and accessories for residential use. FP sells its products to retailers in Europe under the trademark, ''Moda.'' FP holds all worldwide rights to the trademark, including in the United States. USSub is FP's wholly-owned subsidiary in the U.S. market and the exclusive U.S. distributor of FP's merchandise. Historically, USSub dealt only with specialized designers in the U.S. market and advertised in trade publications targeted to this market. Although items sold in the U.S. and Europe are physically identical, USSub's U.S. customers generally resell the merchandise as non-branded merchandise.

(ii) FP retains an independent firm to evaluate the feasibility of selling FP's trademarked merchandise in the general wholesale and retail market in the United States. The study concludes that this segment of the U.S. market, which is not exploited by USSub, may generate substantial profits. Based on this study, FP enters into a separate agreement with USSub, which provides that USSub will develop this market in the United States for the benefit of FP. USSub separately accounts for personnel expenses, overhead, and out-of-pocket costs attributable to the initial stage of the marketing campaign (Phase I). USSub receives as compensation its costs, plus a markup of X%, for activities in Phase I. At the end of Phase I, FP will evaluate the program. If success appears likely, USSub will begin full-scale distribution of trademarked merchandise in the new market segment, pursuant to agreements negotiated with FP at that time.

(iii) Assume that under the contractual arrangements in effect between FP and USSub, the arm's length consideration for the merchandise and the trademark or other intangible property may be determined reliably under one or more transfer pricing methods. At issue in this example is the separate evaluation of the arm's length compensation for the marketing activities conducted by USSub in years 1 and following.

(iv) A functional analysis reveals that USSub's activities consist primarily of modifying the promotional materials created by FP, negotiating media buys, and arranging promotional events. FP separately compensates USSub for all Phase I activities, and detailed accounting information is available regarding the costs of these activities. The Phase I activities of USSub are similar to those of uncontrolled companies that perform, as their primary business activity, a range of advertising and media relations activities on a contract basis for uncontrolled parties.

(v) No information is available concerning the comparable uncontrolled prices for services in transactions similar to those engaged in by FP and USSub. Nor is any information available concerning uncontrolled transactions that would allow application of the cost of services plus method. It is possible to identify uncontrolled distributors or licensees of home furnishings that perform, as one component of their business activities, promotional activities similar to those performed by USSub. However, it is unlikely that publicly available accounting data from these companies would allow computation of the comparable transactional costs or total services costs associated with the marketing or promotional activities that these entities performed, as one component of their business activities. On the other hand, it is possible to identify uncontrolled advertising and media relations companies, the principal business activities of which are similar to the Phase I activities of USSub. Under these circumstances, the most reliable measure of an arm's length price is the comparable profits method of §1.482–9(f). The uncontrolled advertising comparables' treatment of material items, such as classification of items as cost of goods sold or selling, general, and administrative expenses, may differ from that of USSub. Such inconsistencies in accounting treatment between the uncontrolled comparables and the tested party, or among the comparables, are less important when using the ratio of operating profit to total services costs under the comparable profits method for services in §1.482–9(f). Under this method, the operating profit of USSub from the Phase I activities is compared to the operating profit of uncontrolled parties that perform general advertising and media relations as their primary business activity.

Example 12. Residual profit split preferred to other methods. (i) USP is a manufacturer of athletic apparel sold under the AA trademark, to which FP owns the worldwide rights. USP sells AA trademark apparel in countries throughout the world, but prior to year 1, USP did not sell its merchandise in Country X. In year 1, USP acquires an uncontrolled Country X company which becomes its wholly-owned subsidiary, XSub. USP enters into an exclusive distribution arrangement with XSub in Country X. Before being acquired by USP in year 1, XSub distributed athletic apparel purchased from uncontrolled suppliers and resold that merchandise to retailers. After being acquired by

USP in year 1, XSub continues to distribute merchandise from uncontrolled suppliers and also begins to distribute AA trademark apparel. Under a separate agreement with USP, XSub uses its best efforts to promote the AA trademark in Country X, with the goal of maximizing sales volume and revenues from AA merchandise.

(ii) Prior to year 1, USP executed long-term endorsement contracts with several prominent professional athletes. These contracts give USP the right to use the names and likenesses of the athletes in any country in which AA merchandise is sold during the term of the contract. These contracts remain in effect for five years, starting in year 1. Before being acquired by USP, XSub renewed a long-term agreement with SportMart, an uncontrolled company that owns a nationwide chain of sporting goods retailers in Country X. XSub has been SportMart's primary supplier from the time that SportMart began operations. Under the agreement, SportMart will provide AA merchandise preferred shelf-space and will feature AA merchandise at no charge in its print ads and seasonal promotions. In consideration for these commitments, USP and XSub grant SportMart advance access to new products and the right to use the professional athletes under contract with USP in SportMart advertisements featuring AA merchandise (subject to approval of content by USP).

(iii) Assume that it is possible to segregate all transactions by XSub that involve distribution of merchandise acquired from uncontrolled distributors (non-controlled transactions). In addition, assume that, apart from the activities undertaken by USP and XSub to promote AA apparel in Country X, the arm's length compensation for other functions performed by USP and XSub in the Country X market in years 1 and following can be reliably determined. At issue in this *Example 12* is the application of the residual profit split analysis to determine the appropriate division between USP and XSub of the balance of the operating profits from the Country X market, that is the portion attributable to nonroutine contributions to the marketing and promotional activities.

(iv) A functional analysis of the marketing and promotional activities conducted in the Country X market, as described in this example, indicates that both USP and XSub made nonroutine contributions to the business activity. USP contributed the long-term endorsement contracts with professional athletes. XSub contributed its long-term contractual rights with SportMart, which were made more valuable by its successful, long-term relationship with SportMart.

(v) Based on the facts and circumstances, including the fact that both USP and XSub made valuable nonroutine contributions to the marketing and promotional activities and an analysis of the availability (or lack thereof) of comparable and reliable market benchmarks, the Commissioner determines that the most reliable measure of an arm's length result is the residual profit split method in §1.482–9(g). The residual profit split analysis would take into account both routine and nonroutine contributions by USP and XSub, in order to determine an appropriate allocation of the combined operating profits in the Country X market from the sale of AA merchandise and from related promotional and marketing activities.

Example 13. Preference for acquisition price method. (i) USP develops, manufacturers, and distributes pharmaceutical products. USP and FS, USP's wholly-owned subsidiary, enter into a CSA to develop a new oncological drug, Oncol. Immediately prior to entering into the CSA, USP acquires Company X, an unrelated U.S. pharmaceutical company. Company X is solely engaged in oncological pharmaceutical research, and its only significant resources and capabilities are its workforce and its sole patent, which is associated with Compound X, a promising molecular compound derived from a rare plant, which USP reasonably anticipates will contribute to developing Oncol. All of Company X researchers will be engaged solely in research that is reasonably anticipated to contribute to developing Oncol as well. The rights in the Compound X and the commitment of Company X's researchers to the development of Oncol are platform contributions for which compensation is due from FS as part of a PCT.

(ii) In this case, the acquisition price method, based on the lump sum price paid by USP for Company X, is likely to provide a more reliable measure of an arm's length PCT Payment due to USP than the application of any other method. See §§1.482–4(c)(2) and 1.482–7(g)(5)(iv)(A).

Example 14. Preference for market capitalization method. (i) Company X is a publicly traded U.S. company solely engaged in oncological pharmaceutical research and its only significant resources and capabilities are its workforce and its sole patent, which is associated with Compound Y, a promising molecular compound derived from a rare plant. Company X has no marketable products. Company X enters into a CSA with FS, a newly-formed foreign subsidiary, to develop a new oncological drug, Oncol, derived from Compound Y. Compound Y is reasonably anticipated to contribute to developing Oncol. All of Company X researchers will be engaged solely in research that is reasonably anticipated to contribute to developing Oncol under the CSA. The rights in Compound Y and the commitment of Company X's researchers are platform contributions for which compensation is due from FS as part of a PCT.

(ii) In this case, given that Company X's platform contributions covered by PCTs relate to its entire economic value, the application of the market capitalization method, based on the market capitalization of Company X, provides a reliable measure of an arm's length result for Company X's PCTs to the CSA. See §§ 1.482–4(c)(2) and 1.482–7(g)(6)(v)(A).

Example 15. Preference for market capitalization method. (i) MicroDent, Inc. (MDI) is a publicly traded company that developed a new dental surgical microscope ScopeX–1, which drastically shortens many surgical procedures. On January 1 of Year 1, MDI entered into a CSA with a wholly-owned foreign subsidiary (FS) to develop ScopeX–2, the next generation of ScopeX–1. In the CSA, divisional interests are divided on a territorial basis. The rights associated with ScopeX–1, as well as MDI's research capabilities are reasonably anticipated to contribute to the development of ScopeX–2 and are therefore platform contributions for which compensation is due from FS as part of a PCT. At the time of the PCT, MDI's only product was the ScopeX–I microscope, although MDI was in the process of developing ScopeX–2. Concurrent with the CSA, MDI separately transfers exclusive and perpetual exploitation rights associated with ScopeX–1 to FS in the same territory as assigned to FS in the CSA.

(ii) Although the transactions between MDI and FS under the CSA are distinct from the transactions between MDI and FS relating to the exploitation rights for ScopeX–1, it is likely to be more reliable to evaluate the combined effect of the transactions than to evaluate them in isolation. This is because the combined transactions between MDI and FS relate to all of the economic value of MDI (that is, the exploitation rights and research rights associated with ScopeX–1, as well as the research capabilities of MDI). In this case, application of the market capitalization method, based on the enterprise value of MDI on January 1 of Year 1, is likely to provide a reliable measure of an arm's length payment for the aggregated transactions. See §§ 1.482–4(c)(2) and 1.482–7(g)(6)(v)(A).

(iii) Notwithstanding that the market capitalization method provides the most reliable measure of the aggregated transactions between MDI and FS, see § 1.482–7(g)(2)(iv) for further considerations of when further analysis may be required to distinguish between the remuneration to MDI associated with PCTs under the CSA (for research rights and capabilities associated with ScopeX–1) and the remuneration to MDI for the exploitation rights associated with ScopeX–1.

Example 16. Income method (applied using CPM) preferred to acquisition price method. The facts are the same as in *Example 13,* except that the acquisition occurred significantly in advance of formation of the CSA, and reliable adjustments cannot be made for this time difference. In addition, Company X has other valuable molecular patents and associated research capabilities, apart from Compound X, that are not reasonably anticipated to contribute to the development of Oncol and that cannot be reliably valued. The CSA divides divisional interests on a territorial basis. Under the terms of the CSA, USP will undertake all R&D (consisting of laboratory research and clinical testing) and manufacturing associated with Oncol, as well as the distribution activities for its territory (the United States). FS will distribute Oncol in its territory (the rest of the world). FS's distribution activities are routine in nature, and the profitability from its activities may be reliably determined from third-party comparables. FS does not furnish any platform contributions. At the time of the PCT, reliable (ex ante) financial projections associated with the development of Oncol and its separate exploitation in each of USP's and FSub's assigned geographical territories are undertaken. In this case, application of the income method using CPM is likely to provide a more reliable measure of an arm's length result than application of the acquisition price method based on the price paid by USP for Company X. See § 1.482–7(g)(4)(vi) and (5)(iv)(C).

Example 17. Evaluation of alternative methods. (i) The facts are the same as in *Example 13,* except that the acquisition occurred sometime prior to the CSA, and Company X has some areas of promising research that are not reasonably anticipated to contribute to developing Oncol. For purposes of this example, the CSA is assumed to divide divisional interests on a territorial basis. In general, the Commissioner determines that the acquisition price data is useful in informing the arm's length price, but not necessarily determinative. Under the terms of the CSA, USP will undertake all R&D (consisting of laboratory research and clinical testing) and manufacturing associated with Oncol, as well as the distribution activities for its territory (the United States). FS will distribute Oncol in its territory (the rest of the world). FS's distribution activities are routine in nature, and the profitability from its activities may be reliably determined from third-party comparables. At the time of the PCT, financial projections associated with the development of Oncol and its separate exploitation in each of USP's and FSub's assigned geographical territories are undertaken.

(ii) Under the facts, it is possible that the acquisition price method or the income method using CPM might reasonably be applied. Whether the acquisition price method or the income method provides the most reliable evidence of the arm's length price of USP's contributions depends on a number of factors, including the reliability of the financial projections, the reliability of the discount rate chosen, and the extent to which the acquisition price of Company X can be reliably adjusted to account for changes in value over the time period between the acquisition and the formation of the CSA and to account for the value of the in-process research done by Company X that does not constitute platform contributions to the CSA. See §1.482–7(g)(4)(vi) and (5)(iv)(A) and (C).

Example 18. Evaluation of alternative methods. (i) The facts are the same as in *Example 17*, except that FS has a patent on Compound Y, which the parties reasonably anticipate will be useful in mitigating potential side effects associated with Compound X and thereby contribute to the development of Oncol. The rights in Compound Y constitute a platform contribution for which compensation is due from USP as part of a PCT. The value of FS's platform contribution cannot be reliably measured by market benchmarks.

(ii) Under the facts, it is possible that either the acquisition price method and the income method together or the residual profit split method might reasonably be applied to determine the arm's length PCT Payments due between USP and FS. Under the first option the PCT Payment for the platform contributions related to Company X's workforce and Compound X would be determined using the acquisition price method referring to the lump sum price paid by USP for Company X. Because the value of these platform contributions can be determined by reference to a market benchmark, they are considered routine platform contributions. Accordingly, under this option, the platform contribution related to Compound Y would be the only nonroutine platform contribution and the relevant PCT Payment is determined using the income method. Under the second option, rather than looking to the acquisition price for Company X, all the platform contributions are considered nonroutine and the RPSM is applied to determine the PCT Payments for each platform contribution. Under either option, the PCT Payments will be netted against each other.

(iii) Whether the acquisition price method together with the income method or the residual profit split method provides the most reliable evidence of the arm's length price of the platform contributions of USP and FS depends on a number of factors, including the reliability of the determination of the relative values of the platform contributions for purposes of the RPSM, and the extent to which the acquisition price of Company X can be reliably adjusted to account for changes in value over the time period between the acquisition and the formation of the CSA and to account for the value of the rights in the in-process research done by Company X that does not constitute platform contributions to the CSA. In these circumstances, it is also relevant to consider whether the results of each method are consistent with each other, or whether one or both methods are consistent with other potential methods that could be applied. See §1.482–7(g)(4)(vi), (5)(iv), and (7)(iv).

(c) *Effective/applicability date*—(1) *In general.* Paragraphs (a) and (b) *Examples 10* through *12* of this section are generally applicable for taxable years beginning after December 31, 2006. Paragraph (b) *Examples 13* through *18* of this section are generally applicable on January 5, 2009.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of paragraph (b) *Examples 10,11*, and *12* of this section to earlier taxable years in accordance with the rules set forth in §1.482–9(n)(2).

[T.D. 8552, 59 FR 35028, July 8, 1994, as amended by T.D. 9278, 71 FR 44487, Aug. 4, 2006; T.D. 9441, 74 FR 388, Jan. 5, 2009; T.D. 9456, 74 FR 38845, Aug. 4, 2009; 74 FR 46346, Sept. 9, 2009; T.D. 9568, 76 FR 80134, Dec. 22, 2011]

§ 1.482–9 Methods to determine taxable income in connection with a controlled services transaction.

(a) *In general.* The arm's length amount charged in a controlled services transaction must be determined under one of the methods provided for in this section. Each method must be applied in accordance with the provisions of §1.482–1, including the best method rule of §1.482–1(c), the comparability analysis of §1.482–1(d), and the arm's length range of §1.482–1(e), except as those provisions are modified in this section. The methods are—

(1) The services cost method, described in paragraph (b) of this section;

(2) The comparable uncontrolled services price method, described in paragraph (c) of this section;

(3) The gross services margin method, described in paragraph (d) of this section;

(4) The cost of services plus method, described in paragraph (e) of this section;

(5) The comparable profits method, described in §1.482–5 and in paragraph (f) of this section;

(6) The profit split method, described in §1.482–6 and in paragraph (g) of this section; and

(7) Unspecified methods, described in paragraph (h) of this section.

(b) *Services cost method*—(1) *In general.* The services cost method evaluates whether the amount charged for certain services is arm's length by reference to the total services costs (as defined in paragraph (j) of this section) with no markup. If a taxpayer applies the services cost method in accordance with the rules of this paragraph (b), then it will be considered the best method for purposes of §1.482–1(c), and the Commissioner's allocations will be limited to adjusting the amount charged for such services to the properly determined amount of such total services costs.

(2) *Eligibility for the services cost method.* To apply the services cost method to a service in accordance with the rules of this paragraph (b), all of the following requirements must be satisfied with respect to the service—

(i) The service is a covered service as defined in paragraph (b)(3) of this section;

(ii) The service is not an excluded activity as defined in paragraph (b)(4) of this section;

(iii) The service is not precluded from constituting a covered service by the business judgment rule described in paragraph (b)(5) of this section; and

(iv) Adequate books and records are maintained as described in paragraph (b)(6) of this section.

(3) *Covered services.* For purposes of this paragraph (b), covered services consist of a controlled service transaction or a group of controlled service transactions (*see* §1.482–1(f)(2)(i) (aggregation of transactions)) that meet the definition of specified covered services or low margin covered services.

(i) *Specified covered services.* Specified covered services are controlled services transactions that the Commissioner specifies by revenue procedure. Services will be included in such revenue procedure based upon the Commissioner's determination that the specified covered services are support services common among taxpayers across industry sectors and generally do not involve a significant median comparable markup on total services costs. For the definition of the median comparable markup on total services costs, *see* paragraph (b)(3)(ii) of this section. The Commissioner may add to, subtract from, or otherwise revise the specified covered services described in the revenue procedure by subsequent revenue procedure, which amendments will ordinarily be prospective only in effect.

(ii) *Low margin covered services.* Low margin covered services are controlled services transactions for which the median comparable markup on total services costs is less than or equal to seven percent. For purposes of this paragraph (b), the median comparable markup on total services costs means the excess of the arm's length price of the controlled services transaction determined under the general section 482 regulations without regard to this paragraph (b), using the interquartile range described in §1.482–1(e)(2)(iii)(C) and as necessary adjusting to the median of such interquartile range, over total services costs, expressed as a percentage of total services costs.

(4) *Excluded activity.* The following types of activities are excluded activities:

(i) Manufacturing.

(ii) Production.

(iii) Extraction, exploration, or processing of natural resources.

(iv) Construction.

(v) Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement.

(vi) Research, development, or experimentation.

(vii) Engineering or scientific.

(viii) Financial transactions, including guarantees.

(ix) Insurance or reinsurance.

(5) *Not services that contribute significantly to fundamental risks of business success or failure.* A service cannot constitute a covered service unless the taxpayer reasonably concludes in its business judgment that the service does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group, as defined in §1.482–1(i)(6). In evaluating the reasonableness of the conclusion

required by this paragraph (b)(5), consideration will be given to all the facts and circumstances.

(6) *Adequate books and records*. Permanent books of account and records are maintained for as long as the costs with respect to the covered services are incurred by the renderer. Such books and records must include a statement evidencing the taxpayer's intention to apply the services cost method to evaluate the arm's length charge for such services. Such books and records must be adequate to permit verification by the Commissioner of the total services costs incurred by the renderer, including a description of the services in question, identification of the renderer and the recipient of such services, and sufficient documentation to allow verification of the methods used to allocate and apportion such costs to the services in question in accordance with paragraph (k) of this section.

(7) *Shared services arrangement*—(i) *In general*. If the services cost method is used to evaluate the amount charged for covered services, and such services are the subject of a shared services arrangement, then the arm's length charge to each participant for such services will be the portion of the total costs of the services otherwise determined under the services cost method of this paragraph (b) that is properly allocated to such participant pursuant to the arrangement.

(ii) *Requirements for shared services arrangement*. A shared services arrangement must meet the requirements described in this paragraph (b)(7).

(A) *Eligibility*. To be eligible for treatment under this paragraph (b)(7), a shared services arrangement must—

(*1*) Include two or more participants;

(*2*) Include as participants all controlled taxpayers that reasonably anticipate a benefit (as defined under paragraph (l)(3)(i) of this section) from one or more covered services specified in the shared services arrangement; and

(*3*) Be structured such that each covered service (or each reasonable aggregation of services within the meaning of paragraph (b)(7)(iii)(B) of this section) confers a benefit on at least one participant in the shared services arrangement.

(B) *Allocation*. The costs for covered services must be allocated among the participants based on their respective shares of the reasonably anticipated benefits from those services, without regard to whether the anticipated benefits are in fact realized. Reasonably anticipated benefits are benefits as defined in paragraph (l)(3)(i) of this section. The allocation of costs must provide the most reliable measure of the participants' respective shares of the reasonably anticipated benefits under the principles of the best method rule. *See* §1.482–1(c). The allocation must be applied on a consistent basis for all participants and services. The allocation to each participant in each taxable year must reasonably reflect that participant's respective share of reasonably anticipated benefits for such taxable year. If the taxpayer reasonably concluded that the shared services arrangement (including any aggregation pursuant to paragraph (b)(7)(iii)(B) of this section) allocated costs for covered services on a basis that most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to such services, as provided for in this paragraph (b)(7), then the Commissioner may not adjust such allocation basis.

(C) *Documentation*. The taxpayer must maintain sufficient documentation to establish that the requirements of this paragraph (b)(7) are satisfied, and include—

(*1*) A statement evidencing the taxpayer's intention to apply the services cost method to evaluate the arm's length charge for covered services pursuant to a shared services arrangement;

(*2*) A list of the participants and the renderer or renderers of covered services under the shared services arrangement;

(*3*) A description of the basis of allocation to all participants, consistent with the participants' respective shares of reasonably anticipated benefits; and

(*4*) A description of any aggregation of covered services for purposes of the shared services arrangement, and an indication whether this aggregation (if any) differs from the aggregation used to evaluate the median comparable markup for any low margin covered services described in paragraph (b)(3)(ii) of this section.

(iii) *Definitions and special rules*—(A) *Participant.* A participant is a controlled taxpayer that reasonably anticipates benefits from covered services subject to a shared services arrangement that substantially complies with the requirements described in this paragraph (b)(7).

(B) *Aggregation.* Two or more covered services may be aggregated in a reasonable manner taking into account all the facts and circumstances, including whether the relative magnitude of reasonably anticipated benefits of the participants sharing the costs of such aggregated services may be reasonably reflected by the allocation basis employed pursuant to paragraph (b)(7)(ii)(B) of this section. The aggregation of services under a shared services arrangement may differ from the aggregation used to evaluate the median comparable markup for any low margin covered services described in paragraph (b)(3)(ii) of this section, provided that such alternative aggregation can be implemented on a reasonable basis, including appropriately identifying and isolating relevant costs, as necessary.

(C) *Coordination with cost sharing arrangements.* To the extent that an allocation is made to a participant in a shared services arrangement that is also a participant in a cost sharing arrangement subject to §1.482–7T, such amount with respect to covered services is first allocated pursuant to the shared services arrangement under this paragraph (b)(7). Costs allocated pursuant to a shared services arrangement may (if applicable) be further allocated between the intangible property development activity under §1.482–7T and other activities of the participant.

(8) *Examples.* The application of this section is illustrated by the following examples. No inference is intended whether the presence or absence of one or more facts is determinative of the conclusion in any example. For purposes of *Examples 1* through *14*, assume that Company P and its subsidiaries, Company Q and Company R, are corporations and members of the same group of controlled entities (PQR Controlled Group). For purposes of *Example 15*, assume that Company P and its subsidiary, Company S, are corporations and members of the same group of controlled entities (PS Controlled Group). For purposes of *Examples 16* through *24*, assume that Company P and its subsidiaries, Company X, Company Y, and Company Z, are corporations and members of the same group of controlled entities (PXYZ Group) and that Company P and its subsidiaries satisfy all of the requirements for a shared services arrangement specified in paragraphs (b)(7)(ii) and (iii) of this section.

Example 1. Data entry services. (i) Company P, Company Q, and Company R own and operate hospitals. Each owns an electronic database of medical information gathered by doctors and nurses during interviews and treatment of its patients. All three databases are maintained and updated by Company P's administrative support employees who perform data entry activities by entering medical information from the paper records of Company P, Company Q, and Company R into their respective databases.

(ii) Assume that these services relating to data entry are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 2. Data entry services. (i) Company P, Company Q, and Company R specialize in data entry, data processing, and data conversion. Company Q and Company R's data entry activities involve converting medical information data contained in paper records to a digital format. Company P specializes in data entry activities. This specialization reflects, in part, proprietary quality control systems and specially trained data entry experts used to ensure the highest degree of accuracy of data entry services. Company P is engaged by Company Q and Company R to perform these data entry activities for them. Company Q and Company R then charge their customers for the data entry activities performed by Company P.

(ii) Assume that these services performed by Company P relating to data entry are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 3. Recruiting services. (i) Company P, Company Q, and Company R are manufacturing companies that sell their products to unrelated retail establishments. Company P's human resources department recruits mid-level managers and engineers for itself as well as for Company Q and Company R by attending job fairs and other recruitment events. For recruiting higher-level managers and engineers, each of these companies uses recruiters from unrelated executive search firms.

(ii) Assume that these services relating to recruiting are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 4. Recruiting services. (i) Company Q and Company R are executive recruiting service companies that are hired by other companies to recruit professionals. Company P is a recruiting agency that is engaged by Company Q and Company R to perform recruiting activities on their behalf in certain geographic areas.

(ii) Assume that the services performed by Company P are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 5. Credit analysis services. (i) Company P is a manufacturer and distributor of clothing for retail stores. Company Q and Company R are distributors of clothing for retail stores. As part of its operations, personnel in Company P perform credit analysis on its customers. Most of the customers have a history of purchases from Company P, and the credit analysis involves a review of the recent payment history of the customer's account. For new customers, the personnel in Company P perform a basic credit check of the customer using reports from a credit reporting agency. On behalf of Company Q and Company R, Company P performs credit analysis on customers who order clothing from Company Q and Company R using the same method as Company P uses for itself.

(ii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 6. Credit analysis services. (i) Company P, Company Q, and Company R lease furniture to retail customers who present a significant credit risk and are generally unable to lease furniture from other providers. As part of its leasing operations, personnel in Company P perform credit analysis on each of the potential lessees. The personnel have developed special expertise in determining whether a particular customer who presents a significant credit risk (as indicated by credit reporting agencies) will be likely to make the requisite lease payments on a timely basis. Also, as part of its operations, Company P performs similar credit analysis services for Company Q and Company R, which charge correspondingly high monthly lease payments.

(ii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 7. Credit analysis services. (i) Company P is a large full-service bank, which provides products and services to corporate and consumer markets, including unsecured loans, secured loans, lines of credit, letters of credit, conversion of foreign currency, consumer loans, trust services, and sales of certificates of deposit. Company Q makes routine consumer loans to individuals, such as auto loans and home equity loans. Company R makes only business loans to small businesses.

(ii) Company P performs credit analysis and prepares credit reports for itself, as well as for Company Q and Company R. Company P, Company Q and Company R regularly employ these credit reports in the ordinary course of business in making decisions regarding extensions of credit to potential customers (including whether to lend, rate of interest, and loan terms).

(iii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the credit analysis services constitute part of a ''financial transaction'' described in paragraph (b)(4)(viii) of this section. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 8. Data verification services. (i) Company P, Company Q and Company R are manufacturers of industrial supplies. Company P's accounting department performs periodic reviews of the accounts payable information of Company P, Company Q and Company R, and identifies any inaccuracies in the records, such as double-payments and double-charges.

(ii) Assume that these services relating to verification of data are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 9. Data verification services. (i) Company P gathers and inputs information regarding accounts payable and accounts receivable from unrelated parties and utilizes its own computer system to analyze that information for purposes of identifying errors in payment and receipts (data mining). Company P is compensated for these services based on a fee that reflects a percentage of amounts collected by customers as a result of the data mining services. These activities constitute a significant portion of Company P's business. Company P performs similar activities for Company Q and Company R by analyzing their accounts payable and accounts receivable records.

(ii) Assume that these services relating to data mining are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 10. Legal services. (i) Company P is a domestic corporation with two wholly-owned foreign subsidiaries, Company Q and Company R. Company P and its subsidiaries manufacture and distribute equipment used by industrial customers. Company P maintains an in-house legal department consisting of attorneys experienced in a wide range of business and commercial matters. Company Q and Company R maintain small legal departments, consisting of attorneys experienced in matters that most frequently arise in the normal course of business of Company Q and Company R in their respective jurisdictions.

(ii) Company P seeks to maintain in-house legal staff with the ability to address the majority of legal matters that arise in the United States with respect to the operations of Company P, as well as any U.S. reporting or compliance obligations of Company Q or Company R. These include the preparation and review of corporate contracts relating to, for example, product sales, equipment purchases and leases, business liability insurance, real estate, employee salaries and benefits. Company P relies on outside attorneys for major business transactions and highly technical matters such as patent licenses. The in-house legal staffs of Company Q and Company R are much more limited. It is necessary for Company P to retain several local law firms to handle litigation and business disputes arising from the activities of Company Q and Company R. Although Company Q and Company R pay the fees of these law firms, the hiring authority and general oversight of the firms' representation is in the legal department of Company P.

(iii) In determining what portion of the legal expenses of Company P may be allocated to Company Q and Company R, Company P first excludes any expenses relating to legal services that constitute shareholder activities and other items that are not properly analyzed as controlled services. Assume that the remaining services relating to general legal functions performed by in-house legal counsel are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these latter services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 11. Legal services. (i) Company P is a domestic holding company whose operating companies, Company Q and Company R, generate electric power for consumers by operating nuclear plants. Assume that, although Company P owns 100% of the stock of Companies Q and R, the companies do not elect to file a consolidated Federal income tax return with Company P.

(ii) Company P maintains an in-house legal department that includes attorneys who are experts in the areas of Federal utilities regulation, Federal labor and environmental law, and securities law. Companies Q and R maintain their own, smaller in-house legal staffs comprising experienced attorneys in the areas of state and local utilities regulation, state labor and employment law, and general commercial law. The legal department of Company P performs general oversight of the legal affairs of the company and determines whether a particular matter would be more efficiently handled by the Company P legal department, by the legal staffs in the operating companies, or in rare cases, by retained outside counsel. In general, Company P has succeeded in minimizing duplication and overlap of functions between the legal staffs of the various companies or by retained outside counsel.

(iii) The domestic nuclear power plant operations of Companies Q and R are subject to extensive regulation by the U.S. Nuclear Regulatory Commission (NRC). Operators are required to obtain pre-construction approval, operating licenses, and, at the end of the operational life of the nuclear reactor, nuclear decommissioning certificates. Company P files consolidated financial statements on behalf of itself, as well as Companies Q and R, with the United States Securities and Exchange Commission (SEC). In these SEC filings, Company P discloses that failure to obtain any of these licenses (and the related periodic renewals) or agreeing to licenses on terms less favorable than those granted to competitors would have a material adverse impact on the operations of Company Q or Company R. Company Q and Company R do not have in-house legal staff with experience in the NRC area. Company P maintains a group of in-house attorneys with specialized expertise in the NRC area that exclusively represents Company Q and Company R before the NRC. Although Company P occasionally hires an outside law firm or industry expert to assist on particular NRC matters, the majority of the work is performed by the specialized legal staff of Company P.

(iv) Certain of the legal services performed by Company P constitute duplicative or shareholder activities that do not confer a benefit on the other companies and therefore do not need to be allocated to the other companies, while certain other legal services are eligible to be charged to Company Q and Company R in accordance with the services cost method.

(v) Assume that the specialized legal services relating to nuclear licenses performed by in-house legal counsel of Company P are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 12. Group of services. (i) Company P, Company Q, and Company R are manufacturing companies that sell their products to unrelated retail establishments. Company P has an enterprise resource planning (ERP) system that maintains data relating to accounts payable and accounts receivable information for all three companies. Company P's personnel perform the daily operations on this ERP system such as inputting data relating to accounts payable and accounts receivable into the system and extracting data relating to accounts receivable and accounts payable in the form of reports or electronic media and providing those data to all three companies. Periodically, Company P's computer specialists also modify the ERP system to adapt to changing business functions in all three companies. Company P's computer specialists make these changes by either modifying the underlying software program or by purchasing additional software or hardware from unrelated third party vendors.

(ii) Assume that the services relating to accounts payable and accounts receivable are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

(iii) Assume that the services performed by Company P's computer specialists that relate to modifying the ERP system are specifically excluded from the services described in a revenue procedure referenced in paragraph (b)(3) of this section as developing hardware or software solutions (such as systems integration, Web site design, writing computer programs, modifying general applications software, or recommending the purchase of commercially available hardware or software). If these services do not constitute low margin covered services within the meaning of paragraph (b)(3)(ii) of this section, then Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 13. Group of services. (i) Company P manufactures and sells widgets under an exclusive contract to Customer 1. Company Q and Company R sell widgets under exclusive contracts to Customer 2 and Customer 3, respectively. At least one year in advance, each of these customers can accurately forecast its need for widgets. Using these forecasts, each customer over the course of the year places orders for widgets with the appropriate company, Company P, Company Q, or Company R. A customer's actual need for widgets seldom deviates from that customer's forecasted need.

(ii) It is most efficient for the PQR Controlled Group companies to manufacture and store an inventory of widgets in advance of delivery. Although all three companies sell widgets, only Company P maintains a centralized warehouse for widgets. Pursuant to a contract, Company P provides storage of these widgets to Company Q and Company R at an arm's length price.

(iii) Company P's personnel also obtain orders from all three companies' customers to draw up purchase orders for widgets as well as make payment to suppliers for widget replacement parts. In addition, Company P's personnel use data entry to input information regarding orders and sales of widgets and replacement parts for all three companies into a centralized computer system. Company P's personnel also maintain the centralized computer system and extract data for all three companies when necessary.

(iv) Assume that these services relating to tracking purchases and sales of inventory are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 14. Group of services. (i) Company P, Company Q, and Company R assemble and sell gadgets to unrelated customers. Each of these companies purchases the components necessary for assembly of the gadgets from unrelated suppliers. As a service to its subsidiaries, Company P's personnel obtain orders for components from all three companies, prepare purchase orders, and make payment to unrelated suppliers for the components. In addition, Company P's personnel use data entry to input information regarding orders and sales of gadgets for all three companies into a centralized computer. Company P's personnel also maintain the centralized computer system and extract data for all three companies on an as-needed basis. The services provided by Company P personnel, in conjunction with the centralized computer system, constitute a state-of-the-art inventory management system that allows Company P to order components necessary for assembly of the gadgets on a "just-in-time" basis.

(ii) Unrelated suppliers deliver the components directly to Company P, Company Q and Company R. Each company stores the components in its own facilities for use in filling specific customer orders. The companies do not maintain any inventory that is not identified in specific customer orders. Because of the efficiencies associated with services provided by personnel of Company P, all three companies are able to significantly reduce their inventory-related costs. Company P's Chief Executive Officer makes a statement in one of its press conferences with industry analysts that its inventory management system is critical to the company's success.

(iii) Assume that these services relating to tracking purchases and sales of inventory are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 15. Low margin covered services. Company P renders certain accounting services to Company S. Company P uses the services cost method for the accounting services, and determines the amount charged as its total cost of rendering the services, with no markup. Based on an application of the section 482 regulations without regard to this paragraph (b), the interquartile range of arm's length markups on total services costs for these accounting services is between 3%

and 9%, and the median is 6%. Because the median comparable markup on total services costs is 6%, which is less than 7%, the accounting services constitute low margin covered services within the meaning of paragraph (b)(3)(ii) of this section.

Example 16. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P operates a centralized data processing facility that performs automated invoice processing and order generation for all of its subsidiaries, Companies X, Y, Z, pursuant to a shared services arrangement.

(ii) In evaluating the shares of reasonably anticipated benefits from the centralized data processing services, the total value of the merchandise on the invoices and orders may not provide the most reliable measure of reasonably anticipated benefits shares, because value of merchandise sold does not bear a relationship to the anticipated benefits from the underlying covered services.

(iii) The total volume of orders and invoices processed may provide a more reliable basis for evaluating the shares of reasonably anticipated benefits from the data processing services. Alternatively, depending on the facts and circumstances, total central processing unit time attributable to the transactions of each subsidiary may provide a more reliable basis on which to evaluate the shares of reasonably anticipated benefits.

Example 17. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P operates a centralized center that performs human resources functions, such as administration of pension, retirement, and health insurance plans that are made available to employees of its subsidiaries, Companies X, Y, Z, pursuant to a shared services arrangement.

(ii) In evaluating the shares of reasonably anticipated benefits from these centralized services, the total revenues of each subsidiary may not provide the most reliable measure of reasonably anticipated benefit shares, because total revenues do not bear a relationship to the shares of reasonably anticipated benefits from the underlying services.

(iii) Employee headcount or total compensation paid to employees may provide a more reliable basis for evaluating the shares of reasonably anticipated benefits from the covered services.

Example 18. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P performs human resource services (service A) on behalf of the PXYZ Group that qualify for the services cost method. Under that method, Company P determines the amount charged for these services pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. Service A constitutes a specified covered service described in a revenue procedure pursuant to paragraph (b)(3)(i) of this section. The total services costs for service A otherwise determined under the services cost method is 300.

(ii) Companies X, Y and Z reasonably anticipate benefits from service A. Company P does not reasonably anticipate benefits from service A. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of charges pursuant to paragraph (k) of this section to Company X, Y and Z for service A is as follows:

SERVICE A

[Total cost 300]

Company	
X	150
Y	75
Z	75

(iii) The total number of employees (employee headcount) in each company is as follows:

Company X—600 employees.

Company Y—250 employees.

Company Z—250 employees.

(iv) Company P allocates the 300 total services costs of service A based on employee headcount as follows:

SERVICE A

[Total cost 300]

Allocation key	Company	
	Headcount	Amount
X	600	164
Y	250	68
Z	250	68

(v) Based on these facts, Company P may reasonably conclude that the employee headcount allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to service A.

Example 19. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P performs accounts payable services (service B) on behalf of the PXYZ Group and determines the amount charged for the services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. Service B is a specified covered service described in a revenue procedure pursuant to paragraph (b)(3)(i) of this section. The total services costs for service B otherwise determined under the services cost method is 500.

(ii) Companies X, Y and Z reasonably anticipate benefits from service B. Company P does not reasonably anticipate benefits from service B. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of charges pursuant to paragraph (k) of this section to Companies X, Y and Z for service B is as follows:

SERVICE B

[Total cost 500]

Company	
X	125
Y	205
Z	170

(iii) The total number of employees (employee headcount) in each company is as follows:

Company X—600.

Company Y—200.

Company Z—200.

(iv) The total number of transactions (transaction volume) with uncontrolled customers by each company is as follows:

Company X—2,000.

Company Y—4,000.

Company Z—3,500.

(v) If Company P allocated the 500 total services costs of service B based on employee headcount, the resulting allocation would be as follows:

SERVICE B

[Total cost 500]

Allocation key	Company	
	Headcount	Amount
X	600	300
Y	200	100
Z	200	100

(vi) In contrast, if Company P used volume of transactions with uncontrolled customers as the allocation basis under the shared services arrangement, the allocation would be as follows:

SERVICE B

[Total cost 500]

Allocation key	Company	
	Transaction Volume	Amount
X	2,000	105
Y	4,000	211
Z	3,500	184

SERVICE B—Continued

[Total cost 500]

(vii) Based on these facts, Company P may reasonably conclude that the transaction volume, but not the employee headcount, allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to service B.

Example 20. Shared services arrangement and aggregation. (i) Company P performs human resource services (service A) and accounts payable services (service B) on behalf of the PXYZ Group that qualify for the services cost method. Company P determines the amount charged for these services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. Service A and service B are specified covered services described in a revenue procedure pursuant to paragraph (b)(3)(i) of this section. The total services costs otherwise determined under the services cost method for service A is 300 and for service B is 500; total services costs for services A and B are 800. Company P determines that aggregation of services A and B for purposes of the arrangement is appropriate.

(ii) Companies X, Y and Z reasonably anticipate benefits from services A and B. Company P does not reasonably anticipate benefits from services A and B. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of total charges pursuant to paragraph (k) of this section to Companies X, Y and Z for services A and B is as follows:

SERVICES A AND B

[Total cost 800]

Company	
X	350
Y	100
Z	350

(iii) The total volume of transactions with uncontrolled customers in each company is as follows:

Company X—2,000.

Company Y—4,000.

Company Z—4,000.

(iv) The total number of employees in each company is as follows:

Company X—600.

Company Y—200.

Company Z—200.

(v) If Company P allocated the 800 total services costs of services A and B based on transaction volume or employee headcount, the resulting allocation would be as follows:

AGGREGATED SERVICES AB

[Total cost 800]

Company	Allocation key		Allocation key	
	Transaction volume	Amount	Headcount	Amount
X	2,000	160	600	480
Y	4,000	320	200	160
Z	4,000	320	200	160

(vi) In contrast, if aggregated services AB were allocated by reference to the total U.S. dollar value of sales to uncontrolled parties (trade sales) by each company, the following results would obtain:

AGGREGATED SERVICES AB

[Total costs 800]

Company	Allocation key	
	Trade sales (millions)	Amount
X	$400	314
Y	120	94
Z	500	392

(vii) Based on these facts, Company P may reasonably conclude that the trade sales, but not the transaction volume or the employee headcount, allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to services AB.

Example 21. Shared services arrangement and aggregation. (i) Company P performs services A through P on behalf of the PXYZ Group that qualify for the services cost method. Company P determines the amount charged for these services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. All of these services A through P constitute either specified covered services or low margin covered services described in paragraph (b)(3) of this section. The total services costs for services A through P otherwise determined under the services cost method is 500. Company P determines that aggregation of services A through P for purposes of the arrangement is appropriate.

(ii) Companies X and Y reasonably anticipate benefits from services A through P and Company Z reasonably anticipates benefits from services A through M but not from services N through P (Company Z performs services similar to services N through P on its own behalf). Company P does not reasonably anticipate benefits from services A through P. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of total charges pursuant to paragraph (k) of this section to Company X, Y, and Z for services A through P is as follows:

Company	Services A–M (cost 490)	Services N–P (cost 10)	Services A–P (total cost 500)
X	90	5	95
Y	240	5	245
Z	160	160	

(iii) The total volume of transactions with uncontrolled customers in each company is as follows:

Company X—2,000.

Company Y—4,500.

Company Z—3,500.

(iv) Company P allocates the 500 total services costs of services A through P based on transaction volume as follows:

AGGREGATED SERVICES A–Z

[Total costs 500]

Company	Allocation key	
	Transaction volume	Amount
X	2,000	100
Y	4,500	225
Z	3,500	175

(v) Based on these facts, Company P may reasonably conclude that the transaction volume allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to services A through P.

Example 22. Renderer reasonably anticipates benefits. (i) Company P renders services on behalf of the PXYZ Group that qualify for the services cost method. Company P determines the amount charged for these services under such method. Company P's share of reasonably anticipated benefits from services A, B, C, and D is 20% of the total reasonably anticipated benefits of all participants. Company P's total services cost for services A, B, C, and D charged within the group is 100.

(ii) Based on an application of paragraph (b)(7) of this section, Company P charges 80 which is allocated among Companies X, Y, and Z. No charge is made to Company P under the shared services arrangement for activities that it performs on its own behalf.

Example 23. Coordination with cost sharing arrangement. (i) Company P performs human resource services (service A) on behalf of the PXYZ Group that qualify for the services cost method. Company P determines the amount charged for these services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. Service A constitutes a specified covered service described in a revenue procedure pursuant to paragraph (b)(3)(i) of this section. The total services costs for service A otherwise determined under the services cost method is 300.

(ii) Company X, Y, Z, and P reasonably anticipate benefits from service A. Using a basis of allocation that is consistent with the controlled participants' respective shares of the reasonably anticipated benefits from the shared services, the total charge of 300 is allocated as follows:

X—100.
Y—50.
Z—25.
P—125.

(iii) In addition to performing services, P undertakes 500 of R&D and incurs manufacturing and other costs of 1,000.

(iv) Companies P and X enter into a cost sharing arrangement in accordance with §1.482–7T. Under the arrangement, Company P will undertake all intangible property development activities. All of Company P's research and development (R&D) activity is devoted to the intangible property development activity under the cost sharing arrangement. Company P will manufacture, market, and otherwise exploit the product in its defined territory. Companies P and X will share intangible property development costs in accordance with their reasonably anticipated benefits from the intangible property, and Company X will make payments to Company P as required under §1.482–7T. Company X will manufacture, market, and otherwise exploit the product in the rest of the world.

(v) A portion of the charge under the shared services arrangement is in turn allocable to the intangible property development activity undertaken by Company P. The most reliable estimate of the proportion allocable to the intangible property development activity is determined to be 500 (Company P's R&D expenses) divided by 1,500 (Company P's total non-covered services costs), or one-third. Accordingly, one-third of Company P's charge of 125, or 42, is allocated to the intangible property development activity. Companies P and X must share the intangible property development costs of the cost shared intangible property (including the charge of 42 that is allocated under the shared services arrangement) in proportion to their respective shares of reasonably anticipated benefits under the cost sharing arrangement. That is, the reasonably anticipated benefit shares under the cost sharing arrangement are determined separately from reasonably anticipated benefit shares under the shared services arrangement.

Example 24. Coordination with cost sharing arrangement. (i) The facts and analysis are the same as in *Example 25*, except that Company X also performs intangible property development activities related to the cost sharing arrangement. Using a basis of allocation that is consistent with the controlled participants' respective shares of the reasonably anticipated benefits from the shared services, the 300 of service costs is allocated as follows:

X—100.
Y—50.
Z—25.
P—125.

(ii) In addition to performing services, Company P undertakes 500 of R&D and incurs manufacturing and other costs of 1,000. Company X undertakes 400 of R&D and incurs manufacturing and other costs of 600.

(iii) Companies P and X enter into a cost sharing arrangement in accordance with §1.482–7T. Under the arrangement, both Companies P and X will undertake intangible property development activities. All of the research and development activity conducted by Companies P and X is devoted to the intangible property development activity under the cost sharing arrangement. Both Companies P and X will manufacture, market, and otherwise exploit the product in their respective territories and will share intangible property development costs in accordance with their reasonably anticipated benefits from the intangible property, and both will make payments as required under §1.482–7T.

(iv) A portion of the charge under the shared services arrangement is in turn allocable to the intangible property development activities undertaken by Companies P and X. The most reliable estimate of the portion allocable to Company P's intangible property development activity is determined to be 500 (Company P's R&D expenses) divided by 1,500 (P's total non-covered services costs), or one-third. Accordingly, one-third of Company P's allocated services cost method charge of 125, or 42, is allocated to its intangible property development activity.

(v) In addition, it is necessary to determine the portion of the charge under the shared services arrangement to Company X that should be further allocated to Company X's intangible property development activities under the cost sharing arrangement. The most reliable estimate of the portion allocable to Company X's intangible property development activity is 400 (Company X's R&D expenses) divided by 1,000 (Company X's costs), or 40%. Accordingly, 40% of the 100 that was allocated to Company X, or 40, is allocated in turn to Company X's intangible property development activities. Company X makes a payment to Company P of 100 under the shared services arrangement and includes 40 of services cost method charges in the pool of intangible property development costs.

(vi) The parties' respective contributions to intangible property development costs under the cost sharing arrangement are as follows:

P: 500 + (0.333 * 125) = 542
X: 400 + (0.40 * 100) = 440

(c) *Comparable uncontrolled services price method*—(1) *In general.* The comparable uncontrolled services price method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the amount charged in a comparable uncontrolled services transaction.

(2) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482–1(c). The application of these factors under the comparable uncontrolled services price method is discussed in paragraphs (c)(2)(ii) and (iii) of this section.

(ii) *Comparability*—(A) *In general.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the provisions of §1.482–1(d). Although all of the factors described in §1.482–1(d)(3) must be considered, similarity of the services rendered, and of the intangible property (if any) used in performing the services, generally will have the greatest effects on comparability under this method. In addition, because even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. The results derived from applying the comparable uncontrolled services price method generally will be the most direct and reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences from the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the comparable uncontrolled services price method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, if there are material differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's length result.

(B) *Adjustments for differences between controlled and uncontrolled transactions.* If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability provisions of §1.482–1(d)(2). Specific examples of factors that may be particularly relevant to application of this method include—

(*1*) Quality of the services rendered;

(*2*) Contractual terms (for example, scope and terms of warranties or guarantees regarding the services, volume, credit and payment terms, allocation of risks, including any contingent-payment terms and whether costs were incurred without a provision for current reimbursement);

(*3*) Intangible property (if any) used in rendering the services;

(*4*) Geographic market in which the services are rendered or received;

(*5*) Risks borne (for example, costs incurred to render the services, without provision for current reimbursement);

(*6*) Duration or quantitative measure of services rendered;

(*7*) Collateral transactions or ongoing business relationships between the renderer and the recipient, including arrangement for the provision of tangible property in connection with the services; and

(*8*) Alternatives realistically available to the renderer and the recipient.

(iii) *Data and assumptions.* The reliability of the results derived from the comparable uncontrolled services price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. *See* § 1.482–1(c) (best method rule).

(3) *Arm's length range. See* § 1.482–1(e)(2) for the determination of an arm's length range.

(4) *Examples.* The principles of this paragraph (c) are illustrated by the following examples:

Example 1. Internal comparable uncontrolled services price. Company A, a United States corporation, performs shipping, stevedoring, and related services for controlled and uncontrolled parties on a short-term or as-needed basis. Company A charges uncontrolled parties in Country X a uniform fee of $60 per container to place loaded cargo containers in Country X on oceangoing vessels for marine transportation. Company A also performs identical services in Country X for its wholly-owned subsidiary, Company B, and there are no substantial differences between the controlled and uncontrolled transactions. In evaluating the appropriate measure of the arm's length price for the container-loading services performed for Company B, because Company A renders substantially identical services in Country X to both controlled and uncontrolled parties, it is determined that the comparable uncontrolled services price constitutes the best method for determining the arm's length price for the controlled services transaction. Based on the reliable data provided by Company A concerning the price charged for services in comparable uncontrolled transactions, a loading charge of $60 per cargo container will be considered the most reliable measure of the arm's length price for the services rendered to Company B. *See* paragraph (c)(2)(ii)(A) of this section.

Example 2. External comparable uncontrolled services price. (i) The facts are the same as in *Example 1,* except that Company A performs services for Company B, but not for uncontrolled parties. Based on information obtained from unrelated parties (which is determined to be reliable under the comparability standards set forth in paragraph (c)(2) of this section), it is determined that uncontrolled parties in Country X perform services comparable to those rendered by Company A to Company B, and that such parties charge $60 per cargo container.

(ii) In evaluating the appropriate measure of an arm's length price for the loading services that Company A renders to Company B, the $60 per cargo container charge is considered evidence of a comparable uncontrolled services price. *See* paragraph (c)(2)(ii)(A) of this section.

Example 3. External comparable uncontrolled services price. The facts are the same as in *Example 2,* except that uncontrolled parties in Country X render similar loading and stevedoring services, but only under contracts that have a minimum term of one year. If the difference in the duration of the services has a material effect on prices, adjustments to account for these differences must be made to the results of the uncontrolled transactions according to the provisions of § 1.482–1(d)(2), and such adjusted results may be used as a measure of the arm's length result.

Example 4. Use of valuable intangible property. (i) Company A, a United States corporation in the biotechnology sector, renders research and development services exclusively to its affiliates. Company B is Company A's wholly-owned subsidiary in Country X. Company A renders research and development services to Company B.

(ii) In performing its research and development services function, Company A uses proprietary software that it developed internally. Company A uses the software to evaluate certain genetically engineered compounds developed by Company B. Company A owns the copyright on this software and does not license it to uncontrolled parties.

(iii) No uncontrolled parties can be identified that perform services identical or with a high degree of similarity to those performed by Company A. Because there are material differences for which reliable adjustments cannot be made, the comparable uncontrolled services price method is unlikely to provide a reliable measure of the arm's length price. *See* paragraph (c)(2)(ii)(A) of this section.

Example 5. Internal comparable. (i) Company A, a United States corporation, and its subsidiaries render computer consulting services relating to systems integration and networking to business clients in various countries. Company A and its subsidiaries render only consulting services, and do not manufacture computer hardware or software nor distribute such products. The controlled group is organized according to industry specialization, with key industry specialists working for Company A. These personnel typically form the core consulting group that teams with consultants from the local-country subsidiaries to serve clients in the subsidiaries' respective countries.

(ii) Company A and its subsidiaries sometimes undertake engagements directly for clients, and sometimes work as subcontractors to unrelated parties on more extensive supply-chain consulting engagements for clients. In undertaking the latter engagements with third party consultants, Company A typically prices its services based on consulting hours worked multiplied by a rate determined for each category of employee. The company also charges, at no markup, for out-of-pocket expenses such as travel, lodging, and data acquisition charges. The Company has established the following schedule of hourly rates:

Category	Rate
Project managers	$400 per hour.
Technical staff	$300 per hour.

(iii) Thus, for example, a project involving 100 hours of the time of project managers and 400 hours of technical staff time would result in the following project fees (without regard to any out-of-pocket expenses): ([100 hrs. × $400/hr.] + [400 hrs. × $300/hr.]) = $40,000 + $120,000 = $160,000.

(iv) Company B, a Country X subsidiary of Company A, contracts to perform consulting services for a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. In determining an arm's length charge, the price that Company A charges for consulting services as a subcontractor in comparable uncontrolled transactions will be considered evidence of a comparable uncontrolled services price. Thus, in this case, a payment of $144,000, (or [75 hrs. × $400/hr.] + [380 hrs. × $300/hr.] = $30,000 + $114,000) may be used as a measure of the arm's length price for the work performed by Company A project mangers and technical staff. In addition, if the comparable uncontrolled services price method is used, then, consistent with the practices employed by the comparables with respect to similar types of expenses, Company B must reimburse Company A for appropriate out-of-pocket expenses. *See* paragraph (c)(2)(ii)(A) of this section.

Example 6. Adjustments for differences. (i) The facts are the same as in *Example 5*, except that the engagement is undertaken with the client on a fixed fee basis. That is, prior to undertaking the engagement Company B and Company A estimate the resources required to undertake the engagement, and, based on hourly fee rates, charge the client a single fee for completion of the project. Company A's portion of the engagement results in fees of $144,000.

(ii) The engagement, once undertaken, requires 20% more hours by each of Companies A and B than originally estimated. Nevertheless, the unrelated client pays the fixed fee that was agreed upon at the start of the engagement. Company B pays Company A $144,000, in accordance with the fixed fee arrangement.

(iii) Company A often enters into similar fixed fee engagements with clients. In addition, Company A's records for similar engagements show that when it experiences cost overruns, it does not collect additional fees from the client for the difference between projected and actual hours. Accordingly, in evaluating whether the fees paid by Company B to Company A are arm's length, it is determined that no adjustments to the intercompany service charge are warranted. *See* § 1.482–1(d)(3)(ii) and paragraph (c)(2)(ii)(A) of this section.

(5) *Indirect evidence of the price of a comparable uncontrolled services transaction*—(i) *In general.* The price of a comparable uncontrolled services transaction may be derived based on indirect measures of the price charged in comparable uncontrolled services transactions, but only if—

(A) The data are widely and routinely used in the ordinary course of business in the particular industry or market segment for purposes of determining prices actually charged in comparable uncontrolled services transactions;

(B) The data are used to set prices in the controlled services transaction in the same way they are used to set prices in uncontrolled services transactions of the controlled taxpayer, or in the same way they are used by uncontrolled taxpayers to set prices in uncontrolled services transactions; and

(C) The amount charged in the controlled services transaction may be reliably adjusted to reflect differences in quality of the services, contractual terms, market conditions, risks borne (including contingent-payment terms), duration or quantitative measure of services rendered, and other factors that may affect the price to which uncontrolled taxpayers would agree.

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

Example. Indirect evidence of comparable uncontrolled services price. (i) Company A is a United States insurance company. Company A's wholly-owned Country X subsidiary, Company B, performs specialized risk analysis for Company A as well as for uncontrolled parties. In determining the price actually charged to uncontrolled entities for performing such risk analysis, Company B uses a proprietary, multi-factor computer program, which relies on the gross value of the policies in the customer's portfolio, the relative composition of those policies, their location, and the estimated number of personnel hours necessary to complete the project. Uncontrolled companies that perform comparable risk analysis in the same industry or market-segment use similar proprietary computer programs to price transactions with uncontrolled customers (the competitors' programs may incorporate different inputs, or may assign different weights or values to individual inputs, in arriving at the price).

(ii) During the taxable year subject to audit, Company B performed risk analysis for uncontrolled parties as well as for Company A. Because prices charged to uncontrolled customers reflected the composition of each customer's portfolio together with other factors, the prices charged in Company B's uncontrolled transactions do not provide a reliable basis for determining the comparable uncontrolled services price for the similar services rendered to Company A. However, in evaluating an arm's length price for the studies performed by Company B for Company A, Company B's proprietary computer program may be considered as indirect evidence of the comparable uncontrolled services price that would be charged to perform the services for Company A. The reliability of the results obtained by application of this internal computer program as a measure of an arm's length price for the services will be increased to the extent that Company A used the internal computer program to generate actual transaction prices for risk-analysis studies performed for uncontrolled parties during the same taxable year under audit; Company A used data that are widely and routinely used in the ordinary course of business in the insurance industry to determine the price charged; and Company A reliably adjusted the price charged in the controlled services transaction to reflect differences that may affect the price to which uncontrolled taxpayers would agree.

(d) *Gross services margin method*—(1) *In general*. The gross services margin method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. This method ordinarily is used in cases where a controlled taxpayer performs services or functions in connection with an uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer. This method may be used where a controlled taxpayer renders services (agent services) to another member of the controlled group in connection with a transaction between that other member and an uncontrolled taxpayer. This method also may be used in cases where a controlled taxpayer contracts to provide services to an uncontrolled taxpayer (intermediary function) and another member of the controlled group actually performs a portion of the services provided.

(2) *Determination of arm's length price*—(i) *In general*. The gross services margin method evaluates whether the price charged or amount retained by a controlled taxpayer in the controlled services transaction in connection with the relevant uncontrolled transaction is arm's length by determining the appropriate gross profit of the controlled taxpayer.

(ii) *Relevant uncontrolled transaction*. The relevant uncontrolled transaction is a transaction between a member of the controlled group and an uncontrolled taxpayer as to which the controlled taxpayer performs agent services or an intermediary function.

(iii) *Applicable uncontrolled price*. The applicable uncontrolled price is the price paid or received by the uncontrolled taxpayer in the relevant uncontrolled transaction.

(iv) *Appropriate gross services profit*. The appropriate gross services profit is computed by multiplying the applicable uncontrolled price by the gross services profit margin in comparable uncontrolled transactions. The determination of the appropriate gross services profit will take into account any functions performed by other members of the controlled group, as well as any other relevant factors described in §1.482–1(d)(3). The comparable gross services profit margin may be determined by reference to the commission in an uncontrolled transaction, where that commission is stated as a percentage of the price charged in the uncontrolled transaction.

(v) *Arm's length range. See* §1.482–1(e)(2) for determination of the arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482–1(c). The application of these factors under the gross services margin method is discussed in paragraphs (d)(3)(ii) and (iii) of this section.

(ii) *Comparability*—(A) *Functional comparability.* The degree of comparability between an uncontrolled transaction and a controlled transaction is determined by applying the comparability provisions of §1.482–1(d). A gross services profit provides compensation for services or functions that bear a relationship to the relevant uncontrolled transaction, including an operating profit in return for the investment of capital and the assumption of risks by the controlled taxpayer performing the services or functions under review. Therefore, although all of the factors described in §1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of services or functions performed, risks borne, intangible property (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross services profit margin should be derived from comparable uncontrolled transactions by the controlled taxpayer under review, because similar characteristics are more likely found among different transactions by the same controlled taxpayer than among transactions by other parties. In the absence of comparable uncontrolled transactions involving the same controlled taxpayer, an appropriate gross services profit margin may be derived from transactions of uncontrolled taxpayers involving comparable services or functions with respect to similarly related transactions.

(B) *Other comparability factors.* Comparability under this method is not dependent on close similarity of the relevant uncontrolled transaction to the related transactions involved in the uncontrolled comparables. However, substantial differences in the nature of the relevant uncontrolled transaction and the relevant transactions involved in the uncontrolled comparables, such as differences in the type of property transferred or service provided in the relevant uncontrolled transaction, may indicate significant differences in the services or functions performed by the controlled and uncontrolled taxpayers with respect to their respective relevant transactions. Thus, it ordinarily would be expected that the services or functions performed in the controlled and uncontrolled transactions would be with respect to relevant transactions involving the transfer of property within the same product categories or the provision of services of the same general type (for example, information-technology systems design). Furthermore, significant differences in the intangible property (if any) used by the controlled taxpayer in the controlled services transaction as distinct from the uncontrolled comparables may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross services profit margin, adjustments should be made to the gross services profit margin, according to the comparability provisions of §1.482–1(d)(2). For this purpose, consideration of the total services costs associated with functions performed and risks assumed may be necessary because differences in functions performed are often reflected in these costs. If there are differences in functions performed, however, the effect on gross services profit of such differences is not necessarily equal to the differences in the amount of related costs. Specific examples of factors that may be particularly relevant to this method include—

(*1*) Contractual terms (for example, scope and terms of warranties or guarantees regarding the services or function, volume, credit and payment terms, and allocation of risks, including any contingent-payment terms);

(*2*) Intangible property (if any) used in performing the services or function;

(*3*) Geographic market in which the services or function are performed or in which the relevant uncontrolled transaction takes place; and

(*4*) Risks borne, including, if applicable, inventory-type risk.

(D) *Buy-sell distributor*. If a controlled taxpayer that performs an agent service or intermediary function is comparable to a distributor that takes title to goods and resells them, the gross profit margin earned by such distributor on uncontrolled sales, stated as a percentage of the price for the goods, may be used as the comparable gross services profit margin.

(iii) *Data and assumptions*—(A) *In general*. The reliability of the results derived from the gross services margin method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. *See* §1.482–1(c) (best method rule).

(B) *Consistency in accounting*. The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit margin affects the reliability of the results under this method.

(4) *Examples*. The principles of this paragraph (d) are illustrated by the following examples:

Example 1. Agent services. Company A and Company B are members of a controlled group. Company A is a foreign manufacturer of industrial equipment. Company B is a U.S. company that acts as a commission agent for Company A by arranging for Company A to make direct sales of the equipment it manufactures to unrelated purchasers in the U.S. market. Company B does not take title to the equipment but instead receives from Company A commissions that are determined as a specified percentage of the sales price for the equipment that is charged by Company A to the unrelated purchaser. Company B also arranges for direct sales of similar equipment by unrelated foreign manufacturers to unrelated purchasers in the U.S. market. Company B charges these unrelated foreign manufacturers a commission fee of 5% of the sales price charged by the unrelated foreign manufacturers to the unrelated U.S. purchasers for the equipment. Information regarding the comparable agent services provided by Company B to unrelated foreign manufacturers is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjustments for such differences have been made. If the comparable gross services profit margin is 5% of the price charged in the relevant transactions involved in the uncontrolled comparables, then the appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is equal to 5% of the applicable uncontrolled price charged by Company A in sales of equipment in the relevant uncontrolled transactions.

Example 2. Agent services. The facts are the same as in *Example 1*, except that Company B does not act as a commission agent for unrelated parties and it is not possible to obtain reliable information concerning commission rates charged by uncontrolled commission agents that engage in comparable transactions with respect to relevant sales of property. It is possible, however, to obtain reliable information regarding the gross profit margins earned by unrelated parties that briefly take title to and then resell similar property in uncontrolled transactions, in which they purchase the property from foreign manufacturers and resell the property to purchasers in the U.S. market. Analysis of the facts and circumstances indicates that, aside from certain minor differences for which adjustments can be made, the uncontrolled parties that resell property perform similar functions and assume similar risks as Company B performs and assumes when it acts as a commission agent for Company A's sales of property. Under these circumstances, the gross profit margin earned by the unrelated distributors on the purchase and resale of property may be used, subject to any adjustments for any material differences between the controlled and uncontrolled transactions, as a comparable gross services profit margin. The appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is therefore equal to this comparable gross services margin, multiplied by the applicable uncontrolled price charged by Company A in its sales of equipment in the relevant uncontrolled transactions.

Example 3. Agent services. (i) Company A and Company B are members of a controlled group. Company A is a U.S. corporation that renders computer consulting services, including systems integration and networking, to business clients.

(ii) In undertaking engagements with clients, Company A in some cases pays a commission of 3% of its total fees to unrelated parties that assist Company A in obtaining consulting engagements. Typically, such fees are paid to non-computer consulting firms that provide strategic management services for their clients. When Company A obtains a consulting engagement with a client of a non-computer consulting firm, Company A does not subcontract with the other consulting firm, nor does the other consulting firm play any role in Company A's consulting engagement.

(iii) Company B, a Country X subsidiary of Company A, assists Company A in obtaining an engagement to perform computer consulting services for a Company B banking industry client in Country X. Although Company B has an established relationship with its Country X client and was instrumental in arranging for Company A's engagement with the client, Company A's particular expertise was the primary consideration in motivating the client to engage Company A. Based on the relative contributions of Companies A and B in obtaining and undertaking the engagement, Company B's role was primarily to facilitate the consulting engagement between Company A and the Country X client. Information regarding the commissions paid by Company A to unrelated parties for providing similar services to facilitate Company A's consulting engagements is sufficiently complete to conclude that it is likely that all material differences between these uncontrolled transactions and the controlled transaction between Company B and Company A have been identified and that appropriate adjustments have been made for any such differences. If the comparable gross services margin earned by unrelated parties in providing such agent services is 3% of total fees charged in the relevant transactions involved in the uncontrolled comparables, then the appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is equal to this comparable gross services margin (3%), multiplied by the applicable uncontrolled price charged by Company A in its relevant uncontrolled consulting engagement with Company B's client.

Example 4. Intermediary function. (i) The facts are the same as in *Example 3*, except that Company B contracts directly with its Country X client to provide computer consulting services and Company A performs the consulting services on behalf of Company B. Company A does not enter into a consulting engagement with Company B's Country X client. Instead, Company B charges its Country X client an uncontrolled price for the consulting services, and Company B pays a portion of the uncontrolled price to Company A for performing the consulting services on behalf of Company B.

(ii) Analysis of the relative contributions of Companies A and B in obtaining and undertaking the consulting contract indicates that Company B functioned primarily as an intermediary contracting party, and the gross services margin method is the most reliable method for determining the amount that Company B may retain as compensation for its intermediary function with respect to Company A's consulting services. In this case, therefore, because Company B entered into the relevant uncontrolled transaction to provide services, Company B receives the applicable uncontrolled price that is paid by the Country X client for the consulting services. Company A technically performs services for Company B when it performs, on behalf of Company B, the consulting services Company B contracted to provide to the Country X client. The arm's length amount that Company A may charge Company B for performing the consulting services on Company B's behalf is equal to the applicable uncontrolled price received by Company B in the relevant uncontrolled transaction, less Company B's appropriate gross services profit, which is the amount that Company B may retain as compensation for performing the intermediary function.

(iii) Reliable data concerning the commissions that Company A paid to uncontrolled parties for assisting it in obtaining engagements to provide consulting services similar to those it has provided on behalf of Company B provide useful information in applying the gross services margin method. However, consideration should be given to whether the third party commission data may need to be adjusted to account for any additional risk that Company B may have assumed as a result of its function as an intermediary contracting party, compared with the risk it would have assumed if it had provided agent services to assist Company A in entering into an engagement to provide its consulting service directly. In this case, the information regarding the commissions paid by Company A to unrelated parties for providing agent services to facilitate its performance of consulting services for unrelated parties is sufficiently complete to conclude that all material differences between these uncontrolled transactions and the controlled performance of an intermediary function, including possible differences in the amount of risk assumed in connection with performing that function, have been identified and that appropriate adjustments have been made. If the comparable gross services margin earned by unrelated parties in providing such agent services is 3% of total fees charged in Company B's relevant uncontrolled transactions, then the appropriate gross services profit that Company B may retain as compensation for performing an intermediary function (and the amount, therefore, that is deducted from the applicable uncontrolled price to arrive at the arm's length price that Company A may charge Company B for performing consulting services on Company B's behalf) is equal to this comparable gross services margin (3%), multiplied by the applicable uncontrolled price charged by Company B in its contract to provide services to the uncontrolled party.

Example 5. External comparable. (i) The facts are the same as in *Example 4*, except that neither Company A nor Company B engages in transactions with third parties that facilitate similar consulting engagements.

(ii) Analysis of the relative contributions of Companies A and B in obtaining and undertaking the contract indicates that Company B's role was primarily to facilitate the consulting arrangement between Company A and the Country X client. Although no reliable internal data are available regarding comparable transactions with uncontrolled entities, reliable data exist regarding commission rates for similar facilitating services between uncontrolled parties. These data indicate that a 3% commission (3% of total engagement fee) is charged in such transactions. Information regarding the uncontrolled comparables is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. If the appropriate gross services profit margin is 3% of total fees, then an arm's length result of the controlled services transaction is for Company B to retain an amount equal to 3% of total fees paid to it.

(e) *Cost of services plus method*—(1) *In general.* The cost of services plus method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross services profit markup realized in comparable uncontrolled transactions. The cost of services plus method is ordinarily used in cases where the controlled service renderer provides the same or similar services to both controlled and uncontrolled parties. This method is ordinarily not used in cases where the controlled services transaction involves a contingent-payment arrangement, as described in paragraph (i)(2) of this section.

(2) *Determination of arm's length price*—(i) *In general.* The cost of services plus method measures an arm's length price by adding the appropriate gross services profit to the controlled taxpayer's comparable transactional costs.

(ii) *Appropriate gross services profit.* The appropriate gross services profit is computed by multiplying the controlled taxpayer's comparable transactional costs by the gross services profit markup, expressed as a percentage of the comparable transactional costs earned in comparable uncontrolled transactions.

(iii) *Comparable transactional costs.* Comparable transactional costs consist of the costs of providing the services under review that are taken into account as the basis for determining the gross services profit markup in comparable uncontrolled transactions. Depending on the facts and circumstances, such costs typically include all compensation attributable to employees directly involved in the performance of such services, materials and supplies consumed or made available in rendering such services, and may include as well other costs of rendering the services. Comparable transactional costs must be determined on a basis that will facilitate comparison with the comparable uncontrolled transactions. For that reason, comparable transactional costs may not necessarily equal total services costs, as defined in paragraph (j) of this section, and in appropriate cases may be a subset of total services costs. Generally accepted accounting principles or Federal income tax accounting rules (where Federal income tax data for comparable transactions or business activities are available) may provide useful guidance but will not conclusively establish the appropriate comparable transactional costs for purposes of this method.

(iv) *Arm's length range. See* §1.482–1(e)(2) for determination of an arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described

under the best method rule in § 1.482–1(c).

(ii) *Comparability*—(A) *Functional comparability*. The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of § 1.482–1(d). A service renderer's gross services profit provides compensation for performing services related to the controlled services transaction under review, including an operating profit for the service renderer's investment of capital and assumptions of risks. Therefore, although all of the factors described in § 1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of services or functions performed, risks borne, intangible property (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross services profit markup should be derived from comparable uncontrolled transactions of the same taxpayer participating in the controlled services transaction because similar characteristics are more likely to be found among services provided by the same service provider than among services provided by other service providers. In the absence of such services transactions, an appropriate gross services profit markup may be derived from comparable uncontrolled services transactions of other service providers. If the appropriate gross services profit markup is derived from comparable uncontrolled services transactions of other service providers, in evaluating comparability the controlled taxpayer must consider the results under this method expressed as a markup on total services costs of the controlled taxpayer, because differences in functions performed may be reflected in differences in service costs other than those included in comparable transactional costs.

(B) *Other comparability factors*. Comparability under this method is less dependent on close similarity between the services provided than under the comparable uncontrolled services price method. Substantial differences in the services may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions would involve services of the same general type (for example, information-technology systems design). Furthermore, if a significant amount of the controlled taxpayer's comparable transactional costs consists of service costs incurred in a tax accounting period other than the tax accounting period under review, the reliability of the analysis would be reduced. In addition, significant differences in the value of the services rendered, due for example to the use of valuable intangible property, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency-related factors (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between the controlled and uncontrolled transactions*. If there are material differences between the controlled and uncontrolled transactions that would affect the gross services profit markup, adjustments should be made to the gross services profit markup earned in the comparable uncontrolled transaction according to the provisions of § 1.482–1(d)(2). For this purpose, consideration of the comparable transactional costs associated with the functions performed and risks assumed may be necessary, because differences in the functions performed are often reflected in these costs. If there are differences in functions performed, however, the effect on gross services profit of such differences is not necessarily equal to the differences in the amount of related comparable transactional costs. Specific examples of the factors that may be particularly relevant to this method include—

(*1*) The complexity of the services;

(*2*) The duration or quantitative measure of services;

(*3*) Contractual terms (for example, scope and terms of warranties or guarantees provided, volume, credit and payment terms, allocation of risks, including any contingent-payment terms);

(*4*) Economic circumstances; and

(*5*) Risks borne.

(iii) *Data and assumptions*—(A) *In general*. The reliability of the results derived from the cost of services plus method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. *See* §1.482–1(c) (Best method rule).

(B) *Consistency in accounting*. The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit markup affects the reliability of the results under this method. Thus, for example, if differences in cost accounting practices would materially affect the gross services profit markup, the ability to make reliable adjustments for such differences would affect the reliability of the results obtained under this method. Further, reliability under this method depends on the extent to which the controlled and uncontrolled transactions reflect consistent reporting of comparable transactional costs. For purposes of this paragraph (e)(3)(iii)(B), the term *comparable transactional costs* includes the cost of acquiring tangible property that is transferred (or used) with the services, to the extent that the arm's length price of the tangible property is not separately evaluated as a controlled transaction under another provision.

(4) *Examples*. The principles of this paragraph (e) are illustrated by the following examples:

Example 1. Internal comparable. (i) Company A designs and assembles information-technology networks and systems. When Company A renders services for uncontrolled parties, it receives compensation based on time and materials as well as certain other related costs necessary to complete the project. This fee includes the cost of hardware and software purchased from uncontrolled vendors and incorporated in the final network or system, plus a reasonable allocation of certain specified overhead costs incurred by Company A in providing these services. Reliable accounting records maintained by Company A indicate that Company A earned a gross services profit markup of 10% on its time, materials and specified overhead in providing design services during the year under examination on information technology projects for uncontrolled entities.

(ii) Company A designed an information-technology network for its Country X subsidiary, Company B. The services rendered to Company B are similar in scope and complexity to services that Company A rendered to uncontrolled parties during the year under examination. Using Company A's accounting records (which are determined to be reliable under paragraph (e)(3) of this section), it is possible to identify the comparable transactional costs involved in the controlled services transaction with reference to the costs incurred by Company A in rendering similar design services to uncontrolled parties. Company A's records indicate that it does not incur any additional types of costs in rendering similar services to uncontrolled customers. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on the gross services profit markup data derived from Company A's uncontrolled transactions involving similar design services, an arm's length result for the controlled services transaction is equal to the price that will allow Company A to earn a 10% gross services profit markup on its comparable transactional costs.

Example 2. Inability to adjust for differences in comparable transactional costs. The facts are the same as in *Example 1*, except that Company A's staff that rendered the services to Company B consisted primarily of engineers in training status or on temporary rotation from other Company A subsidiaries. In addition, the Company B network incorporated innovative features, including specially designed software suited to Company B's requirements. The use of less-experienced personnel and staff on temporary rotation, together with the special features of the Company B network, significantly increased the time and costs associated with the project as compared to time and costs associated with similar projects completed for uncontrolled customers. These factors constitute material differences between the controlled and the uncontrolled transactions that affect the determination of Company A's comparable transactional costs associated with the controlled services transaction, as well as the gross services profit markup. Moreover, it is not possible to perform reliable adjustments for these differences on the basis of the available accounting data. Under these circumstances, the reliability of the cost of services plus method as a measure of an arm's length price is substantially reduced.

Example 3. Operating loss by reference to total services costs. The facts and analysis are the same as in *Example 1*, except that an unrelated Company C, instead of Company A, renders similar services to uncontrolled parties and publicly available information indicates that Company C earned a gross services profit markup of 10% on its time, materials and certain specified overhead in providing those services. As in *Example 1*, Company A still provides services for its Country X subsidiary, Company B. In accordance with the requirements in paragraph (e)(3)(ii) of this section, the taxpayer performs additional analysis and restates the results of Company A's controlled services transaction with its Country X subsidiary, Company B, in the form of a markup on Company A's total services costs. This analysis by reference to total services costs shows that Company A generated an operating loss on the controlled services transaction, which indicates that functional differences likely exist between the controlled services transaction performed by Company A and uncontrolled services transactions performed by Company C, and that these differences may not be reflected in the comparable transactional costs. Upon further scrutiny, the presence of such functional differences between the controlled and uncontrolled transactions may indicate that the cost of services plus method does not provide the most reliable measure of an arm's length result under the facts and circumstances.

Example 4. Internal comparable. (i) Company A, a U.S. corporation, and its subsidiaries perform computer consulting services relating to systems integration and networking for business clients in various countries. Company A and its subsidiaries render only consulting services and do not manufacture or distribute computer hardware or software to clients. The controlled group is organized according to industry specialization, with key industry specialists working for Company A. These personnel typically form the core consulting group that teams with consultants from the local-country subsidiaries to serve clients in the subsidiaries' respective countries.

(ii) On some occasions, Company A and its subsidiaries undertake engagements directly for clients. On other occasions, they work as subcontractors for uncontrolled parties on more extensive consulting engagements for clients. In undertaking the latter engagements with third-party consultants, Company A typically prices its services at four times the compensation costs of its consultants, defined as the consultants' base salary plus estimated fringe benefits, as defined in this table:

Category	Rate
Project managers	$100 per hour.
Technical staff	$75 per hour.

(iii) In uncontrolled transactions, Company A also charges the customer, at no markup, for out-of-pocket expenses such as travel, lodging, and data acquisition charges. Thus, for example, a project involving 100 hours of time from project managers, and 400 hours of technical staff time would result in total compensation costs to Company A of (100 hrs. × $100/hr.) + (400 hrs. × $75/hr.) = $10,000 + $30,000 = $40,000. Applying the markup of 300%, the total fee charged would thus be (4 × $40,000), or $160,000, plus out-of-pocket expenses.

(iv) Company B, a Country X subsidiary of Company A, contracts to render consulting services to a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses the services of Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on reliable data concerning the compensation costs to Company A, an arm's length result for the controlled services transaction is equal to $144,000. This is calculated as follows: [4 × (75 hrs. × $100/hr.)] + [4 × (380 hrs. × $75/hr.)] = $30,000 + $114,000 = $144,000, reflecting a 300% markup on the total compensation costs for Company A project managers and technical staff. In addition, consistent with Company A's pricing of uncontrolled transactions, Company B must reimburse Company A for appropriate out-of-pocket expenses incurred in performing the services.

(f) *Comparable profits method*—(1) *In general*. The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length, based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. The rules in §1.482–5 relating to the comparable profits method apply to controlled services transactions, except as modified in this paragraph (f).

(2) *Determination of arm's length result*—(i) *Tested party*. This paragraph (f)

applies where the relevant business activity of the tested party as determined under §1.482–5(b)(2) is the rendering of services in a controlled services transaction. Where the tested party determined under §1.482–5(b)(2) is instead the recipient of the controlled services, the rules under this paragraph (f) are not applicable to determine the arm's length result.

(ii) *Profit level indicators.* In addition to the profit level indicators provided in §1.482–5(b)(4), a profit level indicator that may provide a reliable basis for comparing operating profits of the tested party involved in a controlled services transaction and uncontrolled comparables is the ratio of operating profit to total services costs (as defined in paragraph (j) of this section).

(iii) *Comparability and reliability considerations—Data and assumptions—Consistency in accounting.* Consistency in accounting practices between the relevant business activity of the tested party and the uncontrolled service providers is particularly important in determining the reliability of the results under this method, but less than in applying the cost of services plus method. Adjustments may be appropriate if materially different treatment is applied to particular cost items related to the relevant business activity of the tested party and the uncontrolled service providers. For example, adjustments may be appropriate where the tested party and the uncontrolled comparables use inconsistent approaches to classify similar expenses as ''cost of goods sold'' and ''selling, general, and administrative expenses.'' Although distinguishing between these two categories may be difficult, the distinction is less important to the extent that the ratio of operating profit to total services costs is used as the appropriate profit level indicator. Determining whether adjustments are necessary under these or similar circumstances requires thorough analysis of the functions performed and consideration of the cost accounting practices of the tested party and the uncontrolled comparables. Other adjustments as provided in §1.482–5(c)(2)(iv) may also be necessary to increase the reliability of the results under this method.

(3) *Examples.* The principles of this paragraph (f) are illustrated by the following examples:

Example 1. Ratio of operating profit to total services costs as the appropriate profit level indicator. (i) A Country T parent firm, Company A, and its Country Y subsidiary, Company B, both engage in manufacturing as their principal business activity. Company A also performs certain advertising services for itself and its affiliates. In year 1, Company A renders advertising services to Company B.

(ii) Based on the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company A is selected as the tested party. No data are available for comparable independent manufacturing firms that render advertising services to third parties. Financial data are available, however, for ten independent firms that render similar advertising services as their principal business activity in Country X. The ten firms are determined to be comparable under §1.482–5(c). Neither Company A nor the comparable companies use valuable intangible property in rendering the services.

(iii) Based on the available financial data of the comparable companies, it cannot be determined whether these comparable companies report costs for financial accounting purposes in the same manner as the tested party. The publicly available financial data of the comparable companies segregate total services costs into cost of goods sold and sales, general and administrative costs, with no further segmentation of costs provided. Due to the limited information available regarding the cost accounting practices used by the comparable companies, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator. This ratio includes total services costs to minimize the effect of any inconsistency in accounting practices between Company A and the comparable companies.

Example 2. Application of the operating profit to total services costs profit level indicator. (i) Company A is a foreign subsidiary of Company B, a U.S. corporation. Company B is under examination for its year 1 taxable year. Company B renders management consulting services to Company A. Company B's consulting function includes analyzing Company A's operations, benchmarking Company A's financial performance against companies in the same industry, and to the extent necessary, developing a strategy to improve Company A's operational performance. The accounting records of Company B allow reliable identification of the total services costs of the consulting staff associated with the management consulting services rendered to

Company A. Company A reimburses Company B for its costs associated with rendering the consulting services, with no markup.

(ii) Based on all the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company B is selected as the tested party, and its rendering of management consulting services is identified as the relevant business activity. Data are available from ten domestic companies that operate in the industry segment involving management consulting and that perform activities comparable to the relevant business activity of Company B. These comparables include entities that primarily perform management consulting services for uncontrolled parties. The comparables incur similar risks as Company B incurs in performing the consulting services and do not make use of valuable intangible property or special processes.

(iii) Based on the available financial data of the comparables, it cannot be determined whether the comparables report their costs for financial accounting purposes in the same manner as Company B reports its costs in the relevant business activity. The available financial data for the comparables report only an aggregate figure for costs of goods sold and operating expenses, and do not segment the underlying services costs. Due to this limitation, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator.

(iv) For the taxable years 1 through 3, Company B shows the following results for the services performed for Company A:

	Year 1	Year 2	Year 3	Average
Revenues	1,200,000	1,100,000	1,300,000	1,200,000
Cost of Goods Sold	100,000	100,000	N/A	66,667
Operating Expenses	1,100,000	1,000,000	1,300,000	1,133,333
Operating Profit	0	0	0	0

(v) After adjustments have been made to account for identified material differences between the relevant business activity of Company B and the comparables, the average ratio for the taxable years 1 through 3 of operating profit to total services costs is calculated for each of the uncontrolled service providers. Applying each ratio to Company B's average total services costs from the relevant business activity for the taxable years 1 through 3 would lead to the following comparable operating profit (COP) for the services rendered by Company B:

Uncontrolled service provider	OP/Total service costs (percent)	Company B COP
Company 1	15.75	$189,000
Company 2	15.00	180,000
Company 3	14.00	168,000
Company 4	13.30	159,600
Company 5	12.00	144,000
Company 6	11.30	135,600
Company 7	11.25	135,000
Company 8	11.18	134,160
Company 9	11.11	133,320
Company 10	10.75	129,000

(vi) The available data are not sufficiently complete to conclude that it is likely that all material differences between the relevant business activity of Company B and the comparables have been identified. Therefore, an arm's length range can be established only pursuant to §1.482–1(e)(2)(iii)(B). The arm's length range is established by reference to the interquartile range of the results as calculated under §1.482–1(e)(2)(iii)(C), which consists of the results ranging from $168,000 to $134,160. Company B's reported average operating profit of zero ($0) falls outside this range. Therefore, an allocation may be appropriate.

(vii) Because Company B reported income of zero, to determine the amount, if any, of the allocation, Company B's reported operating profit for year 3 is compared to the comparable operating profits derived from the comparables' results for year 3. The ratio of operating profit to total services costs in year 3 is calculated for each of the comparables and applied to Company B's year 3 total services costs to derive the following results:

Uncontrolled service provider	OP/Total service costs (for year 3) (percent)	Company B COP
Company 1	15.00	$195,000
Company 2	14.75	191,750
Company 3	14.00	182,000
Company 4	13.50	175,500
Company 5	12.30	159,900
Company 6	11.05	143,650
Company 7	11.03	143,390
Company 8	11.00	143,000
Company 9	10.50	136,500
Company 10	10.25	133,250

(viii) Based on these results, the median of the comparable operating profits for year 3 is $151,775. Therefore, Company B's income for year 3 is increased by $151,775, the difference between Company B's reported operating profit for year 3 of zero and the median of the comparable operating profits for year 3.

Example 3. Material difference in accounting for stock-based compensation. (i) Taxpayer, a U.S. corporation the stock of which is publicly traded, performs controlled services for its wholly-owned subsidiaries. The arm's length price of these controlled services is evaluated under the comparable profits method for services in paragraph (f) of this section by reference to the net cost plus profit level indicator (PLI). Taxpayer is the tested party under paragraph (f)(2)(i) of this section. The Commissioner identifies the most narrowly identifiable business activity of the tested party for which data are available that incorporate the controlled transaction (the relevant business activity). The Commissioner also identifies four uncontrolled domestic service providers, Companies A, B, C, and D, each of which performs exclusively activities similar to the relevant business activity of Taxpayer that is subject to analysis under paragraph (f) of this section. The stock of Companies A, B, C, and D is publicly traded on a U.S. stock exchange. Assume that Taxpayer makes an election to apply these regulations to earlier taxable years.

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as determined under a method in accordance with U.S. generally accepted accounting principles, the fair value of such stock options attributable to the employees' performance of the relevant business activity is 500 for the taxable year in question. In evaluating the controlled services, Taxpayer includes salaries, fringe benefits, and related compensation of these employees in ''total services costs,'' as defined in paragraph (j) of this section. Taxpayer does not include any amount attributable to stock options in total services costs, nor does it deduct that amount in determining ''reported operating profit'' within the meaning of §1.482–5(d)(5), for the year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D. Under a fair value method in accordance with U.S. generally accepted accounting principles, the comparables include in total compensation the value of the stock options attributable to the employees' performance of the relevant business activity for the annual financial reporting period, and treat this amount as an expense in determining operating profit for financial accounting purposes. The treatment of employee stock options is summarized in the following table:

	Salaries and other non-option compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	500	0
Company A	7,000	2,000	2,000
Company B	4,300	250	250
Company C	12,000	4,500	4,500
Company D	15,000	2,000	2,000

(iv) A material difference in accounting for stock-based compensation (within the meaning of §1.482–7T(d)(3)(i)) exists. Analysis indicates that this difference would materially affect the measure of an arm's length result under this paragraph (f). In making an adjustment to improve comparability under §§1.482–1(d)(2) and 1.482–5(c)(2)(iv), the Commissioner includes in total services costs of the tested party the total compensation costs of 1,500 (including stock option fair value). In addition, the Commissioner calculates the net cost plus PLI by reference to the financial-accounting data of Companies A, B, C, and D, which take into account compensatory stock options.

Example 4. Material difference in utilization of stock-based compensation. (i) The facts are the same as in paragraph (i) of *Example 3.*

(ii) No stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Thus, no deduction for stock options is made in determining ''reported operating profit'' (within the meaning of §1.482–5(d)(5)) for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D, but none of these companies expense stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies A, B, C, and D disclose the fair value of the stock options for financial accounting purposes. The utilization and treatment of employee stock options is summarized in the following table:

	Salaries and other non-option compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	0	N/A

	Salaries and other non-option compensation	Stock options fair value	Stock options expensed
Company A	7,000	2,000	0
Company B	4,300	250	0
Company C	12,000	4,500	0
Company D	15,000	2,000	0

(iv) A material difference in the utilization of stock-based compensation (within the meaning of §1.482–7T(d)(3)(i)) exists. Analysis indicates that these differences would materially affect the measure of an arm's length result under this paragraph (f). In evaluating the comparable operating profits of the tested party, the Commissioner uses Taxpayer's total services costs, which include total compensation costs of 1,000. In considering whether an adjustment is necessary to improve comparability under §§1.482–1(d)(2) and 1.482–5(c)(2)(iv), the Commissioner recognizes that the total compensation provided to employees of Taxpayer is comparable to the total compensation provided to employees of Companies A, B, C, and D. Because Companies A, B, C, and D do not expense stock-based compensation for financial accounting purposes, their reported operating profits must be adjusted in order to improve comparability with the tested party. The Commissioner increases each comparable's total services costs, and also reduces its reported operating profit, by the fair value of the stock-based compensation incurred by the comparable company.

(v) The adjustments to the data of Companies A, B, C, and D described in paragraph (iv) of this *Example 4* are summarized in the following table:

	Salaries and other non-option compensation	Stock options fair value	Total services costs (A)	Operating profit (B)	Net cost plus PLI (B/A) (Percent)
Per financial statements:					
Company A	7,000	2,000	25,000	6,000	24.00
Company B	4,300	250	12,500	2,500	20.00
Company C	12,000	4,500	36,000	11,000	30.56
Company D	15,000	2,000	27,000	7,000	25.93
As adjusted:					
Company A	7,000	2,000	27,000	4,000	14.81
Company B	4,300	250	12,750	2,250	17.65
Company C	12,000	4,500	40,500	6,500	16.05
Company D	15,000	2,000	29,000	5,000	17.24

Example 5. Non-material difference in utilization of stock-based compensation. (i) The facts are the same as in paragraph (i) of *Example 3.*

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as determined under a method in accordance with U.S. generally accepted accounting principles, the fair value of such stock options attributable to the employees' performance of the relevant business activity is 50 for the taxable year. Taxpayer includes salaries, fringe benefits, and all other compensation of these employees (including the stock option fair value) in ''total services costs,'' as defined in paragraph (j) of this section, and deducts these amounts in determining ''reported operating profit'' within the meaning of §1.482–5(d)(5), for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D, but none of these companies expense stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies A, B, C, and D disclose the fair value of the stock options for financial accounting purposes. The utilization and treatment of employee stock options is summarized in the following table:

	Salaries and other non-option compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	50	50
Company A	7,000	100	0
Company B	4,300	40	0

	Salaries and other non-option compensation	Stock options fair value	Stock options expensed
Company C	12,000	130	0
Company D	15,000	75	0

(iv) Analysis of the data reported by Companies A, B, C, and D indicates that an adjustment for differences in utilization of stock-based compensation would not have a material effect on the determination of an arm's length result.

	Salaries and other non-option compensation	Stock options fair value	Total services costs (A)	Operating profit (B)	Net cost plus PLI (B/A) (percent)
Per financial statements:					
Company A	7,000	100	25,000	6,000	24.00
Company B	4,300	40	12,500	2,500	20.00
Company C	12,000	130	36,000	11,000	30.56
Company D	15,000	75	27,000	7,000	25.93
As adjusted:					
Company A	7,000	100	25,100	5,900	23.51
Company B	4,300	40	12,540	2,460	19.62
Company C	12,000	130	36,130	10,870	30.09
Company D	15,000	75	27,075	6,925	25.58

(v) Under the circumstances, the difference in utilization of stock-based compensation would not materially affect the determination of the arm's length result under this paragraph (f). Accordingly, in calculating the net cost plus PLI, no comparability adjustment is made to the data of Companies A, B, C, or D pursuant to §§1.482–1(d)(2) and 1.482–5(c)(2)(iv).

Example 6. Material difference in comparables' accounting for stock-based compensation. (i) The facts are the same as in paragraph (i) of *Example 3*.

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as determined under a method in accordance with U.S. generally accepted accounting principles, the fair value of such stock options attributable to employees' performance of the relevant business activity is 500 for the taxable year. Taxpayer includes salaries, fringe benefits, and all other compensation of these employees (including the stock option fair value) in ''total services costs,'' as defined in paragraph (j) of this section, and deducts these amounts in determining ''reported operating profit'' (within the meaning of §1.482–5(d)(5)) for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D. Companies A and B expense the stock options for financial accounting purposes in accordance with U.S. generally accepted accounting principles. Companies C and D do not expense the stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies C and D disclose the fair value of these options in their financial statements. The utilization and accounting treatment of options are depicted in the following table:

	Salary and other non-option compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	500	500
Company A	7,000	2,000	2,000
Company B	4,300	250	250
Company C	12,000	4,500	0
Company D	15,000	2,000	0

(iv) A material difference in accounting for stock-based compensation (within the meaning of §1.482–7T(d)(3)(i)) exists. Analysis indicates that this difference would materially affect the measure of the arm's length result under paragraph (f) of this section. In evaluating the comparable operating profits of the tested party, the Commissioner includes in total services costs Taxpayer's total compensation costs of 1,500 (including stock option fair value of 500). In considering whether an adjustment is necessary to improve comparability under §§ 1.482–1(d)(2) and 1.482–5(c)(2)(iv), the Commissioner recognizes that the total employee compensation (including stock options provided by Taxpayer and Companies A, B, C, and D) provides a reliable basis for comparison. Because Companies A and B expense stock-based compensation for financial accounting purposes, whereas Companies C and D do not, an adjustment to the comparables' operating profit is necessary. In computing the net cost plus PLI, the Commissioner uses the financial-accounting data of Companies A and B, as reported. The Commissioner increases the total services costs of Companies C and D by amounts equal to the fair value of their respective stock options, and reduces the operating profits of Companies C and D accordingly.

(v) The adjustments described in paragraph (iv) of this *Example 6* are depicted in the following table. For purposes of illustration, the unadjusted data of Companies A and B are also included.

	Salaries and other non-option compensation	Stock options fair value	Total services costs (A)	Operating profit (B)	Net cost plus PLI (B/A) (percent)
Per financial statements:					
Company A	7,000	2,000	27,000	4,000	14.80
Company B	4,300	250	12,750	2,250	17.65
As adjusted:					
Company C	12,000	4,500	40,500	6,500	16.05
Company D	15,000	2,000	29,000	5,000	17.24

(g) *Profit split method*—(1) *In general.* The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The relative value of each controlled taxpayer's contribution is determined in a manner that reflects the functions performed, risks assumed and resources employed by such controlled taxpayer in the relevant business activity. For application of the profit split method (both the comparable profit split and the residual profit split), *see* § 1.482–6. The residual profit split method may not be used where only one controlled taxpayer makes significant nonroutine contributions.

(2) *Examples.* The principles of this paragraph (g) are illustrated by the following examples:

Example 1. Residual profit split. (i) Company A, a corporation resident in Country X, auctions spare parts by means of an interactive database. Company A maintains a database that lists all spare parts available for auction. Company A developed the software used to run the database. Company A's database is managed by Company A employees in a data center located in Country X, where storage and manipulation of data also take place. Company A has a wholly-owned subsidiary, Company B, located in Country Y. Company B performs marketing and advertising activities to promote Company A's interactive database. Company B solicits unrelated companies to auction spare parts on Company A's database, and solicits customers interested in purchasing spare parts online. Company B owns and maintains a computer server in Country Y, where it receives information on spare parts available for auction. Company B has also designed a specialized communications network that connects its data center to Company A's data center in Country X. The communications network allows Company B to enter data from uncontrolled companies on Company A's database located in Country X. Company B's communications network also allows uncontrolled companies to access Company A's interactive database and purchase spare parts. Company B bore the risks and cost of developing this specialized communications network. Company B enters into contracts with uncontrolled companies and provides the companies access to Company A's database through the Company B network.

(ii) Analysis of the facts and circumstances indicates that both Company A and Company B possess valuable intangible property that they use to conduct the spare parts auction business. Company A bore the economic risks of developing and maintaining software and the interactive database. Company B bore the economic risks of developing the necessary technology to transmit information from its server to Company A's data center, and to allow uncontrolled companies to access Company A's database. Company B helped to enhance the value of Company A's trademark and to establish a network of customers in Country Y. In addition, there are no market comparables for the transactions between Company A and Company B to reliably evaluate them separately. Given the facts and circumstances, the Commissioner determines that a residual profit split method will provide the most reliable measure of an arm's length result.

(iii) Under the residual profit split method, profits are first allocated based on the routine contributions of each taxpayer. Routine contributions include general sales, marketing or administrative functions performed by Company B for Company A for which it is possible to identify market returns. Any residual profits will be allocated based on the nonroutine contributions of each taxpayer. Since both Company A and Company B provided nonroutine contributions, the residual profits are allocated based on these contributions.

Example 2. Residual profit split. (i) Company A, a Country 1 corporation, provides specialized services pertaining to the processing and storage of Level 1 hazardous waste (for purposes of this example, the most dangerous type of waste). Under long-term contracts with private companies and governmental entities in Country 1, Company A performs multiple services, including transportation of Level 1 waste, development of handling and storage protocols, recordkeeping, and supervision of waste-storage facilities owned and maintained by the contracting parties. Company A's research and development unit has also developed new and unique processes for transport and storage of Level 1 waste that minimize environmental and occupational effects. In addition to this novel technology, Company A has substantial know-how and a long-term record of safe operations in Country 1.

(ii) Company A's subsidiary, Company B, has been in operation continuously for a number of years in Country 2. Company B has successfully completed several projects in Country 2 involving Level 2 and Level 3 waste, including projects with government-owned entities. Company B has a license in Country 2 to handle Level 2 waste (Level 3 does not require a license). Company B has established a reputation for completing these projects in a responsible manner. Company B has cultivated contacts with procurement officers, regulatory and licensing officials, and other government personnel in Country 2.

(iii) Country 2 government publishes invitations to bid on a project to handle the country's burgeoning volume of Level 1 waste, all of which is generated in government-owned facilities. Bidding is limited to companies that are domiciled in Country 2 and that possess a license from the government to handle Level 1 or Level 2 waste. In an effort to submit a winning bid to secure the contract, In an effort to submit a winning bid to secure the contract, Company B points to its Level 2 license and its record of successful completion of projects, and also demonstrates to Country 2 government that it has access to substantial technical expertise pertaining to processing of Level 1 waste.

(iv) Company A enters into a long-term technical services agreement with Company B. Under this agreement, Company A agrees to supply to Company B project managers and other technical staff who have detailed knowledge of Company A's proprietary Level 1 remediation techniques. Company A commits to perform under any long-term contracts entered into by Company B. Company B agrees to compensate Company A based on a markup on Company A's marginal costs (pro rata compensation and current expenses of Company A personnel). In the bid on the Country 2 contract for Level 1 waste remediation, Company B proposes to use a multidisciplinary team of specialists from Company A and Company B. Project managers from Company A will direct the team, which will also include employees of Company B and will make use of physical assets and facilities owned by Company B. Only Company A and Company B personnel will perform services under the contract. Country 2 grants Company B a license to handle Level 1 waste.

(v) Country 2 grants Company B a five-year, exclusive contract to provide processing services for all Level 1 hazardous waste generated in County 2. Under the contract, Company B is to be paid a fixed price per ton of Level 1 waste that it processes each year. Company B undertakes that all services provided will meet international standards applicable to processing of Level 1 waste. Company B begins performance under the contract.

(vi) Analysis of the facts and circumstances indicates that both Company A and Company B make nonroutine contributions to the Level 1 waste processing activity in Country 2. In addition, it is determined that reliable comparables are not available for the services that Company A provides under the long-term contract, in part because those services incorporate specialized knowledge and process intangible property developed by Company A. It is also determined that reliable comparables are not available for the Level 2 license in Country 2, the successful track record, the government contacts with Country 2 officials, and other intangible property that Company B provided. In view of these facts, the Commissioner determines that the residual profit split method for services in paragraph (g) of this section provides the most reliable means of evaluating the arm's length results for the transaction. In evaluating the appropriate returns to Company A and Company B for their respective contributions, the Commissioner takes into account that the controlled parties incur different risks, because the contract between the controlled parties provides that Company A will be compensated on the basis of marginal costs incurred, plus a markup, whereas the contract between Company B and the government of Country 2 provides that Company B will be compensated on a fixed-price basis per ton of Level 1 waste processed.

(vii) In the first stage of the residual profit split, an arm's length return is determined for routine activities performed by Company B in Country 2, such as transportation, recordkeeping, and administration. In addition, an arm's length return is determined for routine activities performed by Company A (administrative, human resources, *etc.*) in connection with providing personnel to Company B. After the arm's length return for these functions is determined, residual profits may be present. In the second stage of the residual profit split, any residual profit is allocated by reference to the relative value of the nonroutine contributions made by each taxpayer. Company A's nonroutine contributions include its commitment to perform under the contract and the specialized technical knowledge made available through the project managers under the services agreement with Company B. Company B's nonroutine contributions include its licenses to handle Level 1 and Level 2 waste in Country 2, its knowledge of and contacts with procurement, regulatory and licensing officials in the government of Country 2, and its record in Country 2 of successfully handling non-Level 1 waste.

(h) *Unspecified methods.* Methods not specified in paragraphs (b) through (g) of this section may be used to evaluate whether the amount charged in a controlled services transaction is arm's length. Any method used under this paragraph (h) must be applied in accordance with the provisions of §1.482–1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, including economically similar transactions structured as other than services transactions, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled services price method compares a controlled services transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled services transaction. Therefore, in establishing whether a controlled services transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled services transaction (for example, outsourcing a particular service function, rather than performing the function itself). As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. *See* §1.482–1(c). Therefore, in accordance with §1.482–1(d) (comparability), to the extent that an unspecified method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

Example. (i) Company T, a U.S. corporation, develops computer software programs including a real estate investment program that performs financial analysis of commercial real properties. Companies U, V, and W are owned by Company T. The primary business activity of Companies U, V, and W is commercial real estate development. For business reasons, Company T does not sell the computer program to its customers (on a compact disk or via download from Company T's server through the Internet). Instead, Company T maintains the software program on its own server and allows customers to access the program through the Internet by using a password. The transactions between Company T and Companies U, V, and W are structured as controlled services transactions whereby Companies U, V, and W obtain access via the Internet to Company T's software program for financial analysis. Each year, Company T provides a revised version of the computer program including the most recent data on the commercial real estate market, rendering the old version obsolete.

(ii) In evaluating whether the consideration paid by Companies U, V, and W to Company T was arm's length, the Commissioner may consider, subject to the best method rule of §1.482–1(c), Company T's alternative of selling the computer program to Companies U, V, and W on a compact disk or via download through the Internet. The Commissioner determines that the controlled services transactions between Company T and Companies U, V, and W are comparable to the transfer of a similar software program on a compact disk or via download through the Internet between uncontrolled parties. Subject to adjustments being made for material differences between the controlled services transactions and the comparable uncontrolled transactions, the uncontrolled transfers of tangible property may be used to evaluate the arm's length results for the controlled services transactions between Company T and Companies U, V, and W.

(i) *Contingent-payment contractual terms for services*—(1) *Contingent-payment contractual terms recognized in general.* In the case of a contingent-payment arrangement, the arm's length result for the controlled services transaction generally would not require payment by the recipient to the renderer in the tax accounting period in which the service is rendered if the specified contingency does not occur in that period. If the specified contingency occurs in a tax accounting period subsequent to the period in which the service is rendered, the arm's length result for the controlled services transaction generally would require payment by the recipient to the renderer on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer in performing the activities in the absence of a provision that unconditionally obligates the recipient to pay for the activities performed in the tax accounting period in which the service is rendered.

(2) *Contingent-payment arrangement.* For purposes of this paragraph (i), an arrangement will be treated as a contingent-payment arrangement if it meets all of the requirements in paragraph (i)(2)(i) of this section and is consistent with the economic substance and conduct requirement in paragraph (i)(2)(ii) of this section.

(i) *General requirements*—(A) *Written contract.* The arrangement is set forth in a written contract entered into prior to, or contemporaneous with, the start of the activity or group of activities constituting the controlled services transaction.

(B) *Specified contingency.* The contract states that payment for a controlled services transaction is contingent (in whole or in part) upon the happening of a future benefit (within the meaning of §1.482–9(l)(3)) for the recipient directly related to the activity or group of activities. For purposes of the preceding sentence, whether the future benefit is directly related to the activity or group of activities is evaluated based on all the facts and circumstances.

(C) *Basis for payment.* The contract provides for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer.

(ii) *Economic substance and conduct.* The arrangement, including the contingency and the basis for payment, is consistent with the economic substance of the controlled transaction and the conduct of the controlled parties. *See* §1.482–1(d)(3)(ii)(B).

(3) *Commissioner's authority to impute contingent-payment terms.* Consistent with the authority in §1.482–1(d)(3)(ii)(B), the Commissioner may impute contingent-payment contractual terms in a controlled services transaction if the economic substance of the transaction is consistent with the existence of such terms.

(4) *Evaluation of arm's length charge.* Whether the amount charged in a contingent-payment arrangement is arm's length will be evaluated in accordance with this section and other applicable regulations under section 482. In evaluating whether the amount charged in a contingent-payment arrangement for the manufacture, construction, or development of tangible or intangible property owned by the recipient is arm's length, the charge determined under the rules of §§1.482–3 and 1.482–4 for the transfer of similar property may be considered. *See* §1.482–1(f)(2)(ii).

(5) *Examples.* The principles of this paragraph (i) are illustrated by the following examples:

Example 1. (i) Company X is a member of a controlled group that has operated in the pharmaceutical sector for many years. In year 1, Company X enters into a written services agreement with Company Y, another member of the controlled group, whereby Company X will perform certain research and development activities for Company Y. The parties enter into the agreement before Company X undertakes any of the research and development activities covered by the agreement. At the time the agreement is entered into, the possibility that any new products will be developed is highly uncertain and the possible market or markets for any products that may be developed are not known and cannot be estimated with any reliability. Under the agreement, Company Y will own any patent or other rights that result from the activities of Company X under the agreement and Company Y will make payments to Company X only if such activities result in commercial sales of one or more derivative products. In that event, Company Y will pay Company X, for a specified period, x% of Company Y's gross sales of each of such products. Payments are required with respect to each jurisdiction in which Company Y has sales of such a derivative product, beginning with the first year in which the sale of a product occurs in the jurisdiction and continuing for six additional years with respect to sales of that product in that jurisdiction.

(ii) As a result of research and development activities performed by Company X for Company Y in years 1 through 4, a compound is developed that may be more effective than existing medications in the treatment of certain conditions. Company Y registers the patent rights with respect to the compound in several jurisdictions in year 4. In year 6, Company Y begins commercial sales of the product in Jurisdiction A and, in that year, Company Y makes the payment to Company X that is required under the agreement. Sales of the product continue in Jurisdiction A in years 7 through 9 and Company Y makes the payments to Company X in years 7 through 9 that are required under the agreement.

(iii) The years under examination are years 6 through 9. In evaluating whether the contingent-payment terms will be recognized, the Commissioner considers whether the conditions of paragraph (i)(2) of this section are met and whether the arrangement, including the specified contingency and basis of payment, is consistent with the economic substance of the controlled services transaction and with the conduct of the controlled parties. The Commissioner determines that the contingent-payment arrangement is reflected in the written agreement between Company X and Company Y; that commercial sales of products developed under the arrangement represent future benefits for Company Y directly related to the controlled services transaction; and that the basis for the payment provided for in the event such sales occur reflects the recipient's benefit and the renderer's risk. Consistent with §1.482–1(d)(3)(ii)(B) and (iii)(B), the Commissioner determines that the parties' conduct over the term of the agreement has been consistent with their contractual allocation of risk; that Company X has the financial capacity to bear the risk that its research and development services may be unsuccessful and that it may not receive compensation for such services; and that Company X exercises managerial and operational control over the research and development, such that it is reasonable for Company X to assume the risk of those activities. Based on all these facts, the Commissioner determines that the contingent-payment arrangement is consistent with economic substance.

(iv) In determining whether the amount charged under the contingent-payment arrangement in each of years 6 through 9 is arm's length, the Commissioner evaluates under this section and other applicable rules under section 482 the compensation paid in each year for the research and development services. This analysis takes into account that under the contingent-payment terms Company X bears the risk that it might not receive payment for its services in the event that those services do not result in marketable products and the risk that the magnitude of its payment depends on the magnitude of product sales, if any. The Commissioner also considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X's willingness and ability to bear the risk and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, in evaluating whether the compensation of x% of gross sales that is paid to Company X during the first four years of commercial sales of derivative products is arm's length, the Commissioner may consider the royalties (or other consideration) charged for intangible property that are comparable to those incorporated in the derivative products and that resulted from Company X's research and development activities under the contingent-payment arrangement.

Example 2. (i) The facts are the same as in *Example 1*, except that no commercial sales ever materialize with regard to the patented compound so that, consistent with the agreement, Company Y makes no payments to Company X in years 6 through 9.

(ii) Based on all the facts and circumstances, the Commissioner determines that the contingent-payment arrangement is consistent with economic substance, and the result (no payments in years 6 through 9) is consistent with an arm's length result.

Example 3. (i) The facts are the same as in *Example 1*, except that, in the event that Company X's activities result in commercial sales of one or more derivative products by Company Y, Company Y will pay Company X a fee equal to the research and development costs borne by Company X plus an amount equal to x% of such costs, with the payment to be made in the first year in which any such sales occur. The x% markup on costs is within the range, ascertainable in year 1, of markups on costs of independent contract researchers that are compensated under terms that unconditionally obligate the recipient to pay for the activities performed in the tax accounting period in which the service is rendered. In year 6, Company Y makes the single payment to Company X that is required under the arrangement.

(ii) The years under examination are years 6 through 9. In evaluating whether the contingent-payment terms will be recognized, the Commissioner considers whether the requirements of paragraph (i)(2) of this section were met at the time the written agreement was entered into and whether the arrangement, including the specified contingency and basis for payment, is consistent with the economic substance of the controlled services transaction and with the conduct of the controlled parties. The Commissioner determines that the contingent-payment terms are reflected in the written agreement between Company X and Company Y and that commercial sales of products developed under the arrangement represent future benefits for Company Y directly related to the controlled services transaction. However, in this case, the Commissioner determines that the basis for payment provided for in the event such sales occur (costs of the services plus x%, representing the markup for contract research in the absence of any nonpayment risk) does not reflect the recipient's benefit and the renderer's risks in the controlled services transaction. Based on all the facts and circumstances, the Commissioner determines that the contingent-payment arrangement is not consistent with economic substance.

(iii) Accordingly, the Commissioner determines to exercise its authority to impute contingent-payment contractual terms that accord with economic substance, pursuant to paragraph (i)(3) of this section and §1.482–1(d)(3)(ii)(B). In this regard, the Commissioner takes into account that at the time the arrangement was entered into, the possibility that any new products would be developed was highly uncertain and the possible market or markets for any products that may be developed were not known and could not be estimated with any reliability. In such circumstances, it is reasonable to conclude that one possible basis of payment, in order to reflect the recipient's benefit and the renderer's risks, would be a charge equal to a percentage of commercial sales of one or more derivative products that result from the research and development activities. The Commissioner in this case may impute terms that require Company Y to pay Company X a percentage of sales of the products developed under the agreement in each of years 6 through 9.

(iv) In determining an appropriate arm's length charge under such imputed contractual terms, the Commissioner conducts an analysis under this section and other applicable rules under section 482, and considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X's willingness and ability to bear the risks and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, for purposes of its determination, the Commissioner may consider the royalties (or other consideration) charged for intangible property that are comparable to those incorporated in the derivative products that resulted from Company X's research and development activities under the contingent-payment arrangement.

(j) *Total services costs*. For purposes of this section, total services costs means all costs of rendering those services for which total services costs are being determined. Total services costs include all costs in cash or in kind (including stock-based compensation) that, based on analysis of the facts and circumstances, are directly identified with, or reasonably allocated in accordance with the principles of paragraph (k)(2) of this section to, the services. In general, costs for this purpose should comprise provision for all resources expended, used, or made available to achieve the specific objective for which the service is rendered. Reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not necessarily be conclusive regarding inclusion of costs in total services costs. Total services costs do not include interest expense, foreign income taxes (as defined in §1.901–2(a)), or domestic income taxes.

(k) *Allocation of costs*—(1) *In general*. In any case where the renderer's activity that results in a benefit (within the meaning of paragraph (l)(3) of this section) for one recipient in a controlled services transaction also generates a benefit for one or more other members of a controlled group (including the benefit, if any, to the renderer), and the amount charged under this section in the controlled services transaction is determined under a method that makes reference to costs, costs must be allocated among the portions of the activity performed for the benefit of the first mentioned recipient and such other members of the controlled group under this paragraph (k). The principles of this paragraph (k) must also be used whenever it is appropriate to allocate and apportion any class of costs (for example, overhead costs) in order to determine the total services costs of rendering the services. In no event will an allocation of costs based on a generalized or non-specific benefit be appropriate.

(2) *Appropriate method of allocation and apportionment*—(i) *Reasonable method standard*. Any reasonable method may be used to allocate and apportion costs under this section. In establishing the appropriate method of allocation and apportionment, consideration should be given to all bases and factors, including, for example, total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent. The costs incurred by supporting departments may be apportioned to other departments on the basis of reasonable overall estimates, or such costs may be reflected in the other departments' costs by applying reasonable departmental overhead rates. Allocations and apportionments of costs must be made on the basis of the full cost, as opposed to the incremental cost.

(ii) *Use of general practices*. The practices used by the taxpayer to apportion costs in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint venturers, clients, customers, potential investors, or other parties or agencies in interest will be considered as potential indicators of reliable allocation methods, but need not be accorded conclusive weight by the Commissioner. In determining the extent to which allocations are to be made to or from foreign members of a controlled group, practices employed by the domestic members in apportioning costs among themselves will also be considered if the relationships with the foreign members are comparable to the relationships among the domestic members of the controlled group. For example, if for purposes of reporting to public stockholders or to a governmental agency, a corporation apportions the costs attributable to its executive officers among the domestic members of a controlled group on a reasonable and consistent basis, and such officers exercise comparable control over foreign members of the controlled group, such domestic apportionment practice will be considered in determining the allocations to be made to the foreign members.

(3) *Examples*. The principles of this paragraph (k) are illustrated by the following examples:

Example 1. Company A pays an annual license fee of 500x to an uncontrolled taxpayer for unlimited use of a database within the corporate group. Under the terms of the license with the uncontrolled taxpayer, Company A is permitted to use the database for its own use and in rendering research services to its subsidiary, Company B. Company B obtains benefits from the database that are similar to those that it would obtain if it had independently licensed the database from the uncontrolled taxpayer. Evaluation of the arm's length charge (under a method in which costs are relevant) to Company B for the controlled services that incorporate use of the database must take into account the full amount of the license fee of 500x paid by Company A, as reasonably allocated and apportioned to the relevant benefits, although the incremental use of the database for the benefit of Company B did not result in an increase in the license fee paid by Company A.

Example 2. (i) Company A is a consumer products company located in the United States. Companies B and C are wholly-owned subsidiaries of Company A and are located in Countries B and C, respectively. Company A and its subsidiaries manufacture products for sale in their respective markets. Company A hires a consultant who has expertise regarding a manufacturing process used by Company A and its subsidiary, Company B. Company C, the Country C subsidiary, uses a different manufacturing process, and accordingly will not receive any benefit from the outside consultant hired by Company A. In allocating and apportioning the cost of hiring the outside consultant (100), Company A determines that sales constitute the most appropriate allocation key.

(ii) Company A and its subsidiaries have the following sales:

Company	A	B	C	Total
Sales	400	100	200	700

(iii) Because Company C does not obtain any benefit from the consultant, none of the costs are allocated to it. Rather, the costs of 100 are allocated and apportioned ratably to Company A and Company B as the entities that obtain a benefit from the campaign, based on the total sales of those entities (500). An appropriate allocation of the costs of the consultant is as follows:

Company	A	B	Total
Allocation	400/500	100/500	
Amount	80	20	100

(l) *Controlled services transaction*—(1) *In general.* A controlled services transaction includes any activity (as defined in paragraph (l)(2) of this section) by one member of a group of controlled taxpayers (the renderer) that results in a benefit (as defined in paragraph (l)(3) of this section) to one or more other members of the controlled group (the recipient(s)).

(2) *Activity.* An activity includes the performance of functions, assumptions of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances. An activity also includes making available to the recipient any property or other resources of the renderer.

(3) *Benefit*—(i) *In general.* An activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so. An activity is generally considered to confer a benefit if, taking into account the facts and circumstances, an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity on either a fixed or contingent-payment basis, or if the recipient otherwise would have performed for itself the same activity or a similar activity. A benefit may result to the owner of intangible property if the renderer engages in an activity that is reasonably anticipated to result in an increase in the value of that intangible property. Paragraphs (l)(3)(ii) through (v) of this section provide guidelines that indicate the presence or absence of a benefit for the activities in the controlled services transaction.

(ii) *Indirect or remote benefit.* An activity is not considered to provide a benefit to the recipient if, at the time the activity is performed, the present or reasonably anticipated benefit from that activity is so indirect or remote that the recipient would not be willing to pay, on either a fixed or contingent-payment basis, an uncontrolled party to perform a similar activity, and would not be willing to perform such activity for itself for this purpose. The determination whether the benefit from an activity is indirect or remote is based on the nature of the activity and the situation of the recipient, taking into consideration all facts and circumstances.

(iii) *Duplicative activities.* If an activity performed by a controlled taxpayer duplicates an activity that is performed, or that reasonably may be anticipated to be performed, by another controlled taxpayer on or for its own account, the activity is generally not considered to provide a benefit to the recipient, unless the duplicative activity itself provides an additional benefit to the recipient.

(iv) *Shareholder activities.* An activity is not considered to provide a benefit if the sole effect of that activity is either to protect the renderer's capital investment in the recipient or in other members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both. Activities in the nature of day-to-day management generally do not relate to protection of the renderer's capital investment. Based on analysis of the facts and circumstances, activities in connection with a corporate reorganization may be considered to provide a benefit to one or more controlled taxpayers.

(v) *Passive association.* A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer's status as a member of a controlled group. A controlled taxpayer's status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.

(4) *Disaggregation of transactions.* A controlled services transaction may be analyzed as two separate transactions for purposes of determining the arm's length consideration, if that analysis is the most reliable means of determining the arm's length consideration for the controlled services transaction. *See* the best method rule under § 1.482–1(c).

(5) *Examples.* The principles of this paragraph (l) are illustrated by the following examples. In each example, assume that Company X is a U.S. corporation and Company Y is a wholly-owned subsidiary of Company X in Country B.

Example 1. In general. In developing a worldwide advertising and promotional campaign for a consumer product, Company X pays for and obtains designation as an official sponsor of the Olympics. This designation allows Company X and all its subsidiaries, including Company Y, to identify themselves as sponsors and to use the Olympic logo in advertising and promotional campaigns. The Olympic sponsorship campaign generates benefits to Company X, Company Y, and other subsidiaries of Company X.

Example 2. Indirect or remote benefit. Based on recommendations contained in a study performed by its internal staff, Company X implements certain changes in its management structure and the compensation of managers of divisions located in the United States. No changes were recommended or considered for Company Y in Country B. The internal study and the resultant changes in its management may increase the competitiveness and overall efficiency of Company X. Any benefits to Company Y as a result of the study are, however, indirect or remote. Consequently, Company Y is not considered to obtain a benefit from the study.

Example 3. Indirect or remote benefit. Based on recommendations contained in a study performed by its internal staff, Company X decides to make changes to the management structure and management compensation of its subsidiaries, in order to increase their profitability. As a result of the recommendations in the study, Company X implements substantial changes in the management structure and management compensation scheme of Company Y. The study and the changes implemented as a result of the recommendations are anticipated to increase the profitability of Company X and its subsidiaries. The increased management efficiency of Company Y that results from these changes is considered to be a specific and identifiable benefit, rather than remote or speculative.

Example 4. Duplicative activities. At its corporate headquarters in the United States, Company X performs certain treasury functions for Company X and for its subsidiaries, including Company Y. These treasury functions include raising capital, arranging medium and long-term financing for general corporate needs, including cash management. Under these circumstances, the treasury functions performed by Company X do not duplicate the functions performed by Company Y's staff. Accordingly, Company Y is considered to obtain a benefit from the functions performed by Company X.

Example 5. Duplicative activities. The facts are the same as in *Example 4,* except that Company Y's functions include ensuring that the financing requirements of its own operations are met. Analysis of the facts and circumstances indicates that Company Y independently administers all financing and cash-management functions necessary to support its operations, and does not utilize financing obtained by Company X. Under the circumstances, the treasury functions performed by Company X are duplicative of similar functions performed by Company Y's staff, and the duplicative functions do not enhance Company Y's position. Accordingly, Company Y is not considered to obtain a benefit from the duplicative activities performed by Company X.

Example 6. Duplicative activities. Company X's in-house legal staff has specialized expertise in several areas, including intellectual property. The intellectual property legal staff specializes in technology licensing, patents, copyrights, and negotiating and drafting intellectual property agreements. Company Y is involved in negotiations with an unrelated party to enter into a complex joint venture that includes multiple licenses and cross-licenses of patents and copyrights. Company Y retains outside counsel that specializes in intellectual property law to review the transaction documents. Company Y does not have in-house counsel of its own to review intellectual property transaction documents. Outside counsel advises that the terms for the proposed transaction are advantageous to Company Y and that the contracts are valid and fully enforceable. Company X's intellectual property legal staff possess valuable knowledge of Company Y's patents and technological achievements. They are capable of identifying particular scientific attributes protected under patent that strengthen Company Y's negotiating position, and of discovering flaws in the patents offered by the unrelated party. To reduce risk associated with the transaction, Company X's intellectual property legal staff reviews the transaction documents before Company Y executes the contracts. Company X's intellectual property legal staff also separately evaluates the patents and copyrights with respect to the licensing arrangements and concurs in the opinion provided by outside counsel. The activities performed by Company X substantially duplicate the legal services obtained by Company Y, but they also reduce risk associated with the transaction in a way that confers an additional benefit on Company Y.

Example 7. Shareholder activities. Company X is a publicly held corporation. U.S. laws and regulations applicable to publicly held corporations such as Company X require the preparation and filing of periodic reports that show, among other things, profit and loss statements, balance sheets, and other material financial information concerning the company's operations. Company X, Company Y and each of the other subsidiaries maintain their own separate accounting departments that record individual transactions and prepare financial statements in accordance with their local accounting practices. Company Y, and the other subsidiaries, forward the results of their financial performance to Company X, which analyzes and compiles these data into periodic reports in accordance with U.S. laws and regulations. Because Company X's preparation and filing of the reports relate solely to its role as an investor of capital or shareholder in Company Y or to its compliance with reporting, legal, or regulatory requirements, or both, these activities constitute shareholder activities and therefore Company Y is not considered to obtain a benefit from the preparation and filing of the reports.

Example 8. Shareholder activities. The facts are the same as in *Example 7*, except that Company Y's accounting department maintains a general ledger recording individual transactions, but does not prepare any financial statements (such as profit and loss statements and balance sheets). Instead, Company Y forwards the general ledger data to Company X, and Company X analyzes and compiles financial statements for Company Y, as well as for Company X's overall operations, for purposes of complying with U.S. reporting requirements. Company Y is subject to reporting requirements in Country B similar to those applicable to Company X in the United States. Much of the data that Company X analyzes and compiles regarding Company Y's operations for purposes of complying with the U.S. reporting requirements are made available to Company Y for its use in preparing reports that must be filed in Country B. Company Y incorporates these data, after minor adjustments for differences in local accounting practices, into the reports that it files in Country B. Under these circumstances, because Company X's analysis and compilation of Company Y's financial data does not relate solely to its role as an investor of capital or shareholder in Company Y, or to its compliance with reporting, legal, or regulatory requirements, or both, these activities do not constitute shareholder activities.

Example 9. Shareholder activities. Members of Company X's internal audit staff visit Company Y on a semiannual basis in order to review the subsidiary's adherence to internal operating procedures issued by Company X and its compliance with U.S. anti-bribery laws, which apply to Company Y on account of its ownership by a U.S. corporation. Because the sole effect of the reviews by Company X's audit staff is to protect Company X's investment in Company Y, or to facilitate Company X's compliance with U.S. anti-bribery laws, or both, the visits are shareholder activities and therefore Company Y is not considered to obtain a benefit from the visits.

Example 10. Shareholder activities. Country B recently enacted legislation that changed the foreign currency exchange controls applicable to foreign shareholders of Country B corporations. Company X concludes that it may benefit from changing the capital structure of Company Y, thus taking advantage of the new foreign currency exchange control laws in Country B. Company X engages an investment banking firm and a law firm to review the Country B legislation and to propose possible changes to the capital structure of Company Y. Because Company X's retention of the firms facilitates Company Y's ability to pay dividends and other amounts and has the sole effect of protecting Company X's investment in Company Y, these activities constitute shareholder activities and Company Y is not considered to obtain a benefit from the activities.

Example 11. Shareholder activities. The facts are the same as in *Example 10*, except that Company Y bears the full cost of retaining the firms to evaluate the new foreign currency control laws in Country B and to make appropriate changes to its stock ownership by Company X. Company X is considered to obtain a benefit from the rendering by Company Y of these activities, which would be shareholder activities if conducted by Company X (*see Example 10*).

Example 12. Shareholder activities. The facts are the same as in *Example 10*, except that the new laws relate solely to corporate governance in Country B, and Company X retains the law firm and investment banking firm in order to evaluate whether restructuring would increase Company Y's profitability, reduce the number of legal entities in Country B, and increase Company Y's ability to introduce new products more quickly in Country B. Because Company X retained the law firm and the investment banking firm primarily to enhance Company Y's profitability and the efficiency of its operations, and not solely to protect Company X's investment in Company Y or to facilitate Company X's compliance with Country B's corporate laws, or to both, these activities do not constitute shareholder activities.

Example 13. Shareholder activities. Company X establishes detailed personnel policies for its subsidiaries, including Company Y. Company X also reviews and approves the performance appraisals of Company Y's executives, monitors levels of compensation paid to all Company Y personnel, and is involved in hiring and firing decisions regarding the senior executives of Company Y. Because this personnel-related activity by Company X involves day-to-day management of Company Y, this activity does not relate solely to Company X's role as an investor of capital or a shareholder of Company Y, and therefore does not constitute a shareholder activity.

Example 14. Shareholder activities. Each year, Company X conducts a two-day retreat for its senior executives. The purpose of the retreat is to refine the long-term business strategy of Company X and its subsidiaries, including Company Y, and to produce a confidential strategy statement. The strategy statement identifies several potential growth initiatives for Company X and its subsidiaries and lists general means of increasing the profitability of the company as a whole. The strategy statement is made available without charge to Company Y and the other subsidiaries of Company X. Company Y independently evaluates whether to implement some, all, or none of the initiatives contained in the strategy statement. Because the preparation of the strategy statement does not relate solely to Company X's role as an investor of capital or a shareholder of Company Y, the expense of preparing the document is not a shareholder expense.

Example 15. Passive association/benefit. Company X is the parent corporation of a large controlled group that has been in operation in the information-technology sector for ten years. Company Y is a small corporation that was recently acquired by the Company X controlled group from local Country B owners. Several months after the acquisition of Company Y, Company Y obtained a contract to redesign and assemble the information-technology networks and systems of a large financial institution in Country B. The project was significantly larger and more complex than any other project undertaken to date by Company Y. Company Y did not use Company X's marketing intangible property to solicit the contract, and Company X had no involvement in the solicitation, negotiation, or anticipated execution of the contract. For purposes of this section, Company Y is not considered to obtain a benefit from Company X or any other member of the controlled group because the ability of Company Y to obtain the contract, or to obtain the contract on more favorable terms than would have been possible prior to its acquisition by the Company X controlled group, was due to Company Y's status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group.

Example 16. Passive association/benefit. The facts are the same as in *Example 15*, except that Company X executes a performance guarantee with respect to the contract, agreeing to assist in the project if Company Y fails to meet certain mileposts. This performance guarantee allowed Company Y to obtain the contract on materially more favorable terms than otherwise would have been possible. Company Y is considered to obtain a benefit from Company X's execution of the performance guarantee.

Example 17. Passive association/benefit. The facts are the same as in *Example 15*, except that Company X began the process of negotiating the contract with the financial institution in Country B before acquiring Company Y. Once Company Y was acquired by Company X, the contract with the financial institution was entered into by Company Y. Company Y is considered to obtain a benefit from Company X's negotiation of the contract.

Example 18. Passive association/benefit. The facts are the same as in *Example 15*, except that Company X sent a letter to the financial institution in Country B, which represented that Company X had a certain percentage ownership in Company Y and that Company X would maintain that same percentage ownership interest in Company Y until the contract was completed. This letter allowed Company Y to obtain the contract on more favorable terms than otherwise would have been possible. Since this letter from Company X to the financial institution simply affirmed Company Y's status as a member of the controlled group and represented that this status would be maintained until the contract was completed, Company Y is not considered to obtain a benefit from Company X's furnishing of the letter.

Example 19. Passive association/benefit. (i) S is a company that supplies plastic containers to companies in various industries. S establishes the prices for its containers through a price list that offers customers discounts based solely on the volume of containers purchased.

(ii) Company X is the parent corporation of a large controlled group in the information technology sector. Company Y is a wholly-owned subsidiary of Company X located in Country B. Company X and Company Y both purchase plastic containers from unrelated supplier S. In year 1, Company X purchases 1 million units and Company Y purchases 100,000 units. S, basing its prices on purchases by the entire group, completes the order for 1.1 million units at a price of $0.95 per unit, and separately bills and ships the orders to each company. Companies X and Y undertake no bargaining with supplier S with respect to the price charged, and purchase no other products from supplier S.

(iii) R1 and its wholly-owned subsidiary R2 are a controlled group of taxpayers (unrelated to Company X or Company Y) each of which carries out functions comparable to those of Companies X and Y and undertakes purchases of plastic containers from supplier S, identical to those purchased from S by Company X and Company Y, respectively. S, basing its prices on purchases by the entire group, charges R1 and R2 $0.95 per unit for the 1.1 million units ordered. R1 and R2 undertake no bargaining with supplier S with respect to the price charged, and purchase no other products from supplier S.

(iv) U is an uncontrolled taxpayer that carries out comparable functions and undertakes purchases of plastic containers from supplier S identical to Company Y. U is not a member of a controlled group, undertakes no bargaining with supplier S with respect to the price charged, and purchases no other products from supplier S. U purchases 100,000 plastic containers from S at the price of $1.00 per unit.

(v) Company X charges Company Y a fee of $5,000, or $0.05 per unit of plastic containers purchased by Company Y, reflecting the fact that Company Y receives the volume discount from supplier S.

(vi) In evaluating the fee charged by Company X to Company Y, the Commissioner considers whether the transactions between R1, R2, and S or the transactions between U and S provide a more reliable measure of the transactions between Company X, Company Y and S. The Commissioner determines that Company Y's status as a member of a controlled group should be taken into account for purposes of evaluating comparability of the transactions, and concludes that the transactions between R1, R2, and S are more reliably comparable to the transactions between Company X, Company Y, and S. The comparable charge for the purchase was $0.95 per unit. Therefore, obtaining the plastic containers at a favorable rate (and the resulting $5,000 savings) is entirely due to Company Y's status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group. Consequently, Company Y is not considered to obtain a benefit from Company X or any other member of the controlled group.

Example 20. Disaggregation of transactions. (i) X, a domestic corporation, is a pharmaceutical company that develops and manufactures ethical pharmaceutical products. Y, a Country B corporation, is a distribution and marketing company that also performs clinical trials for X in Country B. Because Y does not possess the capability to conduct the trials, it contracts with a third party to undertake the trials at a cost of $100. Y also incurs $25 in expenses related to the third-party contract (for example, in hiring and working with the third party).

(ii) Based on a detailed functional analysis, the Commissioner determines that Y performed functions beyond merely facilitating the clinical trials for X, such as audit controls of the third party performing those trials. In determining the arm's length price, the Commissioner may consider a number of alternatives. For example, for purposes of determining the arm's length price, the Commissioner may determine that the intercompany service is most reliably analyzed on a disaggregated basis as two separate transactions: in this case, the contract between Y and the third party could constitute an internal CUSP with a price of $100. Y would be further entitled to an arm's length remuneration for its facilitating services. If the most reliable method is one that provides a markup on Y's costs, then ''total services cost'' in this context would be $25. Alternatively, the Commissioner may determine that the intercompany service is most reliably analyzed as a single transaction, based on comparable uncontrolled transactions involving the facilitation of similar clinical trial services performed by third parties. If the most reliable method is one that provides a markup on all of Y's costs, and the base of the markup determined by the comparable companies includes the third-party clinical trial costs, then such a markup would be applied to Y's total services cost of $125.

Example 21. Disaggregation of transactions. (i) X performs a number of administrative functions for its subsidiaries, including Y, a distributor of widgets in Country B. These services include those relating to working capital (inventory and accounts receivable/payable) management. To facilitate provision of these services, X purchases an ERP system specifically dedicated to optimizing working capital management. The system, which entails significant third-party costs and which includes substantial intellectual property relating to its software, costs $1,000.

(ii) Based on a detailed functional analysis, the Commissioner determines that in providing administrative services for Y, X performed functions beyond merely operating the ERP system itself, since X was effectively using the ERP as an input to the administrative services it was providing to Y. In determining arm's length price for the services, the Commissioner may consider a number of alternatives. For example, if the most reliable uncontrolled data is derived from companies that use similar ERP systems purchased from third parties to perform similar administrative functions for uncontrolled parties, the Commissioner may determine that a CPM is the best method for measuring the functions performed by X, and, in addition, that a markup on total services costs, based on the markup from the comparable companies, is the most reliable PLI. In this case, total services cost, and the basis for the markup, would include appropriate reflection of the ERP costs of $1,000. Alternatively, X's functions may be most reliably measured based on comparable uncontrolled companies that perform similar administrative functions using their customers' own ERP systems. Under these circumstances, the total services cost would equal X's costs of providing the administrative services excluding the ERP cost of $1,000.

(m) *Coordination with transfer pricing rules for other transactions*—(1) *Services transactions that include other types of transactions.* A transaction structured as a controlled services transaction may include other elements for which a separate category or categories of methods are provided, such as a loan or advance, a rental, or a transfer of tangible or intangible property. *See* §§ 1.482–1(b)(2) and 1.482–2(a), (c), and (d). Whether such an integrated transaction is evaluated as a controlled services transaction under this section or whether one or more elements should be evaluated separately under other sections of the section 482 regulations depends on which approach will provide the most reliable measure of an arm's length result. Ordinarily, an integrated transaction of this type may be evaluated under this section and its separate elements need not be evaluated separately, provided that each component of the transaction may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm's length result in the controlled transaction. *See* § 1.482–1(d)(3).

(2) *Services transactions that effect a transfer of intangible property.* A transaction structured as a controlled services transaction may in certain cases include an element that constitutes the transfer of intangible property or may result in a transfer, in whole or in part, of intangible property. Notwithstanding paragraph (m)(1) of this section, if such element relating to intangible property is material to the evaluation, the arm's length result for the element of the transaction that involves intangible property must be corroborated or determined by an analysis under § 1.482–4.

(3) *Coordination with rules governing cost sharing arrangements.* Section 1.482–7 provides the specific methods to be used to determine arm's length results of controlled transactions in connection with a cost sharing arrangement. This section provides the specific methods to be used to determine arm's length results of a controlled service transaction, including in an arrangement for sharing the costs and risks of developing intangibles other than a cost sharing arrangement covered by § 1.482–7. In the case of such an arrangement, consideration of the principles, methods, comparability, and reliability considerations set forth in § 1.482–7 is relevant in determining the best method, including an unspecified method, under this section, as appropriately adjusted in light of the differences in the facts and circumstances between such arrangement and a cost sharing arrangement.

(4) *Other types of transactions that include controlled services transactions.* A transaction structured other than as a controlled services transaction may include one or more elements for which separate pricing methods are provided in this section. Whether such an integrated transaction is evaluated under another section of the section 482 regulations or whether one or more elements should be evaluated separately under this section depends on which approach will provide the most reliable measure of an arm's length result. Ordinarily, a single method may be applied to such an integrated transaction, and the separate services component of the transaction need not be separately analyzed under this section, provided that the controlled services may be adequately accounted for in

evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm's length results in the controlled transaction. *See* § 1.482–1(d)(3).

(5) *Examples.* The principles of this paragraph (m) are illustrated by the following examples:

Example 1. (i) U.S. parent corporation Company X enters into an agreement to maintain equipment of Company Y, a foreign subsidiary. The maintenance of the equipment requires the use of spare parts. The cost of the spare parts necessary to maintain the equipment amounts to approximately 25 percent of the total costs of maintaining the equipment. Company Y pays a fee that includes a charge for labor and parts.

(ii) Whether this integrated transaction is evaluated as a controlled services transaction or is evaluated as a controlled services transaction and the transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. If it is not possible to find comparable uncontrolled services transactions that involve similar services and tangible property transfers as the controlled transaction between Company X and Company Y, it will be necessary to determine the arm's length charge for the controlled services, and then to evaluate separately the arm's length charge for the tangible property transfers under § 1.482–1 and §§ 1.482–3 through 1.482–6. Alternatively, it may be possible to apply the comparable profits method of § 1.482–5 to evaluate the arm's length profit of Company X or Company Y from the integrated controlled transaction. The comparable profits method may provide the most reliable measure of an arm's length result if uncontrolled parties are identified that perform similar, combined functions of maintaining and providing spare parts for similar equipment.

Example 2. (i) U.S. parent corporation Company X sells industrial equipment to its foreign subsidiary, Company Y. In connection with this sale, Company X renders to Company Y services that consist of demonstrating the use of the equipment and assisting in the effective start-up of the equipment. Company X structures the integrated transaction as a sale of tangible property and determines the transfer price under the comparable uncontrolled price method of § 1.482–3(b).

(ii) Whether this integrated transaction is evaluated as a transfer of tangible property or is evaluated as a controlled services transaction and a transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. In this case, the controlled services may be similar to services rendered in the transactions used to determine the comparable uncontrolled price, or they may appropriately be considered a difference between the controlled transaction and comparable transactions with a definite and reasonably ascertainable effect on price for which appropriate adjustments can be made. *See* § 1.482–1(d)(3)(ii)(A)(*6*). In either case, application of the comparable uncontrolled price method to evaluate the integrated transaction may provide a reliable measure of an arm's length result, and application of a separate transfer pricing method for the controlled services element of the transaction is not necessary.

Example 3. (i) The facts are the same as in *Example 2* except that, after assisting Company Y in start-up, Company X also renders ongoing services, including instruction and supervision regarding Company Y's ongoing use of the equipment. Company X structures the entire transaction, including the incremental ongoing services, as a sale of tangible property, and determines the transfer price under the comparable uncontrolled price method of § 1.482–3(b).

(ii) Whether this integrated transaction is evaluated as a transfer of tangible property or is evaluated as a controlled services transaction and a transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. It may not be possible to identify comparable uncontrolled transactions in which a seller of merchandise renders services similar to the ongoing services rendered by Company X to Company Y. In such a case, the incremental services in connection with ongoing use of the equipment could not be taken into account as a comparability factor because they are not similar to the services rendered in connection with sales of similar tangible property. Accordingly, it may be necessary to evaluate separately the transfer price for such services under this section in order to produce the most reliable measure of an arm's length result. Alternatively, it may be possible to apply the comparable profits method of § 1.482–5 to evaluate the arm's length profit of Company X or Company Y from the integrated controlled transaction. The comparable profits method may provide the most reliable measure of an arm's length result if uncontrolled parties are identified that perform the combined functions of selling equipment and rendering ongoing after-sale services associated with such equipment. In that case, it would not be necessary to separately evaluate the transfer price for the controlled services under this section.

Example 4. (i) Company X, a U.S. corporation, and Company Y, a foreign corporation, are members of a controlled group. Both companies perform research and development activities relating to integrated circuits. In addition, Company Y manufactures integrated circuits. In years 1 through 3, Company X engages in substantial research and development activities, gains significant know-how regarding the development of a particular high-temperature resistant integrated circuit, and memorializes that research in a written report. In years 1 through 3, Company X generates overall net operating losses as a result of the expenditures associated with this research and development effort. At the beginning of year 4, Company X enters into a technical assistance agreement with Company Y. As part of this agreement, the researchers from Company X responsible for this project meet with the researchers from Company Y and provide them with a copy of the written report. Three months later, the researchers from Company Y apply for a patent for a high-temperature resistant integrated circuit based in large part upon the know-how obtained from the researchers from Company X.

(ii) The controlled services transaction between Company X and Company Y includes an element that constitutes the transfer of intangible property (such as, know-how). Because the element relating to the intangible property is material to the arm's length evaluation, the arm's length result for that element must be corroborated or determined by an analysis under §1.482–4.

(6) *Global dealing operations.* [Reserved]

(n) *Effective/applicability date*—(1) *In general.* This section is generally applicable for taxable years beginning after July 31, 2009. In addition, a person may elect to apply the provisions of this section to earlier taxable years. *See* paragraph (n)(2) of this section.

(2) *Election to apply regulations to earlier taxable years*—(i) *Scope of election.* A taxpayer may elect to apply §1.482–1(a)(1), (b)(2)(i), (d)(3)(ii)(C) *Examples 3* through *6,* (d)(3)(v), (f)(2)(ii)(A), (f)(2)(iii)(B), (g)(4)(i), (g)(4)(iii) *Example 1,* (i), (j)(6)(i) and (j)(6)(ii), §1.482–2(b), (f)(1) and (2), §1.482–4(f)(3)(i)(A), (f)(3)(ii) *Examples 1* and *2,* (f)(4), (h)(1) and (2), §1.482–6(c)(2)(ii)(B)(1), (c)(2)(ii)(D), (c)(3)(i)(A), (c)(3)(i)(B), (c)(3)(ii)(D), and (d), §1.482–8(b) *Examples 10* through *12,* (c)(1) and (c)(2), §1.482–9(a) through (m)(2), and (m)(4) through (n)(2), §1.861–8(a)(5)(ii), (b)(3), (e)(4), (f)(4)(i), (g) *Examples 17, 18,* and *30,* §1.6038A–3(a)(3) *Example 4* and (i), §1.6662–6(d)(2)(ii)(B), (d)(2)(iii)(B)(*4*), (d)(2)(iii)(B)(*6*), and (g), and §31.3121(s)–1(c)(2)(iii) and (d) of this chapter to any taxable year beginning after September 10, 2003. Such election requires that all of the provisions of such sections be applied to such taxable year and all subsequent taxable years (earlier taxable years) of the taxpayer making the election.

(ii) *Effect of election.* An election to apply the regulations to earlier taxable years has no effect on the limitations on assessment and collection or on the limitations on credit or refund (*see* Chapter 66 of the Internal Revenue Code).

(iii) *Time and manner of making election.* An election to apply the regulations to earlier taxable years must be made by attaching a statement to the taxpayer's timely filed U.S. tax return (including extensions) for its first taxable year beginning after July 31, 2009.

(iv) *Revocation of election.* An election to apply the regulations to earlier taxable years may not be revoked without the consent of the Commissioner.

[T.D. 9456, 74 FR 38846, Aug. 4, 2009, as amended by 74 FR 46345, Sept. 9, 2009; T.D. 9568, 76 FR 80136, Dec. 22, 2011]

§ 1.483–1 Interest on certain deferred payments.

(a) *Amount constituting interest in certain deferred payment transactions*—(1) *In general.* Except as provided in paragraph (c) of this section, section 483 applies to a contract for the sale or exchange of property if the contract provides for one or more payments due more than 1 year after the date of the sale or exchange, and the contract does not provide for adequate stated interest. In general, a contract has adequate stated interest if the contract provides for a stated rate of interest that is at least equal to the test rate (determined under §1.483–3) and the interest is paid or compounded at least annually. Section 483 may apply to a contract whether the contract is express (written or oral) or implied. For purposes of section 483, a sale or exchange is any transaction treated as a sale or exchange for tax purposes. In addition, for purposes of section 483, property includes debt instruments and investment units, but does not include money, services, or the right to use property. For the treatment of certain obligations given in exchange for services or the use of property, see sections

404 and 467. For purposes of this paragraph (a), money includes functional currency and, in certain circumstances, nonfunctional currency. See §1.988–2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.

(2) *Treatment of contracts to which section 483 applies*—(i) *Treatment of unstated interest.* If section 483 applies to a contract, unstated interest under the contract is treated as interest for tax purposes. Thus, for example, unstated interest is not treated as part of the amount realized from the sale or exchange of property (in the case of the seller), and is not included in the purchaser's basis in the property acquired in the sale or exchange.

(ii) *Method of accounting for interest on contracts subject to section 483.* Any stated or unstated interest on a contract subject to section 483 is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method). See §§1.446–1, 1.451–1, and 1.461–1. For purposes of the preceding sentence, the amount of interest (including unstated interest) allocable to a payment under a contract to which section 483 applies is determined under §1.446–2(e).

(b) *Definitions*—(1) *Deferred payments.* For purposes of the regulations under section 483, a deferred payment means any payment that constitutes all or a part of the sales price (as defined in paragraph (b)(2) of this section), and that is due more than 6 months after the date of the sale or exchange. Except as provided in section 483(c)(2) (relating to the treatment of a debt instrument of the purchaser), a payment may be made in the form of cash, stock or securities, or other property.

(2) *Sales price.* For purposes of section 483, the sales price for any sale or exchange is the sum of the amount due under the contract (other than stated interest) and the amount of any liability included in the amount realized from the sale or exchange. See §1.1001–2. Thus, the sales price for any sale or exchange includes any amount of unstated interest under the contract.

(c) *Exceptions to and limitations on the application of section 483*—(1) *In general.* Sections 483(d), 1274(c)(4), and 1275(b) contain exceptions to and limitations on the application of section 483.

(2) *Sales price of $3,000 or less.* Section 483(d)(2) applies only if it can be determined at the time of the sale or exchange that the sales price cannot exceed $3,000, regardless of whether the sales price eventually paid for the property is less than $3,000.

(3) *Other exceptions and limitations*—(i) *Certain transfers subject to section 1041.* Section 483 does not apply to any transfer of property subject to section 1041 (relating to transfers of property between spouses or incident to divorce).

(ii) *Treatment of certain obligees.* Section 483 does not apply to an obligee under a contract for the sale or exchange of personal use property (within the meaning of section 1275(b)(3)) in the hands of the obligor and that evidences a below-market loan described in section 7872(c)(1).

(iii) *Transactions involving certain demand loans.* Section 483 does not apply to any payment under a contract that evidences a demand loan that is a below-market loan described in section 7872(c)(1).

(iv) *Transactions involving certain annuity contracts.* Section 483 does not apply to any payment under an annuity contract described in section 1275(a)(1)(B) (relating to annuity contracts excluded from the definition of debt instrument).

(v) *Options.* Section 483 does not apply to any payment under an option to buy or sell property.

(d) *Assumptions.* If a debt instrument is assumed, or property is taken subject to a debt instrument, in connection with a sale or exchange of property, the debt instrument is treated for purposes of section 483 in a manner consistent with the rules of §1.1274–5.

(e) *Aggregation rule.* For purposes of section 483, all sales or exchanges that are part of the same transaction (or a series of related transactions) are treated as a single sale or exchange, and all contracts calling for deferred payments arising from the same transaction (or a series of related transactions) are treated as a single contract. This rule, however, generally only applies to contracts and to sales or exchanges involving a single buyer and a single seller.

(f) *Effective date.* This section applies to sales and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4805, Feb. 2, 1994]

§ 1.483–2 Unstated interest.

(a) *In general*—(1) *Adequate stated interest.* For purposes of section 483, a contract has unstated interest if the contract does not provide for adequate stated interest. A contract does not provide for adequate stated interest if the sum of the deferred payments exceeds—

(i) The sum of the present values of the deferred payments and the present values of any stated interest payments due under the contract; or

(ii) In the case of a cash method debt instrument (within the meaning of section 1274A(c)(2)) received in exchange for property in a potentially abusive situation (as defined in §1.1274–3), the fair market value of the property reduced by the fair market value of any consideration other than the debt instrument, and reduced by the sum of all principal payments that are not deferred payments.

(2) *Amount of unstated interest.* For purposes of section 483, unstated interest means an amount equal to the excess of the sum of the deferred payments over the amount described in paragraph (a)(1)(i) or (a)(1)(ii) of this section, whichever is applicable.

(b) *Operational rules*—(1) *In general.* For purposes of paragraph (a) of this section, rules similar to those in §1.1274–2 apply to determine whether a contract has adequate stated interest and the amount of unstated interest, if any, on the contract.

(2) *Present value.* For purposes of paragraph (a) of this section, the present value of any deferred payment or interest payment is determined by discounting the payment from the date it becomes due to the date of the sale or exchange at the test rate of interest applicable to the contract in accordance with §1.483–3.

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

Example 1. Contract that does not have adequate stated interest. On January 1, 1995, A sells B nonpublicly traded property under a contract that calls for a $100,000 payment of principal on January 1, 2005, and 10 annual interest payments of $9,000 on January 1 of each year, beginning on January 1, 1996. Assume that the test rate of interest is 9.2 percent, compounded annually. The contract does not provide for adequate stated interest because it does not provide for interest equal to 9.2 percent, compounded annually. The present value of the deferred payments is $98,727.69. As a result, the contract has unstated interest of $1,272.31 ($100,000 − $98,727.69).

Example 2. Contract that does not have adequate stated interest; no interest for initial short period. On May 1, 1996, A sells B nonpublicly traded property under a contract that calls for B to make a principal payment of $200,000 on December 31, 1998, and semiannual interest payments of $9,000, payable on June 30 and December 31 of each year, beginning on December 31, 1996. Assume that the test rate of interest is 9 percent, compounded semiannually. Even though the contract calls for a stated rate of interest no lower than the test rate of interest, the contract does not provide for adequate stated interest because the stated rate of interest does not apply for the short period from May 1, 1996, through June 30, 1996.

Example 3. Potentially abusive situation. (i) *Facts.* In a potentially abusive situation, a contract for the sale of nonpublicly traded personal property calls for the issuance of a cash method debt instrument (as defined in section 1274A(c)(2)) with a stated principal amount of $700,000, payable in 5 years. No other consideration is given. The debt instrument calls for annual payments of interest over its entire term at a rate of 9.2 percent, compounded annually (the test rate of interest applicable to the debt instrument). Thus, the present value of the deferred payment and the interest payments is $700,000. Assume that the fair market value of the property is $500,000.

(ii) *Amount of unstated interest.* A cash method debt instrument received in exchange for property in a potentially abusive situation provides for adequate stated interest only if the sum of the deferred payments under the instrument does not exceed the fair market value of the property. Because the deferred payment ($700,000) exceeds the fair market value of the property ($500,000), the debt instrument does not provide for adequate stated interest. Therefore, the debt instrument has unstated interest of $200,000.

Example 4. Variable rate debt instrument with adequate stated interest; variable rate as of the issue date greater than the test rate. (i) *Facts.* A contract for the sale of nonpublicly traded property calls for the issuance of a debt instrument in the principal amount of $75,000 due in 10 years. The debt instrument calls for interest payable semiannually at a rate of 3 percentage points above the yield on 6-month Treasury bills at the mid-point of the semiannual period immediately preceding each interest payment date. Assume that the interest rate is a qualified floating rate and that the debt instrument is a variable rate debt instrument within the meaning of §1.1275–5.

(ii) *Adequate stated interest*. Under paragraph (b)(1) of this section, rules similar to those in §1.1274–2(f) apply to determine whether the debt instrument has adequate stated interest. Assume that the test rate of interest applicable to the debt instrument is 9 percent, compounded semiannually. Assume also that the yield on 6-month Treasury bills on the date of the sale is 8.89 percent, which is greater than the yield on 6-month Treasury bills on the first date on which there is a binding written contract that substantially sets forth the terms under which the sale is consummated. Under §1.1274–2(f), the debt instrument is tested for adequate stated interest as if it provided for a stated rate of interest of 11.89 percent (3 percent plus 8.89 percent), compounded semiannually, payable over its entire term. Because the test rate of interest is 9 percent, compounded semiannually, and the debt instrument is treated as providing for stated interest of 11.89 percent, compounded semiannually, the debt instrument provides for adequate stated interest.

(d) *Effective date*. This section applies to sales and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4806, Feb. 2, 1994]

§ 1.483–3 Test rate of interest applicable to a contract.

(a) *General rule*. For purposes of section 483, the test rate of interest for a contract is the same as the test rate that would apply under §1.1274–4 if the contract were a debt instrument. Paragraph (b) of this section, however, provides for a lower test rate in the case of certain sales or exchanges of land between related individuals.

(b) *Lower rate for certain sales or exchanges of land between related individuals*—(1) *Test rate*. In the case of a qualified sale or exchange of land between related individuals (described in section 483(e)), the test rate is not greater than 6 percent, compounded semiannually, or an equivalent rate based on an appropriate compounding period.

(2) *Special rules*. The following rules and definitions apply in determining whether a sale or exchange is a qualified sale under section 483(e):

(i) *Definition of family members*. The members of an individual's family are determined as of the date of the sale or exchange. The members of an individual's family include those individuals described in section 267(c)(4) and the spouses of those individuals. In addition, for purposes of section 267(c)(4), full effect is given to a legal adoption, ancestor means parents and grandparents, and lineal descendants means children and grandchildren.

(ii) *$500,000 limitation*. Section 483(e) does not apply to the extent that the stated principal amount of the debt instrument issued in the sale or exchange, when added to the aggregate stated principal amount of any other debt instruments to which section 483(e) applies that were issued in prior qualified sales between the same two individuals during the same calendar year, exceeds $500,000. See *Example 3* of paragraph (b)(3) of this section.

(iii) *Other limitations*. Section 483(e) does not apply if the parties to a contract include persons other than the related individuals and the parties enter into the contract with an intent to circumvent the purposes of section 483(e). In addition, if the property sold or exchanged includes any property other than land, section 483(e) applies only to the extent that the stated principal amount of the debt instrument issued in the sale or exchange is attributable to the land (based on the relative fair market values of the land and the other property).

(3) *Examples*. The following examples illustrate the rules of this paragraph (b).

Example 1. On January 1, 1995, A sells land to B, A's child, for $650,000. The contract for sale calls for B to make a $250,000 down payment and issue a debt instrument with a stated principal amount of $400,000. Because the stated principal amount of the debt instrument is less than $500,000, the sale is a qualified sale and section 483(e) applies to the debt instrument.

Example 2. The facts are the same as in *Example 1* of paragraph (b)(3) of this section, except that on June 1, 1995, A sells additional land to B under a contract that calls for B to issue a debt instrument with a stated principal amount of $100,000. The stated principal amount of this debt instrument ($100,000) when added to the stated principal amount of the prior debt instrument ($400,000) does not exceed $500,000. Thus, section 483(e) applies to both debt instruments.

Example 3. The facts are the same as in *Example 1* of paragraph (b)(3) of this section, except that on June 1, 1995, A sells additional land to B under a contract that calls for B to issue a debt instrument with a stated principal amount of $150,000. The stated principal amount of this debt instrument when added to the stated principal amount of the prior debt instrument ($400,000) exceeds $500,000. Thus, for purposes of section 483(e), the debt instrument issued in the sale of June 1, 1995, is treated as two separate debt instruments: a $100,000 debt instrument (to which section 483(e) applies) and a $50,000 debt instrument (to which section 1274, if otherwise applicable, applies).

(c) *Effective date.* This section applies to sales and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4807, Feb. 2, 1994]

§ 1.483–4 Contingent payments.

(a) *In general.* This section applies to a contract for the sale or exchange of property (the overall contract) if the contract provides for one or more contingent payments and the contract is subject to section 483. This section applies even if the contract provides for adequate stated interest under § 1.483–2. If this section applies to a contract, interest under the contract is generally computed and accounted for using rules similar to those that would apply if the contract were a debt instrument subject to § 1.1275–4(c). Consequently, all noncontingent payments under the overall contract are treated as if made under a separate contract, and interest accruals on this separate contract are computed under rules similar to those contained in § 1.1275–4(c)(3). Each contingent payment under the overall contract is characterized as principal and interest under rules similar to those contained in § 1.1275–4(c)(4). However, any interest, or amount treated as interest, on a contract subject to this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method).

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

Example 1. Deferred payment sale with contingent interest. (i) *Facts.* On December 31, 1996, A sells depreciable personal property to B. As consideration for the sale, B issues to A a debt instrument with a maturity date of December 31, 2001. The debt instrument provides for a principal payment of $200,000 on the maturity date, and a payment of interest on December 31 of each year, beginning in 1997, equal to a percentage of the total gross income derived from the property in that year. However, the total interest payable on the debt instrument over its entire term is limited to a maximum of $50,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually, and the mid-term applicable Federal rate is 5 percent, compounded annually.

(ii) *Treatment of noncontingent payment as separate contract.* Each payment of interest is a contingent payment. Accordingly, under paragraph (a) of this section, for purposes of applying section 483 to the debt instrument, the right to the noncontingent payment of $200,000 is treated as a separate contract. The amount of unstated interest on this separate contract is equal to $43,295, which is the amount by which the payment ($200,000) exceeds the present value of the payment ($156,705), calculated using the test rate of 5 percent, compounded annually. The $200,000 payment is thus treated as consisting of a payment of interest of $43,295 and a payment of principal of $156,705. The interest is includible in A's gross income, and deductible by B, under their respective methods of accounting.

(iii) *Treatment of contingent payments.* Assume that the amount of the contingent payment that is paid on December 31, 1997, is $20,000. Under paragraph (a) of this section, the $20,000 payment is treated as a payment of principal of $19,231 (the present value, as of the date of sale, of the $20,000 payment, calculated using a test rate equal to 4 percent, compounded annually) and a payment of interest of $769. The $769 interest payment is includible in A's gross income, and deductible by B, in their respective taxable years in which the payment occurs. The amount treated as principal gives B additional basis in the property on December 31, 1997. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 4 percent, compounded annually, for the payments made on December 31, 1998, and December 31, 1999, and a test rate of

5 percent, compounded annually, for the payments made on December 31, 2000, and December 31, 2001.

Example 2. Contingent stock payout. (i) *Facts.* M Corporation and N Corporation each owns one-half of the stock of O Corporation. On December 31, 1996, pursuant to a reorganization qualifying under section 368(a)(1)(B), M acquires the one-half interest of O held by N in exchange for 30,000 shares of M voting stock and a non-assignable right to receive up to 10,000 additional shares of M's voting stock during the next 3 years, provided the net profits of O exceed certain amounts specified in the contract. No interest is provided for in the contract. No additional shares are received in 1997 or in 1998. In 1999, the annual earnings of O exceed the specified amount, and, on December 31, 1999, an additional 3,000 M voting shares are transferred to N. The fair market value of the 3,000 shares on December 31, 1999, is $300,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually. M and N are calendar year taxpayers.

(ii) *Allocation of interest.* Section 1274 does not apply to the right to receive the additional shares because the right is not a debt instrument for federal income tax purposes. As a result, the transfer of the 3,000 M voting shares to N is a deferred payment subject to section 483 and a portion of the shares is treated as unstated interest under that section. The amount of interest allocable to the shares is equal to the excess of $300,000 (the fair market value of the shares on December 31, 1999) over $266,699 (the present value of $300,000, determined by discounting the payment at the test rate of 4 percent, compounded annually, from December 31, 1999, to December 31, 1996). As a result, the amount of interest allocable to the payment of the shares is $33,301 ($300,000–$266,699). Both M and N take the interest into account in 1999.

(c) *Effective date.* This section applies to sales and exchanges that occur on or after August 13, 1996.

[T.D. 8674, 61 FR 30138, June 14, 1996]

REGULATIONS APPLICABLE FOR TAXABLE YEARS BEGINNING ON OR BEFORE APRIL 21, 1993

§ 1.482–1A Allocation of income and deductions among taxpayers.

(a) *Definitions.* When used in this section and in § 1.482–2—

(1) The term ''organization'' includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The term ''trade'' or ''business'' includes any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term ''controlled'' includes any kind of control, direct or indirect, whether 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.

(4) The term ''controlled taxpayer'' means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms ''group'' and ''group of controlled taxpayers'' mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term ''true taxable income'' means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

(3) Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions. It is not intended (except in the case of the computation of consolidated taxable income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated taxable income under subchapter A, chapter 6 of the Code.

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(d) *Method of allocation.* (1) The method of allocating, apportioning, or distributing income, deductions, credits, and allowances to be used by the district director in any case, including the form of the adjustments and the character and source of amounts allocated, shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income. The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory), or any other adjustment which may be appropriate under the circumstances. See §1.482–2 for specific rules relating to methods of allocation in the case of several types of business transactions.

(2) Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as ''primary'' adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the U.S. income tax liability of the other member would be affected

for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U.S. income tax liability of the other member for any pending taxable year. For the purposes of this subparagraph, a "pending taxable year" is any taxable year with respect to which the U.S. income tax return of the other member has been filed by the time the allocation is made, and with respect to which a credit or refund is not barred by the operation of any law or rule of law. If a correlative adjustment is not actually made because it would have no effect on the U.S. income tax liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of determining the U.S. income tax liability of such member for a later taxable year, or for the purposes of determining the U.S. income tax liability of any person for any taxable year. The district director shall furnish to the taxpayer with respect to which the primary adjustment is made a written statement of the amount and nature of the correlative adjustment which is deemed to have been made. For purposes of this subparagraph, a primary adjustment shall not be considered to have been made (and therefore a correlative adjustment is not required to be made) until the first occurring of the following events with respect to the primary adjustment:

(i) The date of assessment of the tax following execution by the taxpayer of a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) with respect to such adjustment,

(ii) Acceptance of a Form 870–AD (Offer of Waiver of Restriction on Assessment and Collection Deficiency in Tax and Acceptance of Overassessment),

(iii) Payment of the deficiency,

(iv) Stipulation in the Tax Court of the United States, or

(v) Final determination of tax liability by offer-in-compromise, closing agreement, or court action.

The principles of this subparagraph may be illustrated by the following examples in each of which it is assumed that X and Y are members of the same group of controlled entities and that they regularly compute their incomes on the basis of a calendar year:

Example 1. Assume that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length rental charge for Y's use of X's tangible property in 1966; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. The primary adjustment is therefore considered to have been made in 1968. Assume further that both X and Y are United States corporations and that Y had net operating losses in 1963, 1964, 1965, 1966, and 1967. Although a correlative adjustment would not have an effect on Y's U.S. income tax liability for any pending taxable year, an adjustment increasing Y's net operating loss for 1966 shall be deemed to have been made for the purposes of determining Y's U.S. income tax liability for 1968 or a later taxable year to which the increased operating loss may be carried. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example 2. Assume that X and Y are United States corporations; that X is in the business of rendering engineering services; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length fee for the rendition of engineering services by X in 1966 relating to the construction of Y's factory; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Assume further that fees for such services would properly constitute a capital expenditure by Y, and that Y does not place the factory in service until 1969. Although a correlative adjustment (increase in basis) would not have an effect on Y's U.S. income tax liability for a pending taxable year, an adjustment increasing the basis of Y's assets for 1966 shall be deemed to have been made in 1968 for the purpose of computing allowable depreciation or gain or loss on disposition for 1969 and any future taxable year. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example 3. Assume that X is a U.S. taxpayer and Y is a foreign taxpayer not engaged in a trade or business in the United

States; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length interest charge on a loan made to Y; that X consents to an assessment reflecting such allocation by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Although a correlative adjustment would not have an effect on Y's U.S. income tax liability, an adjustment in Y's income for 1966 shall be deemed to have been made in 1968 for the purposes of determining the amount of Y's earnings and profits for 1966 and subsequent years, and of any other effect it may have on any person's U.S. income tax liability for any taxable year. The district director shall notify X in writing of the amount and nature of the allocation which is deemed to have been made to Y.

(3) In making distributions, apportionments, or allocations between two members of a group of controlled entities with respect to particular transactions, the district director shall consider the effect upon such members of an arrangement between them for reimbursement within a reasonable period before or after the taxable year if the taxpayer can establish that such an arrangement in fact existed during the taxable year under consideration. The district director shall also consider the effect of any other nonarm's length transaction between them in the taxable year which, if taken into account, would result in a setoff against any allocation which would otherwise be made, provided the taxpayer is able to establish with reasonable specificity that the transaction was not at arm's length and the amount of the appropriate arm's length charge. For purposes of the preceding sentence, the term arm's length refers to the amount which was charged or would have been charged in independent transactions with unrelated parties under the same or similar circumstances considering all the relevant facts and without regard to the rules found in §1.482–2 by which certain charges are deemed to be equal to arm's length. For example, assume that one member of a group performs services which benefit a second member, which would in itself require an allocation to reflect an arm's length charge for the performance of such services. Assume further that the first member can establish that during the same taxable year the second member engages in other nonarm's length transactions which benefit the first member, such as by selling products to the first member at a discount, or purchasing products from the first member at a premium, or paying royalties to the first member in an excessive amount. In such case, the value of the benefits received by the first member as a result of the other activities will be set-off against the allocation which would otherwise be made. If the effect of the set-off is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the United States tax liability of any member, allocations will be made to reflect the correct amount of each category of income or deductions. In order to establish that a set-off to the adjustments proposed by the district director is appropriate, the taxpayer must notify the district director of the basis of any claimed set-off at any time before the expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or before July 16, 1968, whichever is later. The principles of this subparagraph may be illustrated by the following examples, in each of which it is assumed that P and S are calendar year corporations and are both members of the same group of controlled entities:

Example 1. P performs services in 1966 for the benefit of S in connection with S's manufacture and sale of a product. S does not pay P for such services in 1966, but in consideration for such services, agrees in 1966 to pay P a percentage of the amount of sales of the product in 1966 through 1970. In 1966 it appeared this agreement would provide adequate consideration for the services. No allocation will be made with respect to the services performed by P.

Example 2. P renders services to S in connection with the construction of S's factory. An arm's length charge for such services, determined under paragraph (b) of §1.482–2, would be $100,000. During the same taxable year P makes available to S a machine to be used in such construction. P bills S $125,000 for the services, but does not bill for the use of the machine. No allocation will be made with respect to the excessive charge for services or the undercharge for the machine if P can establish that the excessive charge for services was equal to an arm's length charge for the use of the machine, and if the taxable income and income tax liabilities of P and S are not distorted.

Example 3. Assume the same facts as in Example 2, except that, if P had reported $25,000 as rental income and $25,000 less service income, it would have been subject to the tax on personal holding companies. Allocations will be made to reflect the correct amounts of rental income and service income.

(4) If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members under the standards set forth in this section and in §1.482–2 notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period. For example, if one member of a controlled group sells a product at less than an arm's length price to a second member of the group in one taxable year and the second member resells the product to an unrelated party in the next taxable year, the district director may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, notwithstanding that the second member of the group had not realized any gross income from the resale of the product in the first year. Similarly, if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members.

(5) Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such as section 351) providing for nonrecognition of gain or loss. See, for example, ''National Securities Corporation v. Commissioner of Internal Revenue'', 137 F. 2d 600 (3d Cir. 1943), cert. denied 320 U.S. 794 (1943).

(6) If payment or reimbursement for the sale, exchange, or use of property, the rendition of services, or the advance of other consideration among members of a group of controlled entities was prevented, or would have been prevented, at the time of the transaction because of currency or other restrictions imposed under the laws of any foreign country, any distributions, apportionments, or allocations which may be made under section 482 with respect to such transactions may be treated as deferrable income or deductions, providing the taxpayer has, for the year to which the distributions, apportionments, or allocations relate, elected to use a method of accounting in which the reporting of deferrable income is deferred until the income ceases to be deferrable income. Under such method of accounting, referred to in this section as the deferred income method of accounting, any payments or reimbursements which were prevented or would have been prevented, and any deductions attributable directly or indirectly to such payments or reimbursements, shall be deferred until they cease to be deferrable under such method of accounting. If such method of accounting has not been elected with respect to the taxable year to which the allocations under section 482 relate, the taxpayer may elect such method with respect to such allocations (but not with respect to other deferrable income) at any time before the first occurring of the following events with respect to the allocations:

(i) Execution by the taxpayer of Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment);

(ii) Expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments reflecting such allocations or before July 16, 1968, whichever is later; or

(iii) Execution of a closing agreement or offer-in-compromise.

The principles of this subparagraph may be illustrated by the following example in which it is assumed that X, a domestic corporation, and Y, a foreign corporation, are members of the same group of controlled entities:

Example. X, which is in the business of rendering a certain type of service to unrelated parties, renders such services for the benefit of Y in 1965. The direct and indirect costs allocable to such services are $60,000, and an arm's length charge for such services is $100,000. Assume that the district director proposes to increase X's income by $100,000, but that the country in which Y is located would have blocked payment in 1965 for such services. If, prior to the first occurring of the events described in subdivisions (i), (ii), or (iii) of this subparagraph, X elects to use the deferred income method of accounting with respect to such allocation, the $100,000 allocation and the $60,000 of costs are deferrable until such amounts cease to be deferrable under X's method of accounting.

[T.D. 6595, 27 FR 3598, Apr. 14, 1962, as amended by T.D. 6952, 33 FR 5848, Apr. 16, 1968. Redesignated by T.D. 8470, 58 FR 5271, Jan. 21, 1993]

§ 1.482–2A Determination of taxable income in specific situations.

(a)–(c) For applicable rules, see § 1.482–2T (a) through (c).

(d) *Transfer or use of intangible property*—(1) *In general.* (i) Except as otherwise provided in subparagraph (4) of this paragraph, where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities (referred to in this paragraph as the transferor) to another member of the group (referred to in this paragraph as the transferee) for other than an arm's length consideration, the district director may make appropriate allocations to reflect an arm's length consideration for such property or its use. Subparagraph (2) of this paragraph provides rules for determining the form an amount of an appropriate allocation, subparagraph (3) of this paragraph provides a definition of ''intangible property'', and subparagraph (4) of this paragraph provides rules with respect to certain cost-sharing arrangements in connection with the development of intangible property. For purposes of this paragraph, an interest in intangible property may take the form of the right to use such property.

(ii)(*a*) In the absence of a bona fide cost-sharing arrangement (as defined in subparagraph (4) of this paragraph), where one member of a group of related entities undertakes the development of intangible property as a developer within the meaning of (*c*) of this subdivision, no allocation with respect to such development activity shall be made under the rules of this paragraph or any other paragraph of this section (except as provided in (*b*) of this subdivision) until such time as any property developed, or any interest therein, is or is deemed to be transferred, sold, assigned, loaned, or otherwise made available in any manner by the developer to a related entity in a transfer subject to the rules of this paragraph. Where a member of the group other than the developer acquires an interest in the property developed by virtue of obtaining a patent or copyright, or by any other means, the developer shall be deemed to have transferred such interest in such property to the acquiring member in a transaction subject to the rules of this paragraph. For example, if one member of a group (the developer) undertakes to develop a new patentable product and the costs of development are incurred by that entity over a period of 3 years, no allocation with respect to that entity's activity shall be made during such period. The amount of any allocation that may be appropriate at the expiration of such development period when, for example, the patent on the product is transferred, or deemed transferred, to a related entity for other than an arm's length consideration, shall be determined in accordance with the rules of this paragraph.

(*b*) Where one member of a group renders assistance in the form of loans, services, or the use of tangible or intangible property to a developer in connection with an attempt to develop intangible property, the amount of any allocation that may be appropriate with respect to such assistance shall be determined in accordance with the rules of the appropriate paragraph or paragraphs of this section. Thus, where one entity allows a related entity, which is the developer, to use tangible property, such as laboratory equipment, in connection with the development of intangible property, the amount of any allocation that may be appropriate with respect to such use shall be determined in accordance with the rules of paragraph (*c*) of this section. In the event that the district director does not exercise his discretion to make allocations with respect to the assistance rendered to the developer, the value of the assistance shall be allowed as a set-off against any allocation that the district director may make under this paragraph as a result of the transfer of the intangible property to the entity rendering the assistance.

(*c*) The determination as to which member of a group of related entities is a developer and which members of the group are rendering assistance to the developer in connection with its development activities shall be based upon all the facts and circumstances of the individual case. Of all the facts and circumstances to be taken into account in making this determination, greatest weight shall be given to the relative amounts of all the direct and indirect costs of development and the corresponding risks of development borne by the various members of the group, and the relative values of the use of any intangible property of members of the group which is made available without adequate consideration for use in connection with the development activity, which property is likely to contribute to a substantial extent in the production of intangible property. For this purpose, the risk to be borne with respect to development activity is the possibility that such activity will not result in the production of intangible property or that the intangible property produced will not be of sufficient value to allow for the recovery of the costs of developing it. A member will not be considered to have borne the costs and corresponding risks of development unless such member is committed to bearing such costs in advance of, or contemporaneously with, their incurrence and without regard to the success of the project. Other factors that may be relevant in determining which member of the group is the developer include the location of the development activity, the capabilities of the various members to carry on the project independently, and the degree of control over the project exercised by the various members.

(*d*) The principles of this subdivision (ii) may be illustrated by the following examples in which it is assumed that X and Y are corporate members of the same group:

Example 1. X, at the request of Y, undertakes to develop a new machine which will function effectively in the climate in which Y's factory is located. Y agrees to bear all the direct and indirect costs of the project whether or not X successfully develops the machine. Assume that X does not make any of its own intangible property available for use in connection with the project. The machine is successfully developed and Y obtains possession of the intangible property necessary to produce such machine. Based on the facts and circumstances as stated, Y shall be considered to be the developer of the intangible property and, therefore, Y shall not be treated as having obtained the property in a transfer subject to the rules of this paragraph. Any amount which may be allocable with respect to the assistance rendered by X shall be determined in accordance with the rules of (*b*) of this subdivision.

Example 2. Assume the same facts as in Example 1 except that Y agrees to reimburse X for its costs only in the event that the property is successfully developed. In such case X is the developer and Y is deemed to have received the property in a transfer subject to the rules of this paragraph. Therefore, the district director may make an allocation to reflect an arm's length consideration for such property.

Example 3. In 1967 X undertakes to develop product M in its research and development department. X incurs direct and indirect costs of $1 million per year in connection with the project in 1967, 1968, and 1969. In connection with the project, X employs the formula for compound N, which it owns, and which is likely to contribute substantially to the success of the project. The value of the use of the formula for compound N in connection with this project is $750,000. In 1968, 4 chemists employed by Y spend 6 months working on the project in X's laboratory. The salary and other expenses connected with the chemists' employment for that period ($100,000) are paid by Y, for which no charge is made to X. In 1969, product M is perfected and Y obtains patents thereon. X is considered to be the developer of product M since, among other things, it bore the greatest relative share of the costs and risks incurred in connection with this project and made available intangible property (formula for compound N) which was likely to contribute substantially in the development of product M. Accordingly, no allocation with respect to X's development activity should be made before 1969. The property is deemed to have been transferred to Y at that time by virtue of the fact that Y obtained the patent rights to product M. In such case the district director may make an allocation to reflect an arm's length consideration for such transfer. In the event that the district director makes such an allocation and he has not made or does not make an allocation for 1968 with respect to the services of the chemists in accordance with the principles of paragraph (b) of this section, the value of the assistance shall be allowed as a set-off against the amount of the allocation reflecting an arm's length consideration for the transfer of the intangible property.

(2) *Arm's length consideration*. (i) An arm's length consideration shall be in a form which is consistent with the form which would be adopted in transactions between unrelated parties under the same circumstances. To the extent appropriate, an arm's length consideration may take any one or more of the following forms:

(*a*) Royalties based on the transferee's output, sales, profits, or any other measure;

(*b*) Lump-sum payments; or

(*c*) Any other form, including reciprocal licensing rights, which might reasonably have been adopted by unrelated parties under the circumstances, provided that the parties can establish that such form was adopted pursuant to an arrangement which in fact existed between them.

However, where the transferee pays nominal or no consideration for the property or interest therein and where the transferor has retained a substantial interest in the property, an allocation shall be presumed not to take the form of a lump-sum payment.

(ii) In determining the amount of an arm's length consideration, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. Where there have been transfers by the transferor to unrelated parties involving the same or similar intangible property under the same or similar circumstances the amount of the consideration for such transfers shall generally be the best indication of an arm's length consideration.

(iii) Where a sufficiently similar transaction involving an unrelated party cannot be found, the following factors, to the extent appropriate (depending upon the type of intangible property and the form of the transfer), may be considered in arriving at the amount of the arm's length consideration:

(*a*) The prevailing rates in the same industry or for similar property,

(*b*) The offers of competing transferors or the bids of competing transferees,

(*c*) The terms of the transfer, including limitations on the geographic area covered and the exclusive or nonexclusive character of any rights granted,

(*d*) The uniqueness of the property and the period for which it is likely to remain unique,

(*e*) The degree and duration of protection afforded to the property under the laws of the relevant countries.

(*f*) Value of services rendered by the transferor to the transferee in connection with the transfer within the meaning of paragraph (b)(8) of this section,

(*g*) Prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of the property,

(*h*) The capital investment and starting up expenses required of the transferee,

(*i*) The next subdivision is (*j*),

(*j*) The availability of substitutes for the property transferred,

(*k*) The arm's length rates and prices paid by unrelated parties where the property is resold or sublicensed to such parties,

(*l*) The costs incurred by the transferor in developing the property, and

(*m*) Any other fact or circumstance which unrelated parties would have been likely to consider in determining the amount of an arm's length consideration for the property.

(3) *Definition of intangible property*. (i) Solely for the purposes of this section, intangible property shall consist of the items described in subdivision (ii) of this subparagraph, provided that such items have substantial value independent of the services of individual persons.

(ii) The items referred to in subdivision (i) of this subparagraph are as follows:

(*a*) Patents, inventions, formulas, processes, designs, patterns, and other similar items;

(*b*) Copyrights, literary, musical, or artistic compositions, and other similar items;

(*c*) Trademarks, trade names, brand names, and other similar items;

(*d*) Franchises, licenses, contracts, and other similar items;

(*e*) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.

(4) *Sharing of costs and risks.* Where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property, the district director shall not make allocations with respect to such acquisition except as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property. A bona fide cost sharing arrangement is an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced. In order for the arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm's length basis. In order for the sharing of costs and risk to be considered on an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement. If an oral cost sharing arrangement, entered into prior to April 16, 1968, and continued in effect after that date, is otherwise in compliance with the standards prescribed in this subparagraph, it shall constitute a bona fide cost sharing arrangement if it is reduced to writing prior to January 1, 1969.

(e) *Sales of tangible property*—(1) *In general.* (i) Where one member of a group of controlled entities (referred to in this paragraph as the ''seller'') sells or otherwise disposes of tangible property to another member of such group (referred to in this paragraph as the ''buyer'') at other than an arm's length price (such a sale being referred to in this paragraph as a ''controlled sale''), the district director may make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition. An arm's length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller.

(ii) Subparagraphs (2), (3), and (4) of this paragraph describe three methods of determining an arm's-length price and the standards for applying each method. They are, respectively, the comparable uncontrolled price method, the resale price method, and the cost-plus method. In addition, a special rule is provided in subdivision (v) of this subparagraph for use (notwithstanding any other provision of this subdivision) in determining an arm's-length price for an ore or mineral. If there are comparable uncontrolled sales as defined in subparagraph (2) of this paragraph, the comparable uncontrolled price method must be utilized because it is the method likely to result in the most accurate estimate of an arm's-length price (for the reason that it is based upon the price actually paid by unrelated parties for the same or similar products). If there are no comparable uncontrolled sales, then the resale price method must be utilized if the standards for its application are met because it is the method likely to result in the next most accurate estimate in such instances (for the reason that, in such instances, the arm's-length price determined under such method is based more directly upon actual arm's-length transactions than is the cost-plus method). A typical situation where the resale price method may be required is where a manufacturer sells products to a related distributor which, without further processing, resells the products in uncontrolled transactions. If all the standards for the mandatory application of the resale price method are not satisfied, then, as provided in subparagraph (3)(iii) of this paragraph, either that method or the cost-plus method may be used, depending upon which method is more feasible and is likely to result in a more accurate estimate of an arm's-length price. A typical situation where the cost-plus method may be appropriate is where a manufacturer sells products to a related entity which performs substantial manufacturing, assembly, or other processing of the product or adds significant value by reason of its utilization of its intangible property prior to resale in uncontrolled transactions.

(iii) Where the standards for applying one of the three methods of pricing described in subdivision (ii) of this subparagraph are met, such method must, for the purposes of this paragraph, be utilized unless the taxpayer can establish that, considering all the facts and circumstances, some method of pricing other than those described in subdivision (ii) of this subparagraph is clearly more appropriate. Where none of the three methods of pricing described in subdivision (ii) of this subparagraph can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described in subdivision (ii) of this subparagraph, or variations on such methods, can be used.

(iv) The methods of determining arm's length prices described in this section are stated in terms of their application to individual sales of property. However, because of the possibility that a taxpayer may make controlled sales of many different products, or many separate sales of the same product, it may be impractical to analyze every sale for the purposes of determining the arm's length price. It is therefore permissible to determine or verify arm's length prices by applying the appropriate methods of pricing to product lines or other groupings where it is impractical to ascertain an arm's length price for each product or sale. In addition, the district director may determine or verify the arm's length price of all sales to a related entity by employing reasonable statistical sampling techniques.

(v) The price for a mineral product which is sold at the stage at which mining or extraction ends shall be determined under the provisions of §§1.613–3 and 1.613–4.

(2) *Comparable uncontrolled price method.* (i) Under the method of pricing described as the ''comparable uncontrolled price method'', the arm's length price of a controlled sale is equal to the price paid in comparable uncontrolled sales, adjusted as provided in subdivision (ii) of this subparagraph.

(ii) ''Uncontrolled sales'' are sales in which the seller and the buyer are not members of the same controlled group. These include (*a*) sales made by a member of the controlled group to an unrelated party, (*b*) sales made to a member of the controlled group by an unrelated party, and (*c*) sales made in which the parties are not members of the controlled group and are not related to each other. However, uncontrolled sales do not include sales at unrealistic prices, as for example where a member makes uncontrolled sales in small quantities at a price designed to justify a nonarm's length price on a large volume of controlled sales. Uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. For this purpose, differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price. If the differences can be reflected by such adjustment, then the price of the uncontrolled sale as adjusted constitutes the comparable uncontrolled sale price. Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place. Whether and to what extent differences in the various properties and circumstances affect price, and whether differences render sales noncomparable, depends upon the particular circumstances and property involved. The principles of this subdivision may be illustrated by the following examples, in each of which it is assumed that X makes both controlled and uncontrolled sales of the identical property:

Example 1. Assume that the circumstances surrounding the controlled and the uncontrolled sales are identical, except for the fact that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. X's factory. Since differences in terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, such differences do not normally render the uncontrolled sales noncomparable to the controlled sales.

Example 2. Assume that the circumstances surrounding the controlled and uncontrolled sales are identical, except for the fact that X affixes its valuable trademark in the controlled sales, and does not affix its trademark in uncontrolled sales. Since the effects on price of differences in intangible property associated with the sale of tangible property, such as trademarks, are normally not reasonably ascertainable, such differences would normally render the uncontrolled sales noncomparable.

Example 3. Assume that the circumstances surrounding the controlled and uncontrolled sales are identical, except for the fact that X, a manufacturer of business machines, makes certain minor modifications in the physical properties of the machines to satisfy safety specifications or other specific requirements of a customer in controlled sales, and does not make these modifications in uncontrolled sales. Since minor physical differences in the product generally have a definite and reasonably ascertainable effect on prices, such differences do not normally render the uncontrolled sales noncomparable to the controlled sales.

(iii) Where there are two or more comparable uncontrolled sales susceptible of adjustment as defined in subdivision (ii) of this subparagraph, the comparable uncontrolled sale or sales requiring the fewest and simplest adjustments provided in subdivision (ii) of this subparagraph should generally be selected. Thus, for example, if a taxpayer makes comparable uncontrolled sales of a particular product which differ from the controlled sale only with respect to the terms of delivery, and makes other comparable uncontrolled sales of the product which differ from the controlled sale with respect to both terms of delivery and terms of payment, the comparable uncontrolled sales differing only with respect to terms of delivery should be selected as the comparable uncontrolled sale.

(iv) One of the circumstances which may affect the price of property is the fact that the seller may desire to make sales at less than a normal profit for the primary purpose of establishing or maintaining a market for his products. Thus, a seller may be willing to reduce the price of a product, for a time, in order to introduce his product into an area or in order to meet competition. However, controlled sales may be priced in such a manner only if such price would have been charged in an uncontrolled sale under comparable circumstances. Such fact may be demonstrated by showing that the buyer in the controlled sale made corresponding reductions in the resale price to uncontrolled purchasers, or that such buyer engaged in substantially greater sales promotion activities with respect to the product involved in the controlled sale than with respect to other products. For example, assume X, a manufacturer of batteries, commences to sell car batteries to Y, a subsidiary of X, for resale in a new market. In its existing markets X's batteries sell to independent retailers at $20 per unit, and X sells them to wholesalers at $17 per unit. Y also sells X's batteries to independent retailers at $20 per unit. X's batteries are not known in the new market in which Y is operating. In order to engage competitively in the new market Y incurs selling and advertising costs substantially higher than those incurred for its sales of other products. Under these circumstances X may sell to Y, for a time, at less than $17 to take into account the increased selling and advertising activities of Y in penetrating and establishing the new market. This may be done even though it may result in a transfer price from X to Y which is below X's full costs of manufacturing the product.

(3) *Resale price method.* (i) Under the pricing method described as the ''resale price method'', the arm's length price

of a controlled sale is equal to the applicable resale price (as defined in subdivision (iv) or (v) of this subparagraph), reduced by an appropriate markup, and adjusted as provided in subdivision (ix) of this subparagraph. An appropriate markup is computed by multiplying the applicable resale price by the appropriate markup percentage as defined in subdivision (vi) of this subparagraph. Thus, where one member of a group of controlled entities sells property to another member which resells the property in uncontrolled sales, if the applicable resale price of the property involved in the uncontrolled sale is $100 and the appropriate markup percentage for resales by the buyer is 20 percent, the arm's length price of the controlled sale is $80 ($100 minus 20 percent × $100), adjusted as provided in subdivision (ix) of this subparagraph.

(ii) The resale price method must be used to compute an arm's length price of a controlled sale if all the following circumstances exist:

(*a*) There are no comparable uncontrolled sales as defined in subparagraph (2) of this paragraph.

(*b*) An applicable resale price, as defined in subdivision (iv) or (v) of this subparagraph, is available with respect to resales made within a reasonable time before or after the time of the controlled sale.

(*c*) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by physically altering the product before resale. For this purpose packaging, repacking, labeling, or minor assembly of property does not constitute physical alteration.

(*d*) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by the use of intangible property. See §1.482–2(d)(3) for the definition of intangible property.

(iii) Notwithstanding the fact that one or both of the requirements of subdivision (ii) (*c*) or (*d*) of this subparagraph may not be met, the resale price method may be used if such method is more feasible and is likely to result in a more accurate determination of an arm's length price than the use of the cost plus method. Thus, even though one of the requirements of such subdivision is not satisfied, the resale price method may nevertheless be more appropriate than the cost plus method because the computations and evaluations required under the former method may be fewer and easier to make than under the latter method. In general, the resale price method is more appropriate when the functions performed by the seller are more extensive and more difficult to evaluate than the functions performed by the buyer (reseller). The principle of this subdivision may be illustrated by the following examples in each of which it is assumed that corporation X developed a valuable patent covering product M which it manufactures and sells to corporation Y in a controlled sale, and for which there is no comparable uncontrolled sale:

Example 1. Corporation Y adds a component to product M and resells the assembled product in an uncontrolled sale within a reasonable time after the controlled sale of product M. Assume further that the addition of the component added more than an insubstantial amount to the value of product M, but that Y's function in purchasing the component and assembling the product prior to sale was subject to reasonably precise valuation. Although the controlled sale and resale does not meet the requirements of subdivision (ii)(*c*) of this subparagraph, the resale price method may be used under the circumstances because that method involves computations and evaluations which are fewer and easier to make than under the cost plus method. This is because X's use of a patent may be more difficult to evaluate in determining an appropriate gross profit percentage under the cost plus method, than is evaluation of Y's assembling function in determining the appropriate markup percentage under the resale price method.

Example 2. Corporation Y resells product M in an uncontrolled sale within a reasonable time after the controlled sale after attaching its valuable trademark to it. Assume further that it can be demonstrated through comparison with other uncontrolled sales of Y that the addition of Y's trademark to a product usually adds 25 percent to the markup on its sales. On the other hand, the effect of X's use of its patent is difficult to evaluate in applying the cost plus method because no reasonable standard of comparison is available. Although the controlled sale and resale does not meet the requirements of subdivision (ii)(*d*) of this subparagraph, the resale price method may be used because that method involves computations and evaluation which are fewer and easier to make than under the cost plus method. That is because, under the circumstances, X's use of a patent is more difficult to evaluate in determining an appropriate gross profit percentage under the cost plus method, than is evaluation of the use of Y's trademark in determining the appropriate markup percentage under the resale price method.

(iv) For the purposes of this subparagraph the ''applicable resale price'' is the price at which it is anticipated that property purchased in the controlled sale will be resold by the buyer in an uncontrolled sale. The ''applicable resale price'' will generally be equal to either the price at which current resales of the same property are being made or the resale price of the particular item of property involved.

(v) Where the property purchased in the controlled sale is resold in another controlled sale, the ''applicable resale price'' is the price at which such property is finally resold in an uncontrolled sale, providing that the series of sales as a whole meets all the requirements of subdivision (ii) of this subparagraph or that the resale price method is used pursuant to subdivision (iii) of this subparagraph. In such case, the determination of the appropriate markup percentage shall take into account the function or functions performed by all members of the group participating in the series of sales and resales. Thus, if X sells a product to Y in a controlled sale, Y sells the product to Z in a controlled sale, and Z sells the product in an uncontrolled sale, the resale price method must be used if Y and Z together have not added more than an insubstantial amount to the value of the product through physical alteration or the application of intangible property, and the final resale occurs within a reasonable time of the sale from X to Y. In such case, the applicable resale price is the price at which Z sells the product in the uncontrolled sale, and the appropriate markup percentage shall take into account the functions performed by both Y and Z.

(vi) For the purposes of this subparagraph, the appropriate markup percentage is equal to the percentage of gross profit (expressed as a percentage of sales) earned by the buyer (reseller) or another party on the resale of property which is both purchased and resold in an uncontrolled transaction, which resale is most similar to the applicable resale of the property involved in the controlled sale. The following are the most important characteristics to be considered in determining the similarity of resales:

(*a*) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances.

(*b*) The functions performed by the reseller with respect to the property. For example: packaging, labeling, delivering, maintenance of inventory, minor assembly, advertising, selling at wholesale, selling at retail, billing, maintenance of accounts receivable, and servicing.

(*c*) The effect on price of any intangible property utilized by the reseller in connection with the property resold. For example: patents, trademarks, trade names.

(*d*) The geographic market in which the functions are performed by the reseller.

In general, the similarity to be sought relates to the probable effect upon the markup percentage of any differences in such characteristics between the uncontrolled purchases and resales on the one hand and the controlled purchases and resales on the other hand. Thus, close physical similarity of the property involved in the sales compared is not required under the resale price method since a lack of close physical similarity is not necessarily indicative of dissimilar markup percentages.

(vii) Whenever possible, markup percentages should be derived from uncontrolled purchases and resales of the buyer (reseller) involved in the controlled sale, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of resales by the same buyer (reseller) which meet the standards of subdivision (vi) of this subparagraph, evidence of an appropriate markup percentage may be derived from resales by other resellers selling in the same or a similar market in which the controlled buyer (reseller) is selling providing such resellers perform comparable functions. Where the function performed by the reseller is similar to the function performed by a sales agent which does not take title, such sales agent will be considered a reseller for the purpose of determining an appropriate markup percentage under this subparagraph and the commission earned by such sales agent, expressed as a percentage of the sales price of the goods, may constitute the appropriate markup percentage. If the controlled buyer (reseller) is located in a foreign country and information on resales by other resellers in the same foreign market is not available, then markup percentages earned by United States resellers performing comparable functions may be used. In the absence of data on markup percentages of particular sales or groups of sales, the prevailing markup percentage in the particular industry involved may be appropriate.

(viii) In calculating the markup percentage earned on uncontrolled purchases and resales, and in applying such percentage to the applicable resale price to determine the appropriate markup, the same elements which enter into the computation of the sales price and the costs of goods sold of the property involved in the comparable uncontrolled purchases and resales should enter into such computation in the case of the property involved in the controlled purchases and resales. Thus, if freight-in and packaging expense are elements of the cost of goods sold in comparable uncontrolled purchases, then such elements should also be taken into account in computing the cost of goods sold of the controlled purchase. Similarly, if the comparable markup percentage is based upon net sales (after reduction for returns and allowances) of uncontrolled resellers, such percentage must be applied to net sales of the buyer (reseller).

(ix) In determining an arm's length price appropriate adjustment must be made to reflect any material differences between the uncontrolled purchases and resales used as the basis for the calculation of the appropriate markup percentage and the resales of property involved in the controlled sale. The differences referred to in this subdivision are those differences in functions or circumstances which have a definite and reasonably ascertainable effect on price. The principles of this subdivision may be illustrated by the following example:

Example. Assume that X and Y are members of the same group of controlled entities and that Y purchases electric mixers from X and electric toasters from uncontrolled entities. Y performs substantially similar functions with respect to resales of both the mixers and the toasters, except that it does not warrant the toasters, but does provide a 90-day warranty for the mixers. Y normally earns a gross profit on toasters of 20 percent of gross selling price. The 20-percent gross profit on the resale of toasters is an appropriate markup percentage, but the price of the controlled sale computed with reference to such rate must be adjusted to reflect the difference in terms (the warranty).

(4) *Cost plus method.* (i) Under the pricing method described as the ''cost plus method'', the arm's length price of a controlled sale of property shall be computed by adding to the cost of producing such property (as computed in subdivision (ii) of this subparagraph), an amount which is equal to such cost multiplied by the appropriate gross profit percentage (as computed in subdivision (iii) of this subparagraph), plus or minus any adjustments as provided in subdivision (v) of this subparagraph.

(ii) For the purposes of this subparagraph, the cost of producing the property involved in the controlled sale, and the costs which enter into the computation of the appropriate gross profit percentage shall be computed in a consistent manner in accordance with sound accounting practices for allocating or apportioning costs, which neither favors nor burdens controlled sales in comparison with uncontrolled sales. Thus, if the costs used in computing the appropriate gross profit percentage are comprised of the full cost of goods sold, including direct and indirect costs, then the cost of producing the property involved in the controlled sales must be comprised of the full cost of goods sold, including direct and indirect costs. On the other hand, if the costs used in computing the appropriate gross profit percentage are comprised only of direct costs, the cost of producing the property involved in the controlled sale must be comprised only of direct costs. The term ''cost of producing'', as used in this subparagraph, includes the cost of acquiring property which is held for resale.

(iii) For the purposes of this subparagraph, the appropriate gross profit percentage is equal to the gross profit percentage (expressed as a percentage of cost) earned by the seller or another party on the uncontrolled sale or sales of property which are most similar to the controlled sale in question. The following are the most important characteristics to be considered in determining the similarity of the uncontrolled sale or sales:

(*a*) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances.

(*b*) The functions performed by the seller with respect to the property sold. For example: contract manufacturing, product assembly, selling activity, processing, servicing, delivering.

(*c*) The effect of any intangible property used by the seller in connection with the property sold. For example: patents, trademarks, trade names.

(*d*) The geographic market in which the functions are performed by the seller. In general, the similarity to be sought relates to the probable effect upon the margin of gross profit of any differences in such characteristics between the uncontrolled sales and the controlled sale. Thus, close physical similarity of the property involved in the sales compared is not required under the cost plus method since a lack of close physical similarity is not necessarily indicative of dissimilar profit margins. See subparagraph (2)(iv) of this paragraph, relating to sales made at less than a normal profit for the primary purpose of establishing or maintaining a market.

(iv) Whenever possible, gross profit percentages should be derived from uncontrolled sales made by the seller involved in the controlled sale, because similar characteristics are more likely to be found among sales of property made by the same seller than among sales made by other sellers. In the absence of such sales, evidence of an appropriate gross profit percentage may be derived from similar uncontrolled sales by other sellers whether or not such sellers are members of the controlled group. Where the function performed by the seller is similar to the function performed by a purchasing agent which does not take title, such purchasing agent will be considered a seller for the purpose of determining an appropriate gross profit percentage under this subparagraph and the commission earned by such purchasing agent, expressed as a percentage of the purchase price of the goods, may constitute the appropriate gross profit percentage. In the absence of data on gross profit percentages of particular sales or groups of sales which are similar to the controlled sale, the prevailing gross profit percentages in the particular industry involved may be appropriate.

(v) Where the most similar sale or sales from which the appropriate gross profit percentage is derived differ in any material respect from the controlled sale, the arm's length price which is computed by applying such percentage must be adjusted to reflect such differences to the extent such differences would warrant an adjustment of price in uncontrolled transactions. The differences referred to in this subdivision are those differences which have a definite and reasonably ascertainable effect on price.

(Sec. 385 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 613 and 68A Stat. 917; 26 U.S.C. 385 and 7805))

[T.D. 6952, 33 FR 5849, Apr. 16, 1968]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.482–2A, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

REGULATIONS APPLICABLE ON OR BEFORE JANUARY 4, 2009.

§ 1.482–7A Methods to determine taxable income in connection with a cost sharing arrangement.

(a) *In general*—(1) *Scope and application of the rules in this section.* A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.

A taxpayer may claim that a cost sharing arrangement is a qualified cost sharing arrangement only if the agreement meets the requirements of paragraph (b) of this section. Consistent with the rules of § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms), the district director may apply the rules of this section to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding a failure to comply with any requirement of this section. A qualified cost sharing arrangement, or an arrangement to which the district director applies the rules of this section, will not be treated as a partnership to which the rules of subchapter K apply. See § 301.7701–3(e) of this chapter. Furthermore, a participant that is a foreign corporation or nonresident alien individual will not be treated as engaged in trade or business within the United States solely by reason of its participation in such an arrangement. See generally § 1.864–2(a).

(2) *Limitation on allocations.* The district director shall not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development, under the rules of this section. If a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer (other than in consideration for bearing a share of the costs of the intangible's development), then the district director may make appropriate allocations to reflect an arm's length consideration for the acquisition of the interest in such intangible under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6. See paragraph (g) of this section. An interest in an intangible includes any commercially transferable interest, the benefits of which are susceptible of valuation. See § 1.482–4(b) for the definition of an intangible.

(3) *Coordination with § 1.482–1.* A qualified cost sharing arrangement produces results that are consistent with an arm's length result within the meaning of § 1.482–1(b)(1) if, and only if, each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development (as required by paragraph (a)(2) of this section) and all other requirements of this section are satisfied.

(4) *Cross references.* Paragraph (c) of this section defines participant. Paragraph (d) of this section defines the costs of intangible development. Paragraph (e) of this section defines the anticipated benefits of intangible development. Paragraph (f) of this section provides rules governing cost allocations. Paragraph (g) of this section provides rules governing transfers of intangibles other than in consideration for bearing a share of the costs of the intangible's development. Rules governing the character of payments made pursuant to a qualified cost sharing arrangement are provided in paragraph (h) of this section. Paragraph (i) of this section provides accounting requirements. Paragraph (j) of this section provides administrative requirements. Paragraph (k) of this section provides an effective date. Paragraph (l) provides a transition rule.

(b) *Qualified cost sharing arrangement.* A qualified cost sharing arrangement must—

(1) Include two or more participants;

(2) Provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits;

(3) Provide for adjustment to the controlled participants' shares of intangible development costs to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement; and

(4) Be recorded in a document that is contemporaneous with the formation (and any revision) of the cost sharing arrangement and that includes—

(i) A list of the arrangement's participants, and any other member of the controlled group that will benefit from the use of intangibles developed under the cost sharing arrangement;

(ii) The information described in paragraphs (b)(2) and (b)(3) of this section;

(iii) A description of the scope of the research and development to be undertaken, including the intangible or class of intangibles intended to be developed;

(iv) A description of each participant's interest in any covered intangibles. A covered intangible is any intangible property that is developed as a result of the research and development undertaken under the cost sharing arrangement (intangible development area);

(v) The duration of the arrangement; and

(vi) The conditions under which the arrangement may be modified or terminated and the consequences of such modification or termination, such as the interest that each participant will receive in any covered intangibles.

(c) *Participant*—(1) *In general.* For purposes of this section, a participant is a controlled taxpayer that meets the requirements of this paragraph (c)(1) (controlled participant) or an uncontrolled taxpayer that is a party to the cost sharing arrangement (uncontrolled participant). See §1.482–1(i)(5) for the definitions of controlled and uncontrolled taxpayers. A controlled taxpayer may be a controlled participant only if it—

(i) Reasonably anticipates that it will derive benefits from the use of covered intangibles;

(ii) Substantially complies with the accounting requirements described in paragraph (i) of this section; and

(iii) Substantially complies with the administrative requirements described in paragraph (j) of this section.

(iv) The following example illustrates paragraph (c)(1)(i) of this section:

Example. Foreign Parent (FP) is a foreign corporation engaged in the extraction of a natural resource. FP has a U.S. subsidiary (USS) to which FP sells supplies of this resource for sale in the United States. FP enters into a cost sharing arrangement with USS to develop a new machine to extract the natural resource. The machine uses a new extraction process that will be patented in the United States and in other countries. The cost sharing arrangement provides that USS will receive the rights to use the machine in the extraction of the natural resource in the United States, and FP will receive the rights in the rest of the world. This resource does not, however, exist in the United States. Despite the fact that USS has received the right to use this process in the United States, USS is not a qualified participant because it will not derive a benefit from the use of the intangible developed under the cost sharing arrangement.

(2) *Treatment of a controlled taxpayer that is not a controlled participant*—(i) *In general.* If a controlled taxpayer that is not a controlled participant (within the meaning of this paragraph (c)) provides assistance in relation to the research and development undertaken in the intangible development area, it must receive consideration from the controlled participants under the rules of §1.482–4(f)(3)(iii) (Allocations with respect to assistance provided to the owner). For purposes of paragraph (d) of this section, such consideration is treated as an operating expense and each controlled participant must be treated as incurring a share of such consideration equal to its share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section).

(ii) *Example.* The following example illustrates this paragraph (c)(2):

Example. (i) U.S. Parent (USP), one foreign subsidiary (FS), and a second foreign subsidiary constituting the group's research arm (R + D) enter into a cost sharing agreement to develop manufacturing intangibles for a new product line A. USP and FS are assigned the exclusive rights to exploit the intangibles respectively in the United States and the rest of the world, where each presently manufactures and sells various existing product lines. R + D is not assigned any rights to exploit the intangibles. R + D's activity consists solely in carrying out research for the group. It is reliably projected that the shares of reasonably anticipated benefits of USP and FS will be 66⅔% and 33⅓, respectively, and the parties' agreement provides that USP and FS will reimburse 66⅔% and 33⅓%, respectively, of the intangible development costs incurred by R + D with respect to the new intangible.

(ii) R + D does not qualify as a controlled participant within the meaning of paragraph (c) of this section, because it will not derive any benefits from the use of covered intangibles. Therefore, R + D is treated as a service provider for purposes of this section and must receive arm's length consideration for the assistance it is deemed to provide to USP and FS, under the rules of §1.482–4(f)(3)(iii).

Such consideration must be treated as intangible development costs incurred by USP and FS in proportion to their shares of reasonably anticipated benefits (i.e., 66⅔% and 33⅓%, respectively). R + D will not be considered to bear any share of the intangible development costs under the arrangement.

(3) *Treatment of consolidated group.* For purposes of this section, all members of the same affiliated group (within the meaning of section 1504(a)) that join in the filing of a consolidated return for the taxable year under section 1501 shall be treated as one taxpayer.

(d) *Costs*—(1) *Intangible development costs.* For purposes of this section, a controlled participant's costs of developing intangibles for a taxable year mean all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of the following items: operating expenses as defined in §1.482–5(d)(3), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses, as defined in §1.482–5(d)(3)) the charge for the use of any tangible property made available to the qualified cost sharing arrangement. If tangible property is made available to the qualified cost sharing arrangement by a controlled participant, the determination of the appropriate charge will be governed by the rules of §1.482–2(c) (Use of tangible property). Intangible development costs do not include the consideration for the use of any intangible property made available to the qualified cost sharing arrangement. See paragraph (g)(2) of this section. If a particular cost contributes to the intangible development area and other areas or other business activities, the cost must be allocated between the intangible development area and the other areas or business activities on a reasonable basis. In such a case, it is necessary to estimate the total benefits attributable to the cost incurred. The share of such cost allocated to the intangible development area must correspond to covered intangibles' share of the total benefits. Costs that do not contribute to the intangible development area are not taken into account.

(2) *Stock-based compensation*—(i) *In general.* For purposes of this section, a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term *stock-based compensation* means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) *Identification of stock-based compensation related to intangible development.* The determination of whether stock-based compensation is related to the intangible development area within the meaning of paragraph (d)(1) of this section is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles covered by the arrangement is included as an intangible development cost under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of a new stock option for purposes of this paragraph (d)(2)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) *Measurement and timing of stock-based compensation expense*—(A) *In general.* Except as otherwise provided in this paragraph (d)(2)(iii), the operating expense attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for Federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an operating expense under this section for the taxable year for which the deduction is allowable.

(*1*) *Transfers to which section 421 applies.* Solely for purposes of this paragraph (d)(2)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

(*2*) *Deductions of foreign controlled participants.* Solely for purposes of this paragraph (d)(2)(iii)(A), an amount is treated as an allowable deduction of a controlled participant to the extent that a deduction would be allowable to a United States taxpayer.

(*3*) *Modification of stock option.* Solely for purposes of this paragraph (d)(2)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(2)(ii) of this section, to constitute the grant of a new stock option not related to the development of intangibles, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an operating expense as of the date of the modification.

(*4*) *Expiration or termination of qualified cost sharing arrangement.* Solely for purposes of this paragraph (d)(2)(iii)(A), if an item of stock-based compensation related to the development of intangibles is not exercised during the term of a qualified cost sharing arrangement, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the qualified cost sharing arrangement, provided that the stock-based compensation is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an operating expense as of the date of the expiration or termination of the qualified cost sharing arrangement.

(B) *Election with respect to options on publicly traded stock*—(1) *In general.* With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a qualified cost sharing arrangement may elect to take into account all operating expenses attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

(*2*) *Publicly traded stock.* As used in this paragraph (d)(2)(iii)(B), the term *publicly traded stock* means stock that is regularly traded on an established United States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year.

(*3*) *Generally accepted accounting principles.* For purposes of this paragraph (d)(2)(iii)(B), a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that either—

(*i*) The fair value of the stock options under consideration is reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets; or (*ii*) In the absence of a reconciliation between such other accounting principles and United States generally accepted accounting principles that reflects the fair value of the stock options under consideration, such other accounting principles require that the fair value of the stock options under consideration be reflected as a charge against income in audited financial statements or disclosed in footnotes to such statements.

(*4*) *Time and manner of making the election.* The election described in this paragraph (d)(2)(iii)(B) is made by an explicit reference to the election in the written cost sharing agreement required by paragraph (b)(4) of this section or in a written amendment to the cost sharing agreement entered into with the consent of the Commissioner pursuant to paragraph (d)(2)(iii)(C) of this section. In the case of a qualified cost sharing arrangement in existence on August 26, 2003, the election must be made by written amendment to the cost sharing agreement not later than the latest due date (with regard to extensions) of a Federal income tax return of any controlled participant for the first taxable year beginning after August 26, 2003, and the consent of the Commissioner is not required.

(C) *Consistency.* Generally, all controlled participants in a qualified cost sharing arrangement taking options on publicly traded stock into account under paragraph (d)(2)(iii)(A) or (B) of this section must use that same method of measurement and timing for all options on publicly traded stock with respect to that qualified cost sharing arrangement. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner's consent is obtained. All controlled participants in the qualified cost sharing arrangement must join in requests for the Commissioner's consent under this paragraph. Thus, for example, if the controlled participants make the election described in paragraph (d)(2)(iii)(B) of this section upon the formation of the qualified cost sharing arrangement, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained. Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(2)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(2)(iii)(B)(*4*) of this section, the controlled participants may make the election described in paragraph (d)(2)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

(3) *Examples.* The following examples illustrate this paragraph (d):

Example 1. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a qualified cost sharing arrangement to develop a better mousetrap. USS and FP share the costs of FP's research and development facility that will be exclusively dedicated to this research, the salaries of the researchers, and reasonable overhead costs attributable to the project. They also share the cost of a conference facility that is at the disposal of the senior executive management of each company but does not contribute to the research and development activities in any measurable way. In this case, the cost of the conference facility must be excluded from the amount of intangible development costs.

Example 2. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a qualified cost sharing arrangement to develop a new device. USP and FS share the costs of a research and development facility, the salaries of researchers, and reasonable overhead costs attributable to the project. USP also incurs costs related to field testing of the device, but does not include them in the amount of intangible development costs of the cost sharing arrangement. The district director may determine that the field testing costs are intangible development costs that must be shared.

(e) *Anticipated benefits*—(1) *Benefits.* Benefits are additional income generated or costs saved by the use of covered intangibles.

(2) *Reasonably anticipated benefits.* For purposes of this section, a controlled participant's reasonably anticipated benefits are the aggregate benefits that it reasonably anticipates that it will derive from covered intangibles.

(f) *Cost allocations*—(1) *In general.* For purposes of determining whether a cost allocation authorized by paragraph (a)(2) of this section is appropriate for a taxable year, a controlled participant's share of intangible development costs for the taxable year under a qualified cost sharing arrangement must be compared to its share of reasonably anticipated benefits under the arrangement. A controlled participant's share of intangible development costs is determined under paragraph (f)(2) of this section. A controlled participant's share of reasonably anticipated benefits under the arrangement is determined under paragraph (f)(3) of this section. In determining whether benefits were reasonably anticipated, it may be appropriate to compare actual benefits to anticipated benefits, as described in paragraph (f)(3)(iv) of this section.

(2) *Share of intangible development costs*—(i) *In general.* A controlled participant's share of intangible development costs for a taxable year is equal to its intangible development costs for the taxable year (as defined in paragraph (d) of this section), divided by the sum of the intangible development costs for the taxable year (as defined in paragraph (d) of this section) of all the controlled participants.

(ii) *Example.* The following example illustrates this paragraph (f)(2):

Example. (i) U.S. Parent (USP), Foreign Subsidiary (FS), and Unrelated Third Party (UTP) enter into a cost sharing arrangement to develop new audio technology. In the first year of the arrangement, the controlled participants incur $2,250,000 in the intangible development area, all of which is incurred directly by USP. In the first year, UTP makes a $250,000 cost sharing payment to USP, and FS makes a $800,000 cost sharing payment to USP, under the terms of the arrangement. For that year, the intangible development costs borne by USP are $1,200,000 (its $2,250,000 intangible development costs directly incurred, minus the cost sharing payments it receives of $250,000 from UTP and $800,000 from FS); the intangible development costs borne by FS are $800,000 (its cost sharing payment); and the intangible development costs borne by all of the controlled participants are $2,000,000 (the sum of the intangible development costs borne by USP and FS of $1,200,000 and $800,000, respectively). Thus, for the first year, USP's share of intangible development costs is 60% ($1,200,000 divided by $2,000,000), and FS's share of intangible development costs is 40% ($800,000 divided by $2,000,000).

(ii) For purposes of determining whether a cost allocation authorized by paragraph §1.482–7(a)(2) is appropriate for the first year, the district director must compare USP's and FS's shares of intangible development costs for that year to their shares of reasonably anticipated benefits. See paragraph (f)(3) of this section.

(3) *Share of reasonably anticipated benefits*—(i) *In general.* A controlled participant's share of reasonably anticipated benefits under a qualified cost sharing arrangement is equal to its reasonably anticipated benefits (as defined in paragraph (e)(2) of this section), divided by the sum of the reasonably anticipated benefits (as defined in paragraph (e)(2) of this section) of all the controlled participants. The anticipated benefits of an uncontrolled participant will not be included for purposes of determining each controlled participant's share of anticipated benefits. A controlled participant's share of reasonably anticipated benefits will be determined using the most reliable estimate of reasonably anticipated benefits. In determining which of two or more available estimates is most reliable, the quality of the data and assumptions used in the analysis must be taken into account, consistent with §1.482–1(c)(2)(ii) (Data and assumptions). Thus, the reliability of an estimate will depend largely on the completeness and accuracy of the data, the soundness of the assumptions, and the relative effects of particular deficiencies in data or assumptions on different estimates. If two estimates are equally reliable, no adjustment should be made based on differences in the results. The following factors will be particularly relevant in determining the reliability of an estimate of anticipated benefits—

(A) The reliability of the basis used for measuring benefits, as described in paragraph (f)(3)(ii) of this section; and

(B) The reliability of the projections used to estimate benefits, as described in paragraph (f)(3)(iv) of this section.

(ii) *Measure of benefits.* In order to estimate a controlled participant's share of anticipated benefits from covered intangibles, the amount of benefits that each of the controlled participants is reasonably anticipated to derive from covered intangibles must be measured on a basis that is consistent for all such participants. See paragraph (f)(3)(iii)(E), *Example 8*, of this section. If a controlled participant transfers covered intangibles to another controlled taxpayer, such participant's benefits from the transferred intangibles must be measured by reference to the transferee's benefits, disregarding any consideration paid by the transferee to the controlled participant (such as a royalty pursuant to a license agreement). Anticipated benefits are measured either on a direct basis, by reference to estimated additional income to be generated or costs to be saved by the use of covered intangibles, or on an indirect basis, by reference to certain measurements that reasonably can be assumed to be related to income generated or costs saved. Such indirect bases of measurement of anticipated benefits are described in paragraph (f)(3)(iii) of this section. A controlled participant's anticipated benefits must be measured on the most reliable basis, whether direct or indirect. In determining which of two bases of measurement of reasonably anticipated benefits is most reliable, the factors set forth in §1.482–1(c)(2)(ii) (Data and assumptions) must be taken into account. It normally will be expected that the basis that provided the most reliable estimate for a particular year will continue to provide the most reliable estimate in subsequent years, absent a material change in the factors that affect the reliability of the estimate. Regardless of whether a direct or indirect basis of measurement is used, adjustments may be required to account for material differences in the activities that controlled participants undertake to exploit their interests in covered intangibles. See *Example 6* of paragraph (f)(3)(iii)(E) of this section.

(iii) *Indirect bases for measuring anticipated benefits*. Indirect bases for measuring anticipated benefits from participation in a qualified cost sharing arrangement include the following:

(A) *Units used, produced or sold*. Units of items used, produced or sold by each controlled participant in the business activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to the covered intangibles per unit of the item or items used, produced or sold. This circumstance is most likely to arise when the covered intangibles are exploited by the controlled participants in the use, production or sale of substantially uniform items under similar economic conditions.

(B) *Sales*. Sales by each controlled participant in the business activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to covered intangibles per dollar of sales. This circumstance is most likely to arise if the costs of exploiting covered intangibles are not substantial relative to the revenues generated, or if the principal effect of using covered intangibles is to increase the controlled participants' revenues (e.g., through a price premium on the products they sell) without affecting their costs substantially. Sales by each controlled participant are unlikely to provide a reliable basis for measuring benefits unless each controlled participant operates at the same market level (e.g., manufacturing, distribution, etc.).

(C) *Operating profit*. Operating profit of each controlled participant from the activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that such profit is largely attributable to the use of covered intangibles, or if the share of profits attributable to the use of covered intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when covered intangibles are integral to the activity that generates the profit and the activity could not be carried on or would generate little profit without use of those intangibles.

(D) *Other bases for measuring anticipated benefits*. Other bases for measuring anticipated benefits may, in some circumstances, be appropriate, but only to the extent that there is expected to be a reasonably identifiable relationship between the basis of measurement used and additional income generated or costs saved by the use of covered intangibles. For example, a division of costs based on employee compensation would be considered unreliable unless there were a relationship between the amount of compensation and the expected income of the controlled participants from the use of covered intangibles.

(E) *Examples*. The following examples illustrate this paragraph (f)(3)(iii):

Example 1. Foreign Parent (FP) and U.S. Subsidiary (USS) both produce a feedstock for the manufacture of various high-performance plastic products. Producing the feedstock requires large amounts of electricity, which accounts for a significant portion of its production cost. FP and USS enter into a cost sharing arrangement to develop a new process that will reduce the amount of electricity required to produce a unit of the feedstock. FP and USS currently both incur an electricity cost of X% of its other production costs and rates for each are expected to remain similar in the future. How much the new process, if it is successful, will reduce the amount of electricity required to produce a unit of the feedstock is uncertain, but it will be about the same amount for both companies. Therefore, the cost savings each company is expected to achieve after implementing the new process are similar relative to the total amount of the feedstock produced. Under the cost sharing arrangement FP and USS divide the costs of developing the new process based on the units of the feedstock each is anticipated to produce in the future. In this case, units produced is the most reliable basis for measuring benefits and dividing the intangible development costs because each participant is expected to have a similar decrease in costs per unit of the feedstock produced.

Example 2. The facts are the same as in *Example 1*, except that USS pays X% of its other production costs for electricity while FP pays 2X% of its other production costs. In this case, units produced is not the most reliable basis for measuring benefits and dividing the intangible development costs because the participants do not expect to have a similar decrease in costs per unit of the feedstock produced. The district director determines that the most reliable measure of benefit shares may be based on units of the feedstock produced if FP's units are weighted relative to USS's units by a factor of 2. This reflects the fact that FP pays twice as much as USS as a percentage of its other production costs for electricity and, therefore, FP's savings per unit of the feedstock would be twice USS's savings from any new process eventually developed.

Example 3. The facts are the same as in *Example 2*, except that to supply the particular needs of the U.S. market USS manufactures the feedstock with somewhat different properties than FP's feedstock. This requires USS to employ a somewhat different production process than does FP. Because of this difference, it will be more costly for USS to adopt any new process that may be developed under the cost sharing agreement. In this case, units produced is not the most reliable basis for measuring benefit shares. In order to reliably determine benefit shares, the district director offsets the reasonably anticipated costs of adopting the new process against the reasonably anticipated total savings in electricity costs.

Example 4. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new anesthetic drugs. USP obtains the right to use any resulting patent in the U.S. market, and FS obtains the right to use the patent in the European market. USP and FS divide costs on the basis of anticipated operating profit from each patent under development. USP anticipates that it will receive a much higher profit than FS per unit sold because drug prices are uncontrolled in the U.S., whereas drug prices are regulated in many European countries. In this case, the controlled taxpayers' basis for measuring benefits is the most reliable.

Example 5. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) both manufacture and sell fertilizers. They enter into a cost sharing arrangement to develop a new pellet form of a common agricultural fertilizer that is currently available only in powder form. Under the cost sharing arrangement, USS obtains the rights to produce and sell the new form of fertilizer for the U.S. market while FP obtains the rights to produce and sell the fertilizer for the rest of the world. The costs of developing the new form of fertilizer are divided on the basis of the anticipated sales of fertilizer in the participants' respective markets.

(ii) If the research and development is successful the pellet form will deliver the fertilizer more efficiently to crops and less fertilizer will be required to achieve the same effect on crop growth. The pellet form of fertilizer can be expected to sell at a price premium over the powder form of fertilizer based on the savings in the amount of fertilizer that needs to be used. If the research and development is successful, the costs of producing pellet fertilizer are expected to be approximately the same as the costs of producing powder fertilizer and the same for both FP and USS. Both FP and USS operate at approximately the same market levels, selling their fertilizers largely to independent distributors.

(iii) In this case, the controlled taxpayers' basis for measuring benefits is the most reliable.

Example 6. The facts are the same as in *Example 5,* except that FP distributes its fertilizers directly while USS sells to independent distributors. In this case, sales of USS and FP are not the most reliable basis for measuring benefits unless adjustments are made to account for the difference in market levels at which the sales occur.

Example 7. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop materials that will be used to train all new entry-level employees. FP and USS determine that the new materials will save approximately ten hours of training time per employee. Because their entry-level employees are paid on differing wage scales, FP and USS decide that they should not divide costs based on the number of entry-level employees hired by each. Rather, they divide costs based on compensation paid to the entry-level employees hired by each. In this case, the basis used for measuring benefits is the most reliable because there is a direct relationship between compensation paid to new entry-level employees and costs saved by FP and USS from the use of the new training materials.

Example 8. U.S. Parent (USP), Foreign Subsidiary 1 (FS1) and Foreign Subsidiary 2 (FS2) enter into a cost sharing arrangement to develop computer software that each will market and install on customers' computer systems. The participants divide costs on the basis of projected sales by USP, FS1, and FS2 of the software in their respective geographic areas. However, FS1 plans not only to sell but also to license the software to unrelated customers, and FS1's licensing income (which is a percentage of the licensees' sales) is not counted in the projected benefits. In this case, the basis used for measuring the benefits of each participant is not the most reliable because all of the benefits received by participants are not taken into account. In order to reliably determine benefit shares, FS1's projected benefits from licensing must be included in the measurement on a basis that is the same as that used to measure its own and the other participants' projected benefits from sales (e.g., all participants might measure their benefits on the basis of operating profit).

(iv) *Projections used to estimate anticipated benefits*—(A) *In general.* The reliability of an estimate of anticipated benefits also depends upon the reliability of projections used in making the estimate. Projections required for this purpose generally include a determination of the time period between the inception of the research and development and the receipt of benefits, a projection of the time over which benefits will be received, and a projection of the benefits anticipated for each year in which it is anticipated that the intangible will generate benefits. A projection of the relevant basis for measuring anticipated benefits may require a projection of the factors that underlie it. For example, a projection of operating profits may require a projection of sales, cost of sales, operating expenses, and other factors that affect operating profits. If it is anticipated that there will be significant variation among controlled participants in the timing of their receipt of benefits, and consequently benefit shares are expected to vary significantly over the years in which benefits will be received, it may be necessary to use the present discounted value of the projected benefits to reliably determine each controlled participant's share of those benefits. If it is not anticipated that benefit shares will significantly change over time, current annual benefit shares may provide a reliable projection of anticipated benefit shares. This circumstance is most likely to occur when the cost sharing arrangement is a long-term arrangement, the arrangement covers a wide variety of intangibles, the composition of the covered intangibles is unlikely to change, the covered intangibles are unlikely to generate unusual profits, and each controlled participant's share of the market is stable.

(B) *Unreliable projections.* A significant divergence between projected benefit shares and actual benefit shares may indicate that the projections were not reliable. In such a case, the district director may use actual benefits as the most reliable measure of anticipated benefits. If benefits are projected over a period of years, and the projections for initial years of the period prove to be unreliable, this may indicate that the projections for the remaining years of the period are also unreliable and thus should be adjusted. Projections will not be considered unreliable based on a divergence between a controlled participant's projected benefit share and actual benefit share if the amount of such divergence for every controlled participant is less than or equal to 20% of the participant's projected benefit share. Further, the district director will not make an allocation based on such divergence if the difference is due to an extraordinary event, beyond the control of the participants, that could not reasonably have been anticipated at the time that costs were shared. For purposes of this paragraph, all controlled participants that are not U.S. persons will be treated as a single controlled participant. Therefore, an adjustment based on an unreliable projection will be made to the cost shares of foreign controlled participants only if there is a matching adjustment to the cost shares of controlled participants that are U.S. persons. Nothing in this paragraph (f)(3)(iv)(B) will prevent the district director from making an allocation if the taxpayer did not use the most reliable basis for measuring anticipated benefits. For example, if the taxpayer measures anticipated benefits based on units sold, and the district director determines that another basis is more reliable for measuring anticipated benefits, then the fact that actual units sold were within 20% of the projected unit sales will not preclude an allocation under this section.

(C) *Foreign-to-foreign adjustments.* Notwithstanding the limitations on adjustments provided in paragraph (f)(3)(iv)(B) of this section, adjustments to cost shares based on an unreliable projection also may be made solely among foreign controlled participants if the variation between actual and projected benefits has the effect of substantially reducing U.S. tax.

(D) *Examples.* The following examples illustrate this paragraph (f)(3)(iv):

Example 1. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop a new car model. The participants plan to spend four years developing the new model and four years producing and selling the new model. USS and FP project total sales of $4 billion and $2 billion, respectively, over the planned four years of exploitation of the new model. Cost shares are divided for each year based on projected total sales. Therefore, USS bears 66⅔% of each year's intangible development costs and FP bears 33⅓% of such costs.

(ii) USS typically begins producing and selling new car models a year after FP begins producing and selling new car models. The district director determines that in order to reflect USS's one-year lag in introducing new car models, a more reliable projection of each participant's share of benefits would be based on a projection of all four years of sales for each participant, discounted to present value.

Example 2. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new and improved household cleaning products. Both participants have sold household cleaning products for many years and have stable market shares. The products under development are unlikely to produce unusual profits for either participant. The participants divide costs on the basis of each participant's current sales of household cleaning products. In this case, the participants' future benefit shares are reliably projected by current sales of cleaning products.

Example 3. The facts are the same as in *Example 2,* except that FS's market share is rapidly expanding because of the business failure of a competitor in its geographic area. The district director determines that the participants' future benefit shares are not reliably projected by current sales of cleaning products and that FS's benefit projections should take into account its growth in sales.

Example 4. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop synthetic fertilizers and insecticides. FP and USS share costs on the basis of each participant's current sales of fertilizers and insecticides. The market shares of the participants have been stable for fertilizers, but FP's market share for insecticides has been expanding. The district director determines that the participants' projections of benefit shares are reliable with regard to fertilizers, but not reliable with regard to insecticides; a more reliable projection of benefit shares would take into account the expanding market share for insecticides.

Example 5. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new food products, dividing costs on the basis of projected sales two years in the future. In year 1, USP and FS project that their sales in year 3 will be equal, and they divide costs accordingly. In year 3, the district director examines the participants' method for dividing costs. USP and FS actually accounted for 42% and 58% of total sales, respectively. The district director agrees that sales two years in the future provide a reliable basis for estimating benefit shares. Because the differences between USP's and FS's actual and projected benefit shares are less than 20% of their projected benefit shares, the projection of future benefits for year 3 is reliable.

Example 6. The facts are the same as in *Example 5,* except that the in year 3 USP and FS actually accounted for 35% and 65% of total sales, respectively. The divergence between USP's projected and actual benefit shares is greater than 20% of USP's projected benefit share and is not due to an extraordinary event beyond the control of the participants. The district director concludes that the projection of anticipated benefit shares was unreliable, and uses actual benefits as the basis for an adjustment to the cost shares borne by USP and FS.

Example 7. U.S. Parent (USP), a U.S. corporation, and its foreign subsidiary (FS) enter a cost sharing arrangement in year 1. They project that they will begin to receive benefits from covered intangibles in years 4 through 6, and that USP will receive 60% of total benefits and FS 40% of total benefits. In years 4 through 6, USP and FS actually receive 50% each of the total benefits. In evaluating the reliability of the participants' projections, the district director compares these actual benefit shares to the projected benefit shares. Although USP's actual benefit share (50%) is within 20% of its projected benefit share (60%), FS's actual benefit share (50%) is not within 20% of its projected benefit share (40%). Based on this discrepancy, the district director may conclude that the participants' projections were not reliable and may use actual benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

Example 8. Three controlled taxpayers, USP, FS1 and FS2 enter into a cost sharing arrangement. FS1 and FS2 are foreign. USP is a United States corporation that controls all the stock of FS1 and FS2. The participants project that they will share the total benefits of the covered intangibles in the following percentages: USP 50%; FS1 30%; and FS2 20%. Actual benefit shares are as follows: USP 45%; FS1 25%; and FS2 30%. In evaluating the reliability of the participants' projections, the district director compares these actual benefit shares to the projected benefit shares. For this purpose, FS1 and FS2 are treated as a single participant. The actual benefit share received by USP (45%) is within 20% of its projected benefit share (50%). In addition, the non-US participants' actual benefit share (55%) is also within 20% of their projected benefit share (50%). Therefore, the district director concludes that the participants' projections of future benefits were reliable, despite the fact that FS2's actual benefit share (30%) is not within 20% of its projected benefit share (20%).

Example 9. The facts are the same as in *Example 8.* In addition, the district director determines that FS2 has significant operating losses and has no earnings and profits, and that FS1 is profitable and has earnings and profits. Based on all the evidence, the district director concludes that the participants arranged that FS1 would bear a larger cost share than appropriate in order to reduce FS1's earnings and profits and thereby reduce inclusions USP otherwise would be deemed to have on account of FS1 under subpart F. Pursuant to §1.482–7 (f)(3)(iv)(C), the district director may make an adjustment solely to the cost shares borne by FS1 and FS2 because FS2's projection of future benefits was unreliable and the variation between actual and projected benefits had the effect of substantially reducing USP's U.S. income tax liability (on account of FS1 subpart F income).

Example 10. (i)(A) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement in 1996 to develop a new treatment for baldness. USS's interest in any treatment developed is the right to produce and sell the treatment in the U.S. market while FP retains rights to produce and sell the treatment in the rest of the world. USS and FP measure their anticipated benefits from the cost sharing arrangement based on their respective projected future sales of the baldness treatment. The following sales projections are used:

SALES

[In millions of dollars]

Year	USS	FP
1997	5	10
1998	20	20
1999	30	30
2000	40	40
2001	40	40
2002	40	40
2003	40	40
2004	20	20
2005	10	10
2006	5	5

(B) In 1997, the first year of sales, USS is projected to have lower sales than FP due to lags in U.S. regulatory approval for the baldness treatment. In each subsequent year USS and FP are projected to have equal sales. Sales are projected to build over the first three years of the period, level off for several years, and then decline over the final years of the period as new and improved baldness treatments reach the market.

(ii) To account for USS's lag in sales in the first year, the present discounted value of sales over the period is used as the basis for measuring benefits. Based on the risk associated with this venture, a discount rate of 10 percent is selected. The present discounted value of projected sales is determined to be approximately $154.4 million for USS and $158.9 million for FP. On this basis USS and FP are projected to obtain approximately

49.3% and 50.7% of the benefit, respectively, and the costs of developing the baldness treatment are shared accordingly.

(iii) (A) In the year 2002 the district director examines the cost sharing arrangement. USS and FP have obtained the following sales results through the year 2001:

SALES

[In millions of dollars]

Year	USS	FP
1997	0	17
1998	17	35
1999	25	41
2000	38	41
2001	39	41

(B) USS's sales initially grew more slowly than projected while FP's sales grew more quickly. In each of the first three years of the period the share of total sales of at least one of the parties diverged by over 20% from its projected share of sales. However, by the year 2001 both parties' sales had leveled off at approximately their projected values. Taking into account this leveling off of sales and all the facts and circumstances, the district director determines that it is appropriate to use the original projections for the remaining years of sales. Combining the actual results through the year 2001 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $141.6 million for USS and $187.3 million for FP. This result implies that USS and FP obtain approximately 43.1% and 56.9%, respectively, of the anticipated benefits from the baldness treatment. Because these benefit shares are within 20% of the benefit shares calculated based on the original sales projections, the district director determines that, based on the difference between actual and projected benefit shares, the original projections were not unreliable. No adjustment is made based on the difference between actual and projected benefit shares.

Example 11. (i) The facts are the same as in *Example 10,* except that the actual sales results through the year 2001 are as follows:

SALES

[In millions of dollars]

Year	USS	FP
1997	0	17
1998	17	35
1999	25	44
2000	34	54
2001	36	55

(ii) Based on the discrepancy between the projections and the actual results and on consideration of all the facts, the district director determines that for the remaining years the following sales projections are more reliable than the original projections:

SALES

[In millions of dollars]

Year	USS	FP
2002	36	55
2003	36	55
2004	18	28
2005	9	14
2006	4.5	7

(iii) Combining the actual results through the year 2001 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $131.2 million for USS and $229.4 million for FP. This result implies that USS and FP obtain approximately 35.4% and 63.6%, respectively, of the anticipated benefits from the baldness treatment. These benefit shares diverge by greater than 20% from the benefit shares calculated based on the original sales projections, and the district director determines that, based on the difference between actual and projected benefit shares, the original projections were unreliable. The district director adjusts costs shares for each of the taxable years under examination to conform them to the recalculated shares of anticipated benefits.

(4) *Timing of allocations.* If the district director reallocates costs under the provisions of this paragraph (f), the allocation must be reflected for tax purposes in the year in which the costs were incurred. When a cost sharing payment is owed by one member of a qualified cost sharing arrangement to another member, the district director may make appropriate allocations to reflect an arm's length rate of interest for the time value of money, consistent with the provisions of § 1.482–2(a) (Loans or advances).

(g) *Allocations of income, deductions or other tax items to reflect transfers of intangibles (buy-in)*—(1) *In general.* A controlled participant that makes intangible property available to a qualified cost sharing arrangement will be treated as having transferred interests in such property to the other controlled participants, and such other controlled participants must make buy-in payments to it, as provided in paragraph (g)(2) of this section. If the other controlled participants fail to make such payments, the district director may make appropriate allocations, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, to reflect an arm's length consideration for the transferred intangible property. Further, if a group of controlled taxpayers participates in a qualified cost sharing arrangement, any change in the controlled participants' interests in covered intangibles, whether by reason of entry of a new participant or otherwise by reason of transfers (including deemed transfers) of interests among existing participants, is a transfer of intangible property, and the district director may make appropriate allocations, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, to reflect an arm's length consideration for the transfer. See paragraphs (g) (3), (4), and (5) of this section. Paragraph (g)(6) of this section provides rules for assigning unassigned interests under a qualified cost sharing arrangement.

(2) *Pre-existing intangibles.* If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner. The buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6, multiplied by the controlled participant's share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced to the extent of any payments owed to it under this paragraph (g)(2) from other controlled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. See paragraph (g)(8), *Example 4,* of this section. Such payments will be treated as consideration for a transfer of an interest in the intangible property made available to the qualified cost sharing arrangement by the payee. Any payment to or from an uncontrolled participant in consideration for intangible property made available to the qualified cost sharing arrangement will be shared by the controlled participants in accordance with their shares of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced by such a share of payments owed from an uncontrolled participant to the same extent as by any payments owed from other controlled participants under this paragraph (g)(2). See paragraph (g)(8), *Example 5,* of this section.

(3) *New controlled participant.* If a new controlled participant enters a qualified cost sharing arrangement and acquires any interest in the covered intangibles, then the new participant must pay an arm's length consideration, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, for such interest to each controlled participant from whom such interest was acquired.

(4) *Controlled participant relinquishes interests.* A controlled participant in a qualified cost sharing arrangement may be deemed to have acquired an interest in one or more covered intangibles if another controlled participant transfers, abandons, or otherwise relinquishes an interest under the arrangement, to the benefit of the first participant. If such a relinquishment occurs, the participant relinquishing the interest must receive an arm's length consideration, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, for its interest. If the controlled participant that has relinquished its interest subsequently uses that interest, then that participant must pay an arm's length consideration, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, to the controlled participant that acquired the interest.

(5) *Conduct inconsistent with the terms of a cost sharing arrangement.* If, after any cost allocations authorized by paragraph (a)(2) of this section, a controlled participant bears costs of intangible development that over a period of years are consistently and materially greater or lesser than its share of reasonably anticipated benefits, then the district director may conclude that the economic substance of the arrangement between the controlled participants is inconsistent with the terms of the cost sharing arrangement. In such a case, the district director may disregard such terms and impute an

agreement consistent with the controlled participants' course of conduct, under which a controlled participant that bore a disproportionately greater share of costs received additional interests in covered intangibles. See §1.482–1(d)(3)(ii)(B) (Identifying contractual terms) and §1.482- 4(f)(3)(ii) (Identification of owner). Accordingly, that participant must receive an arm's length payment from any controlled participant whose share of the intangible development costs is less than its share of reasonably anticipated benefits over time, under the provisions of §§1.482–1 and 1.482–4 through 1.482–6.

(6) *Failure to assign interests under a qualified cost sharing arrangement.* If a qualified cost sharing arrangement fails to assign an interest in a covered intangible, then each controlled participant will be deemed to hold a share in such interest equal to its share of the costs of developing such intangible. For this purpose, if cost shares have varied materially over the period during which such intangible was developed, then the costs of developing the intangible must be measured by their present discounted value as of the date when the first such costs were incurred.

(7) *Form of consideration.* The consideration for an acquisition described in this paragraph (g) may take any of the following forms:

(i) *Lump sum payments.* For the treatment of lump sum payments, see §1.482–4(f)(5) (Lump sum payments);

(ii) *Installment payments.* Installment payments spread over the period of use of the intangible by the transferee, with interest calculated in accordance with §1.482–2(a) (Loans or advances); and

(iii) *Royalties.* Royalties or other payments contingent on the use of the intangible by the transferee.

(8) *Examples.* The following examples illustrate allocations described in this paragraph (g):

Example 1. In year one, four members of a controlled group enter into a cost sharing arrangement to develop a commercially feasible process for capturing energy from nuclear fusion. Based on a reliable projection of their future benefits, each cost sharing participant bears an equal share of the costs. The cost of developing intangibles for each participant with respect to the project is approximately $1 million per year. In year ten, a fifth member of the controlled group joins the cost sharing group and agrees to bear one-fifth of the future costs in exchange for part of the fourth member's territory reasonably anticipated to yield benefits amounting to one-fifth of the total benefits. The fair market value of intangible property within the arrangement at the time the fifth company joins the arrangement is $45 million. The new member must pay one-fifth of that amount (that is, $9 million total) to the fourth member from whom it acquired its interest in covered intangibles.

Example 2. U.S. Subsidiary (USS), Foreign Subsidiary (FS) and Foreign Parent (FP) enter into a cost sharing arrangement to develop new products within the Group X product line. USS manufactures and sells Group X products in North America, FS manufactures and sells Group X products in South America, and FP manufactures and sells Group X products in the rest of the world. USS, FS and FP project that each will manufacture and sell a third of the Group X products under development, and they share costs on the basis of projected sales of manufactured products. When the new Group X products are developed, however, USS ceases to manufacture Group X products, and FP sells its Group X products to USS for resale in the North American market. USS earns a return on its resale activity that is appropriate given its function as a distributor, but does not earn a return attributable to exploiting covered intangibles. The district director determines that USS's share of the costs (one-third) was greater than its share of reasonably anticipated benefits (zero) and that it has transferred an interest in the intangibles for which it should receive a payment from FP, whose share of the intangible development costs (one-third) was less than its share of reasonably anticipated benefits over time (two-thirds). An allocation is made under §§1.482–1 and 1.482–4 through 1.482–6 from FP to USS to recognize USS' one-third interest in the intangibles. No allocation is made from FS to USS because FS did not exploit USS's interest in covered intangibles.

Example 3. U.S. Parent (USP), Foreign Subsidiary 1 (FS1), and Foreign Subsidiary 2 (FS2) enter into a cost sharing arrangement to develop a cure for the common cold. Costs are shared USP–50%, FS1–40% and FS2–10% on the basis of projected units of cold medicine to be produced by each. After ten years of research and development, FS1 withdraws from the arrangement, transferring its interests in the intangibles under development to USP in exchange for a lump sum payment of $10 million. The district director may review this lump sum payment, under the provisions of §1.482–4(f)(5), to ensure that the amount is commensurate with the income attributable to the intangibles.

Example 4. (i) Four members A, B, C, and D of a controlled group form a cost sharing arrangement to develop the next generation technology for their business. Based on a reliable projection of their future benefits, the participants agree to bear shares of the costs incurred during the term of the agreement in the following percentages: A 40%; B 15%; C 25%; and D 20%. The arm's length charges, under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6, for the use of the existing intangible property they respectively make available to the cost sharing arrangement are in the following amounts for the taxable year: A 80X; B 40X; C 30X; and D 30X. The provisional (before offsets) and final buy-in payments/receipts among A, B, C, and D are shown in the table as follows:

[All amounts stated in X's]

	A	B	C	D
Payments	<40>	<21>	<37.5>	<30>
Receipts	48	34	22.5	24
Final	8	13	<15>	<6>

(ii) The first row/first column shows A's provisional buy-in payment equal to the product of 100X (sum of 40X, 30X, and 30X) and A's share of anticipated benefits of 40%. The second row/first column shows A's provisional buy-in receipts equal to the sum of the products of 80X and B's, C's, and D's anticipated benefits shares (15%, 25%, and 20%, respectively). The other entries in the first two rows of the table are similarly computed. The last row shows the final buy-in receipts/payments after offsets. Thus, for the taxable year, A and B are treated as receiving the 8X and 13X, respectively, pro rata out of payments by C and D of 15X and 6X, respectively.

Example 5. A and B, two members of a controlled group form a cost sharing arrangement with an unrelated third party C to develop a new technology useable in their respective businesses. Based on a reliable projection of their future benefits, A and B agree to bear shares of 60% and 40%, respectively, of the costs incurred during the term of the agreement. A also makes available its existing technology for purposes of the research to be undertaken. The arm's length charge, under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6, for the use of the existing technology is 100X for the taxable year. Under its agreement with A and B, C must make a specified cost sharing payment as well as a payment of 50X for the taxable year on account of the pre- existing intangible property made available to the cost sharing arrangement. B's provisional buy-in payment (before offsets) to A for the taxable year is 40X (the product of 100X and B's anticipated benefits share of 40%). C's payment of 50X is shared provisionally between A and B in accordance with their shares of reasonably anticipated benefits, 30X (50X times 60%) to A and 20X (50X times 40%) to B. B's final buy-in payment (after offsets) is 20X (40X less 20X). A is treated as receiving the 70X total provisional payments (40X plus 30X) pro rata out of the final payments by B and C of 20X and 50X, respectively.

(h) *Character of payments made pursuant to a qualified cost sharing arrangement*—(1) *In general.* Payments made pursuant to a qualified cost sharing arrangement (other than payments described in paragraph (g) of this section) generally will be considered costs of developing intangibles of the payor and reimbursements of the same kind of costs of developing intangibles of the payee. For purposes of this paragraph (h), a controlled participant's payment required under a qualified cost sharing arrangement is deemed to be reduced to the extent of any payments owed to it under the arrangement from other controlled or uncontrolled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. Such payments will be applied pro rata against deductions for the taxable year that the payee is allowed in connection with the qualified cost sharing arrangement. Payments received in excess of such deductions will be treated as in consideration for use of the tangible property made available to the qualified cost sharing arrangement by the payee. For purposes of the research credit determined under section 41, cost sharing payments among controlled participants will be treated as provided for intra-group transactions in § 1.41–6(e). Any payment made or received by a taxpayer pursuant to an arrangement that the district director determines not to be a qualified cost sharing arrangement, or a payment made or received pursuant to paragraph (g) of this section, will be subject to the provisions of §§1.482–1 and 1.482–4 through 1.482–6. Any payment that in substance constitutes a cost sharing payment will be treated as such for purposes of this section, regardless of its characterization under foreign law.

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

Example 1. U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) form a cost sharing arrangement to develop a miniature widget, the Small R. Based on a reliable projection of their future benefits, USP agrees to bear 40% and FS to bear 60% of the costs incurred during the term of the agreement. The principal costs in the intangible development area are operating expenses incurred by FS in Country Z of 100X annually, and operating expenses incurred by USP in the United States also of 100X annually. Of the total costs of 200X, USP's share is 80X and FS's share is 120X, so that FS must make a payment to USP of 20X. This payment will be treated as a reimbursement of 20X of USP's operating expenses in the United States. Accordingly, USP's Form 1120 will reflect an 80X deduction on account of activities performed in the United States for purposes of allocation and apportionment of the deduction to source. The Form 5471 for FS will reflect a 100X deduction on account of activities performed in Country Z, and a 20X deduction on account of activities performed in the United States.

Example 2. The facts are the same as in *Example 1,* except that the 100X of costs borne by USP consist of 5X of operating expenses incurred by USP in the United States and 95X of fair market value rental cost for a facility in the United States. The depreciation deduction attributable to the U.S. facility is 7X. The 20X net payment by FS to USP will first be applied in reduction pro rata of the 5X deduction for operating expenses and the 7X depreciation deduction attributable to the U.S. facility. The 8X remainder will be treated as rent for the U.S. facility.

(i) *Accounting requirements.* The accounting requirements of this paragraph are that the controlled participants in a qualified cost sharing arrangement must use a consistent method of accounting to measure costs and benefits, and must translate foreign currencies on a consistent basis.

(j) *Administrative requirements*—(1) *In general.* The administrative requirements of this paragraph consist of the documentation requirements of paragraph (j)(2) of this section and the reporting requirements of paragraph (j)(3) of this section.

(2) *Documentation*—(i) *Requirements.* A controlled participant must maintain sufficient documentation to establish that the requirements of paragraphs (b)(4) and (c)(1) of this section have been met, as well as the additional documentation specified in this paragraph (j)(2)(i), and must provide any such documentation to the Internal Revenue Service within 30 days of a request (unless an extension is granted by the district director). Documents necessary to establish the following must also be maintained—

(A) The total amount of costs incurred pursuant to the arrangement;

(B) The costs borne by each controlled participant;

(C) A description of the method used to determine each controlled participant's share of the intangible development costs, including the projections used to estimate benefits, and an explanation of why that method was selected;

(D) The accounting method used to determine the costs and benefits of the intangible development (including the method used to translate foreign currencies), and, to the extent that the method materially differs from U.S. generally accepted accounting principles, an explanation of such material differences;

(E) Prior research, if any, undertaken in the intangible development area, any tangible or intangible property made available for use in the arrangement, by each controlled participant, and any information used to establish the value of pre-existing and covered intangibles; and

(F) The amount taken into account as operating expenses attributable to stock-based compensation, including the method of measurement and timing used with respect to that amount as well as the data, as of date of grant, used to identify stock-based compensation related to the development of covered intangibles.

(ii) *Coordination with penalty regulation.* The documents described in paragraph (j)(2)(i) of this section will satisfy the principal documents requirement under §1.6662–6(d)(2)(iii)(B) with respect to a qualified cost sharing arrangement.

(3) *Reporting requirements.* A controlled participant must attach to its U.S. income tax return a statement indicating that it is a participant in a qualified cost sharing arrangement, and listing the other controlled participants in the arrangement. A controlled participant that is not required to file a U.S. income tax return must ensure that such a statement is attached to Schedule M of any Form 5471 or to any Form 5472 filed with respect to that participant.

(k) *Effective date.* This section applies for taxable years beginning on or after January 1, 1996. However, paragraphs (a)(3), (d)(2) and (j)(2)(i)(F) of this section apply for stock-based compensation granted in taxable years beginning on or after August 26, 2003.

(l) *Transition rule.* A cost sharing arrangement will be considered a qualified cost sharing arrangement, within the meaning of this section, if, prior to January 1, 1996, the arrangement was a bona fide cost sharing arrangement under the provisions of §1.482–7T (as contained in the 26 CFR part 1 edition revised as of April 1, 1995), but only if the arrangement is amended, if necessary, to conform with the provisions of this section by December 31, 1996.

[T.D. 8632, 60 FR 65557, Dec. 20, 1995, as amended by T.D. 8670, 61 FR 21956, May 13, 1996; 61 FR 33656, June 28, 1996; T.D. 8930, 66 FR 295, Jan. 3, 2001; T.D. 9088, 68 FR 51177, Aug. 26, 2003; 69 FR 13473, Mar. 23, 2004. Redesignated by T.D. 9441, 74 FR 352, Jan. 5, 2009]

§§ 1.484–1.500 [Reserved]

FINDING AIDS

A list of CFR titles, subtitles, chapters, subchapters and parts and an alphabetical list of agencies publishing in the CFR are included in the CFR Index and Finding Aids volume to the Code of Federal Regulations which is published separately and revised annually.

Table of CFR Titles and Chapters

(Revised as of April 1, 2016)

Title 1—General Provisions

Title 2—Grants and Agreements

Title 2—Grants and Agreements—Continued

Title 3—The President

Title 4—Accounts

Title 5—Administrative Personnel

Chap.	
XXIX	Federal Communications Commission (Parts 3900—3999)
XXX	Farm Credit System Insurance Corporation (Parts 4000—4099)
XXXI	Farm Credit Administration (Parts 4100—4199)
XXXIII	Overseas Private Investment Corporation (Parts 4300—4399)
XXXIV	Securities and Exchange Commission (Parts 4400—4499)
XXXV	Office of Personnel Management (Parts 4500—4599)
XXXVI	Department of Homeland Security (Parts 4600—4699)
XXXVII	Federal Election Commission (Parts 4700—4799)
XL	Interstate Commerce Commission (Parts 5000—5099)
XLI	Commodity Futures Trading Commission (Parts 5100—5199)
XLII	Department of Labor (Parts 5200—5299)
XLIII	National Science Foundation (Parts 5300—5399)
XLV	Department of Health and Human Services (Parts 5500—5599)
XLVI	Postal Rate Commission (Parts 5600—5699)
XLVII	Federal Trade Commission (Parts 5700—5799)
XLVIII	Nuclear Regulatory Commission (Parts 5800—5899)
XLIX	Federal Labor Relations Authority (Parts 5900—5999)
L	Department of Transportation (Parts 6000—6099)
LII	Export-Import Bank of the United States (Parts 6200—6299)
LIII	Department of Education (Parts 6300—6399)
LIV	Environmental Protection Agency (Parts 6400—6499)
LV	National Endowment for the Arts (Parts 6500—6599)
LVI	National Endowment for the Humanities (Parts 6600—6699)
LVII	General Services Administration (Parts 6700—6799)
LVIII	Board of Governors of the Federal Reserve System (Parts 6800—6899)
LIX	National Aeronautics and Space Administration (Parts 6900—6999)
LX	United States Postal Service (Parts 7000—7099)
LXI	National Labor Relations Board (Parts 7100—7199)
LXII	Equal Employment Opportunity Commission (Parts 7200—7299)
LXIII	Inter-American Foundation (Parts 7300—7399)
LXIV	Merit Systems Protection Board (Parts 7400—7499)
LXV	Department of Housing and Urban Development (Parts 7500—7599)
LXVI	National Archives and Records Administration (Parts 7600—7699)
LXVII	Institute of Museum and Library Services (Parts 7700—7799)
LXVIII	Commission on Civil Rights (Parts 7800—7899)
LXIX	Tennessee Valley Authority (Parts 7900—7999)
LXX	Court Services and Offender Supervision Agency for the District of Columbia (Parts 8000—8099)
LXXI	Consumer Product Safety Commission (Parts 8100—8199)
LXXIII	Department of Agriculture (Parts 8300—8399)
LXXIV	Federal Mine Safety and Health Review Commission (Parts 8400—8499)

Title 5—Administrative Personnel—Continued

Chap.	
LXXVI	Federal Retirement Thrift Investment Board (Parts 8600—8699)
LXXVII	Office of Management and Budget (Parts 8700—8799)
LXXX	Federal Housing Finance Agency (Parts 9000—9099)
LXXXIII	Special Inspector General for Afghanistan Reconstruction (Parts 9300—9399)
LXXXIV	Bureau of Consumer Financial Protection (Parts 9400—9499)
LXXXVI	National Credit Union Administration (Parts 9600—9699)
XCVII	Department of Homeland Security Human Resources Management System (Department of Homeland Security—Office of Personnel Management) (Parts 9700—9799)
XCVII	Council of the Inspectors General on Integrity and Efficiency (Parts 9800—9899)
XCIX	Military Compensation and Retirement Modernization Commission (Parts 9900—9999)
C	National Council on Disability (Partys 10000—10049)

Title 6—Domestic Security

I	Department of Homeland Security, Office of the Secretary (Parts 1—199)
X	Privacy and Civil Liberties Oversight Board (Parts 1000—1099)

Title 7—Agriculture

	SUBTITLE A—OFFICE OF THE SECRETARY OF AGRICULTURE (PARTS 0—26)
	SUBTITLE B—REGULATIONS OF THE DEPARTMENT OF AGRICULTURE
I	Agricultural Marketing Service (Standards, Inspections, Marketing Practices), Department of Agriculture (Parts 27—209)
II	Food and Nutrition Service, Department of Agriculture (Parts 210—299)
III	Animal and Plant Health Inspection Service, Department of Agriculture (Parts 300—399)
IV	Federal Crop Insurance Corporation, Department of Agriculture (Parts 400—499)
V	Agricultural Research Service, Department of Agriculture (Parts 500—599)
VI	Natural Resources Conservation Service, Department of Agriculture (Parts 600—699)
VII	Farm Service Agency, Department of Agriculture (Parts 700—799)
VIII	Grain Inspection, Packers and Stockyards Administration (Federal Grain Inspection Service), Department of Agriculture (Parts 800—899)
IX	Agricultural Marketing Service (Marketing Agreements and Orders; Fruits, Vegetables, Nuts), Department of Agriculture (Parts 900—999)
X	Agricultural Marketing Service (Marketing Agreements and Orders; Milk), Department of Agriculture (Parts 1000—1199)

Title 7—Agriculture—Continued

Chap.	
XI	Agricultural Marketing Service (Marketing Agreements and Orders; Miscellaneous Commodities), Department of Agriculture (Parts 1200—1299)
XIV	Commodity Credit Corporation, Department of Agriculture (Parts 1400—1499)
XV	Foreign Agricultural Service, Department of Agriculture (Parts 1500—1599)
XVI	Rural Telephone Bank, Department of Agriculture (Parts 1600—1699)
XVII	Rural Utilities Service, Department of Agriculture (Parts 1700—1799)
XVIII	Rural Housing Service, Rural Business-Cooperative Service, Rural Utilities Service, and Farm Service Agency, Department of Agriculture (Parts 1800—2099)
XX	Local Television Loan Guarantee Board (Parts 2200—2299)
XXV	Office of Advocacy and Outreach, Department of Agriculture (Parts 2500—2599)
XXVI	Office of Inspector General, Department of Agriculture (Parts 2600—2699)
XXVII	Office of Information Resources Management, Department of Agriculture (Parts 2700—2799)
XXVIII	Office of Operations, Department of Agriculture (Parts 2800—2899)
XXIX	Office of Energy Policy and New Uses, Department of Agriculture (Parts 2900—2999)
XXX	Office of the Chief Financial Officer, Department of Agriculture (Parts 3000—3099)
XXXI	Office of Environmental Quality, Department of Agriculture (Parts 3100—3199)
XXXII	Office of Procurement and Property Management, Department of Agriculture (Parts 3200—3299)
XXXIII	Office of Transportation, Department of Agriculture (Parts 3300—3399)
XXXIV	National Institute of Food and Agriculture (Parts 3400—3499)
XXXV	Rural Housing Service, Department of Agriculture (Parts 3500—3599)
XXXVI	National Agricultural Statistics Service, Department of Agriculture (Parts 3600—3699)
XXXVII	Economic Research Service, Department of Agriculture (Parts 3700—3799)
XXXVIII	World Agricultural Outlook Board, Department of Agriculture (Parts 3800—3899)
XLI	[Reserved]
XLII	Rural Business-Cooperative Service and Rural Utilities Service, Department of Agriculture (Parts 4200—4299)

Title 8—Aliens and Nationality

I	Department of Homeland Security (Immigration and Naturalization) (Parts 1—499)

Title 8—Aliens and Nationality—Continued

Title 9—Animals and Animal Products

Title 10—Energy

Title 11—Federal Elections

Title 12—Banks and Banking

Title 12—Banks and Banking—Continued

Title 13—Business Credit and Assistance

Title 14—Aeronautics and Space

Title 15—Commerce and Foreign Trade

Title 15—Commerce and Foreign Trade—Continued

Title 16—Commercial Practices

Title 17—Commodity and Securities Exchanges

Title 18—Conservation of Power and Water Resources

Title 19—Customs Duties

Title 20—Employees' Benefits

Title 20—Employees' Benefits—Continued

Title 21—Food and Drugs

Title 22—Foreign Relations

Title 23—Highways

Title 24—Housing and Urban Development

Title 25—Indians

Title 26—Internal Revenue

Title 27—Alcohol, Tobacco Products and Firearms

Title 28—Judicial Administration

Title 29—Labor

Title 29—Labor—Continued

Title 30—Mineral Resources

Title 31—Money and Finance: Treasury

Title 32—National Defense

Title 33—Navigation and Navigable Waters

Title 34—Education

Title 34—Education—Continued

Chap.	
IV	Office of Career, Technical and Adult Education, Department of Education (Parts 400—499)
V	Office of Bilingual Education and Minority Languages Affairs, Department of Education (Parts 500—599)[Reserved]
VI	Office of Postsecondary Education, Department of Education (Parts 600—699)
VII	Office of Educational Research and Improvement, Department of Education (Parts 700—799)[Reserved]
	SUBTITLE C—REGULATIONS RELATING TO EDUCATION
XI	[Reserved]
XII	National Council on Disability (Parts 1200—1299)

Title 35 [Reserved]

Title 36—Parks, Forests, and Public Property

I	National Park Service, Department of the Interior (Parts 1—199)
II	Forest Service, Department of Agriculture (Parts 200—299)
III	Corps of Engineers, Department of the Army (Parts 300—399)
IV	American Battle Monuments Commission (Parts 400—499)
V	Smithsonian Institution (Parts 500—599)
VI	[Reserved]
VII	Library of Congress (Parts 700—799)
VIII	Advisory Council on Historic Preservation (Parts 800—899)
IX	Pennsylvania Avenue Development Corporation (Parts 900—999)
X	Presidio Trust (Parts 1000—1099)
XI	Architectural and Transportation Barriers Compliance Board (Parts 1100—1199)
XII	National Archives and Records Administration (Parts 1200—1299)
XV	Oklahoma City National Memorial Trust (Parts 1500—1599)
XVI	Morris K. Udall Scholarship and Excellence in National Environmental Policy Foundation (Parts 1600—1699)

Title 37—Patents, Trademarks, and Copyrights

I	United States Patent and Trademark Office, Department of Commerce (Parts 1—199)
II	U.S. Copyright Office, Library of Congress (Parts 200—299)
III	Copyright Royalty Board, Library of Congress (Parts 300—399)
IV	Assistant Secretary for Technology Policy, Department of Commerce (Parts 400—599)

Title 38—Pensions, Bonuses, and Veterans' Relief

I	Department of Veterans Affairs (Parts 0—199)
II	Armed Forces Retirement Home (Parts 200—299)

Title 39—Postal Service

Title 40—Protection of Environment

Title 41—Public Contracts and Property Management

Title 45—Public Welfare—Continued

Title 46—Shipping

Title 47—Telecommunication

Title 48—Federal Acquisition Regulations System

Title 49—Transportation

Chap.	
	SUBTITLE A—OFFICE OF THE SECRETARY OF TRANSPORTATION (PARTS 1—99)
	SUBTITLE B—OTHER REGULATIONS RELATING TO TRANSPORTATION
I	Pipeline and Hazardous Materials Safety Administration, Department of Transportation (Parts 100—199)
II	Federal Railroad Administration, Department of Transportation (Parts 200—299)
III	Federal Motor Carrier Safety Administration, Department of Transportation (Parts 300—399)
IV	Coast Guard, Department of Homeland Security (Parts 400—499)
V	National Highway Traffic Safety Administration, Department of Transportation (Parts 500—599)
VI	Federal Transit Administration, Department of Transportation (Parts 600—699)
VII	National Railroad Passenger Corporation (AMTRAK) (Parts 700—799)
VIII	National Transportation Safety Board (Parts 800—999)
X	Surface Transportation Board, Department of Transportation (Parts 1000—1399)
XI	Research and Innovative Technology Administration, Department of Transportation (Parts 1400—1499) [Reserved]
XII	Transportation Security Administration, Department of Homeland Security (Parts 1500—1699)

Title 50—Wildlife and Fisheries

I	United States Fish and Wildlife Service, Department of the Interior (Parts 1—199)
II	National Marine Fisheries Service, National Oceanic and Atmospheric Administration, Department of Commerce (Parts 200—299)
III	International Fishing and Related Activities (Parts 300—399)
IV	Joint Regulations (United States Fish and Wildlife Service, Department of the Interior and National Marine Fisheries Service, National Oceanic and Atmospheric Administration, Department of Commerce); Endangered Species Committee Regulations (Parts 400—499)
V	Marine Mammal Commission (Parts 500—599)
VI	Fishery Conservation and Management, National Oceanic and Atmospheric Administration, Department of Commerce (Parts 600—699)

Alphabetical List of Agencies Appearing in the CFR

(Revised as of April 1, 2016)

Agency	CFR Title, Subtitle or Chapter
Administrative Committee of the Federal Register	1, I
Administrative Conference of the United States	1, III
Advisory Council on Historic Preservation	36, VIII
Advocacy and Outreach, Office of	7, XXV
Afghanistan Reconstruction, Special Inspector General for	5, LXXXIII
African Development Foundation	22, XV
Federal Acquisition Regulation	48, 57
Agency for International Development	2, VII; 22, II
Federal Acquisition Regulation	48, 7
Agricultural Marketing Service	7, I, IX, X, XI
Agricultural Research Service	7, V
Agriculture Department	2, IV; 5, LXXIII
Advocacy and Outreach, Office of	7, XXV
Agricultural Marketing Service	7, I, IX, X, XI
Agricultural Research Service	7, V
Animal and Plant Health Inspection Service	7, III; 9, I
Chief Financial Officer, Office of	7, XXX
Commodity Credit Corporation	7, XIV
Economic Research Service	7, XXXVII
Energy Policy and New Uses, Office of	2, IX; 7, XXIX
Environmental Quality, Office of	7, XXXI
Farm Service Agency	7, VII, XVIII
Federal Acquisition Regulation	48, 4
Federal Crop Insurance Corporation	7, IV
Food and Nutrition Service	7, II
Food Safety and Inspection Service	9, III
Foreign Agricultural Service	7, XV
Forest Service	36, II
Grain Inspection, Packers and Stockyards Administration	7, VIII; 9, II
Information Resources Management, Office of	7, XXVII
Inspector General, Office of	7, XXVI
National Agricultural Library	7, XLI
National Agricultural Statistics Service	7, XXXVI
National Institute of Food and Agriculture	7, XXXIV
Natural Resources Conservation Service	7, VI
Operations, Office of	7, XXVIII
Procurement and Property Management, Office of	7, XXXII
Rural Business-Cooperative Service	7, XVIII, XLII
Rural Development Administration	7, XLII
Rural Housing Service	7, XVIII, XXXV
Rural Telephone Bank	7, XVI
Rural Utilities Service	7, XVII, XVIII, XLII
Secretary of Agriculture, Office of	7, Subtitle A
Transportation, Office of	7, XXXIII
World Agricultural Outlook Board	7, XXXVIII
Air Force Department	32, VII
Federal Acquisition Regulation Supplement	48, 53
Air Transportation Stabilization Board	14, VI
Alcohol and Tobacco Tax and Trade Bureau	27, I
Alcohol, Tobacco, Firearms, and Explosives, Bureau of	27, II
AMTRAK	49, VII
American Battle Monuments Commission	36, IV
American Indians, Office of the Special Trustee	25, VII

Agency	CFR Title, Subtitle or Chapter
Animal and Plant Health Inspection Service	7, III; 9, I
Appalachian Regional Commission	5, IX
Architectural and Transportation Barriers Compliance Board	36, XI
Arctic Research Commission	45, XXIII
Armed Forces Retirement Home	5, XI
Army Department	32, V
Engineers, Corps of	33, II; 36, III
Federal Acquisition Regulation	48, 51
Bilingual Education and Minority Languages Affairs, Office of	34, V
Blind or Severely Disabled, Committee for Purchase from People Who Are	41, 51
Broadcasting Board of Governors	22, V
Federal Acquisition Regulation	48, 19
Career, Technical and Adult Education, Office of	34, IV
Census Bureau	15, I
Centers for Medicare & Medicaid Services	42, IV
Central Intelligence Agency	32, XIX
Chemical Safety and Hazardous Investigation Board	40, VI
Chief Financial Officer, Office of	7, XXX
Child Support Enforcement, Office of	45, III
Children and Families, Administration for	45, II, III, IV, X
Civil Rights, Commission on	5, LXVIII; 45, VII
Civil Rights, Office for	34, I
Council of the Inspectors General on Integrity and Efficiency	5, XCVIII
Court Services and Offender Supervision Agency for the District of Columbia	5, LXX
Coast Guard	33, I; 46, I; 49, IV
Coast Guard (Great Lakes Pilotage)	46, III
Commerce Department	2, XIII; 44, IV; 50, VI
Census Bureau	15, I
Economic Analysis, Bureau of	15, VIII
Economic Development Administration	13, III
Emergency Management and Assistance	44, IV
Federal Acquisition Regulation	48, 13
Foreign-Trade Zones Board	15, IV
Industry and Security, Bureau of	15, VII
International Trade Administration	15, III; 19, III
National Institute of Standards and Technology	15, II
National Marine Fisheries Service	50, II, IV
National Oceanic and Atmospheric Administration	15, IX; 50, II, III, IV, VI
National Telecommunications and Information Administration	15, XXIII; 47, III, IV
National Weather Service	15, IX
Patent and Trademark Office, United States	37, I
Productivity, Technology and Innovation, Assistant Secretary for	37, IV
Secretary of Commerce, Office of	15, Subtitle A
Technology Administration	15, XI
Technology Policy, Assistant Secretary for	37, IV
Commercial Space Transportation	14, III
Commodity Credit Corporation	7, XIV
Commodity Futures Trading Commission	5, XLI; 17, I
Community Planning and Development, Office of Assistant Secretary for	24, V, VI
Community Services, Office of	45, X
Comptroller of the Currency	12, I
Construction Industry Collective Bargaining Commission	29, IX
Consumer Financial Protection Bureau	5, LXXXIV; 12, X
Consumer Product Safety Commission	5, LXXI; 16, II
Copyright Royalty Board	37, III
Corporation for National and Community Service	2, XXII; 45, XII, XXV
Cost Accounting Standards Board	48, 99
Council on Environmental Quality	40, V
Court Services and Offender Supervision Agency for the District of Columbia	5, LXX; 28, VIII
Customs and Border Protection	19, I
Defense Contract Audit Agency	32, I

Agency	CFR Title, Subtitle or Chapter
National Drug Control Policy, Office of	2, XXXVI; 21, III
National Security Council	32, XXI; 47, 2
Presidential Documents	3
Science and Technology Policy, Office of	32, XXIV; 47, II
Trade Representative, Office of the United States	15, XX
Export-Import Bank of the United States	2, XXXV; 5, LII; 12, IV
Family Assistance, Office of	45, II
Farm Credit Administration	5, XXXI; 12, VI
Farm Credit System Insurance Corporation	5, XXX; 12, XIV
Farm Service Agency	7, VII, XVIII
Federal Acquisition Regulation	48, 1
Federal Aviation Administration	14, I
Commercial Space Transportation	14, III
Federal Claims Collection Standards	31, IX
Federal Communications Commission	5, XXIX; 47, I
Federal Contract Compliance Programs, Office of	41, 60
Federal Crop Insurance Corporation	7, IV
Federal Deposit Insurance Corporation	5, XXII; 12, III
Federal Election Commission	5, XXXVII; 11, I
Federal Emergency Management Agency	44, I
Federal Employees Group Life Insurance Federal Acquisition Regulation	48, 21
Federal Employees Health Benefits Acquisition Regulation	48, 16
Federal Energy Regulatory Commission	5, XXIV; 18, I
Federal Financial Institutions Examination Council	12, XI
Federal Financing Bank	12, VIII
Federal Highway Administration	23, I, II
Federal Home Loan Mortgage Corporation	1, IV
Federal Housing Enterprise Oversight Office	12, XVII
Federal Housing Finance Agency	5, LXXX; 12, XII
Federal Housing Finance Board	12, IX
Federal Labor Relations Authority	5, XIV, XLIX; 22, XIV
Federal Law Enforcement Training Center	31, VII
Federal Management Regulation	41, 102
Federal Maritime Commission	46, IV
Federal Mediation and Conciliation Service	29, XII
Federal Mine Safety and Health Review Commission	5, LXXIV; 29, XXVII
Federal Motor Carrier Safety Administration	49, III
Federal Prison Industries, Inc.	28, III
Federal Procurement Policy Office	48, 99
Federal Property Management Regulations	41, 101
Federal Railroad Administration	49, II
Federal Register, Administrative Committee of	1, I
Federal Register, Office of	1, II
Federal Reserve System	12, II
Board of Governors	5, LVIII
Federal Retirement Thrift Investment Board	5, VI, LXXVI
Federal Service Impasses Panel	5, XIV
Federal Trade Commission	5, XLVII; 16, I
Federal Transit Administration	49, VI
Federal Travel Regulation System	41, Subtitle F
Financial Crimes Enforcement Network	31, X
Financial Research Office	12, XVI
Financial Stability Oversight Council	12, XIII
Fine Arts, Commission on	45, XXI
Fiscal Service	31, II
Fish and Wildlife Service, United States	50, I, IV
Food and Drug Administration	21, I
Food and Nutrition Service	7, II
Food Safety and Inspection Service	9, III
Foreign Agricultural Service	7, XV
Foreign Assets Control, Office of	31, V
Foreign Claims Settlement Commission of the United States	45, V
Foreign Service Grievance Board	22, IX
Foreign Service Impasse Disputes Panel	22, XIV
Foreign Service Labor Relations Board	22, XIV
Foreign-Trade Zones Board	15, IV

Agency	CFR Title, Subtitle or Chapter
Forest Service	36, II
General Services Administration	5, LVII; 41, 105
Contract Appeals, Board of	48, 61
Federal Acquisition Regulation	48, 5
Federal Management Regulation	41, 102
Federal Property Management Regulations	41, 101
Federal Travel Regulation System	41, Subtitle F
General	41, 300
Payment From a Non-Federal Source for Travel Expenses	41, 304
Payment of Expenses Connected With the Death of Certain Employees	41, 303
Relocation Allowances	41, 302
Temporary Duty (TDY) Travel Allowances	41, 301
Geological Survey	30, IV
Government Accountability Office	4, I
Government Ethics, Office of	5, XVI
Government National Mortgage Association	24, III
Grain Inspection, Packers and Stockyards Administration	7, VIII; 9, II
Gulf Coast Ecosystem Restoration Council	2, LIX; 40, VIII
Harry S. Truman Scholarship Foundation	45, XVIII
Health and Human Services, Department of	2, III; 5, XLV; 45, Subtitle A,
Centers for Medicare & Medicaid Services	42, IV
Child Support Enforcement, Office of	45, III
Children and Families, Administration for	45, II, III, IV, X
Community Services, Office of	45, X
Family Assistance, Office of	45, II
Federal Acquisition Regulation	48, 3
Food and Drug Administration	21, I
Human Development Services, Office of	45, XIII
Indian Health Service	25, V
Inspector General (Health Care), Office of	42, V
Public Health Service	42, I
Refugee Resettlement, Office of	45, IV
Homeland Security, Department of	2, XXX; 5, XXXVI; 6, I; 8, I
Coast Guard	33, I; 46, I; 49, IV
Coast Guard (Great Lakes Pilotage)	46, III
Customs and Border Protection	19, I
Federal Emergency Management Agency	44, I
Human Resources Management and Labor Relations Systems	5, XCVII
Immigration and Customs Enforcement Bureau	19, IV
Transportation Security Administration	49, XII
HOPE for Homeowners Program, Board of Directors of	24, XXIV
Housing and Urban Development, Department of	2, XXIV; 5, LXV; 24, Subtitle B
Community Planning and Development, Office of Assistant Secretary for	24, V, VI
Equal Opportunity, Office of Assistant Secretary for	24, I
Federal Acquisition Regulation	48, 24
Federal Housing Enterprise Oversight, Office of	12, XVII
Government National Mortgage Association	24, III
Housing—Federal Housing Commissioner, Office of Assistant Secretary for	24, II, VIII, X, XX
Housing, Office of, and Multifamily Housing Assistance Restructuring, Office of	24, IV
Inspector General, Office of	24, XII
Public and Indian Housing, Office of Assistant Secretary for	24, IX
Secretary, Office of	24, Subtitle A, VII
Housing—Federal Housing Commissioner, Office of Assistant Secretary for	24, II, VIII, X, XX
Housing, Office of, and Multifamily Housing Assistance Restructuring, Office of	24, IV
Human Development Services, Office of	45, XIII
Immigration and Customs Enforcement Bureau	19, IV
Immigration Review, Executive Office for	8, V

Agency	CFR Title, Subtitle or Chapter
Independent Counsel, Office of	28, VII
Independent Counsel, Offices of	28, VI
Indian Affairs, Bureau of	25, I, V
Indian Affairs, Office of the Assistant Secretary	25, VI
Indian Arts and Crafts Board	25, II
Indian Health Service	25, V
Industry and Security, Bureau of	15, VII
Information Resources Management, Office of	7, XXVII
Information Security Oversight Office, National Archives and Records Administration	32, XX
Inspector General	
Agriculture Department	7, XXVI
Health and Human Services Department	42, V
Housing and Urban Development Department	24, XII, XV
Institute of Peace, United States	22, XVII
Inter-American Foundation	5, LXIII; 22, X
Interior Department	2, XIV
American Indians, Office of the Special Trustee	25, VII
Endangered Species Committee	50, IV
Federal Acquisition Regulation	48, 14
Federal Property Management Regulations System	41, 114
Fish and Wildlife Service, United States	50, I, IV
Geological Survey	30, IV
Indian Affairs, Bureau of	25, I, V
Indian Affairs, Office of the Assistant Secretary	25, VI
Indian Arts and Crafts Board	25, II
Land Management, Bureau of	43, II
National Indian Gaming Commission	25, III
National Park Service	36, I
Natural Resource Revenue, Office of	30, XII
Ocean Energy Management, Bureau of	30, V
Reclamation, Bureau of	43, I
Safety and Enforcement Bureau, Bureau of	30, II
Secretary of the Interior, Office of	2, XIV; 43, Subtitle A
Surface Mining Reclamation and Enforcement, Office of	30, VII
Internal Revenue Service	26, I
International Boundary and Water Commission, United States and Mexico, United States Section	22, XI
International Development, United States Agency for	22, II
Federal Acquisition Regulation	48, 7
International Development Cooperation Agency, United States	22, XII
International Joint Commission, United States and Canada	22, IV
International Organizations Employees Loyalty Board	5, V
International Trade Administration	15, III; 19, III
International Trade Commission, United States	19, II
Interstate Commerce Commission	5, XL
Investment Security, Office of	31, VIII
James Madison Memorial Fellowship Foundation	45, XXIV
Japan–United States Friendship Commission	22, XVI
Joint Board for the Enrollment of Actuaries	20, VIII
Justice Department	2, XXVIII; 5, XXVIII; 28, I, XI; 40, IV
Alcohol, Tobacco, Firearms, and Explosives, Bureau of	27, II
Drug Enforcement Administration	21, II
Federal Acquisition Regulation	48, 28
Federal Claims Collection Standards	31, IX
Federal Prison Industries, Inc.	28, III
Foreign Claims Settlement Commission of the United States	45, V
Immigration Review, Executive Office for	8, V
Independent Counsel, Offices of	28, VI
Prisons, Bureau of	28, V
Property Management Regulations	41, 128
Labor Department	2, XXIX; 5, XLII
Employee Benefits Security Administration	29, XXV
Employees' Compensation Appeals Board	20, IV

Agency	CFR Title, Subtitle or Chapter
Employment and Training Administration	20, V
Employment Standards Administration	20, VI
Federal Acquisition Regulation	48, 29
Federal Contract Compliance Programs, Office of	41, 60
Federal Procurement Regulations System	41, 50
Labor-Management Standards, Office of	29, II, IV
Mine Safety and Health Administration	30, I
Occupational Safety and Health Administration	29, XVII
Public Contracts	41, 50
Secretary of Labor, Office of	29, Subtitle A
Veterans' Employment and Training Service, Office of the Assistant Secretary for	41, 61; 20, IX
Wage and Hour Division	29, V
Workers' Compensation Programs, Office of	20, I, VII
Labor-Management Standards, Office of	29, II, IV
Land Management, Bureau of	43, II
Legal Services Corporation	45, XVI
Library of Congress	36, VII
Copyright Royalty Board	37, III
U.S. Copyright Office	37, II
Local Television Loan Guarantee Board	7, XX
Management and Budget, Office of	5, III, LXXVII; 14, VI; 48, 99
Marine Mammal Commission	50, V
Maritime Administration	46, II
Merit Systems Protection Board	5, II, LXIV
Micronesian Status Negotiations, Office for	32, XXVII
Military Compensation and Retirement Modernization Commission	5, XCIX
Millennium Challenge Corporation	22, XIII
Mine Safety and Health Administration	30, I
Minority Business Development Agency	15, XIV
Miscellaneous Agencies	1, IV
Monetary Offices	31, I
Morris K. Udall Scholarship and Excellence in National Environmental Policy Foundation	36, XVI
Museum and Library Services, Institute of	2, XXXI
National Aeronautics and Space Administration	2, XVIII; 5, LIX; 14, V
Federal Acquisition Regulation	48, 18
National Agricultural Library	7, XLI
National Agricultural Statistics Service	7, XXXVI
National and Community Service, Corporation for	2, XXII; 45, XII, XXV
National Archives and Records Administration	2, XXVI; 5, LXVI; 36, XII
Information Security Oversight Office	32, XX
National Capital Planning Commission	1, IV
National Commission for Employment Policy	1, IV
National Commission on Libraries and Information Science	45, XVII
National Council on Disability	5, C; 34, XII
National Counterintelligence Center	32, XVIII
National Credit Union Administration	5, LXXXVI; 12, VII
National Crime Prevention and Privacy Compact Council	28, IX
National Drug Control Policy, Office of	2, XXXVI; 21, III
National Endowment for the Arts	2, XXXII
National Endowment for the Humanities	2, XXXIII
National Foundation on the Arts and the Humanities	45, XI
National Geospatial-Intelligence Agency	32, I
National Highway Traffic Safety Administration	23, II, III; 47, VI; 49, V
National Imagery and Mapping Agency	32, I
National Indian Gaming Commission	25, III
National Institute of Food and Agriculture	7, XXXIV
National Institute of Standards and Technology	15, II
National Intelligence, Office of Director of	5, IV; 32, XVII
National Labor Relations Board	5, LXI; 29, I
National Marine Fisheries Service	50, II, IV
National Mediation Board	29, X
National Oceanic and Atmospheric Administration	15, IX; 50, II, III, IV, VI

Agency	CFR Title, Subtitle or Chapter
National Park Service	36, I
National Railroad Adjustment Board	29, III
National Railroad Passenger Corporation (AMTRAK)	49, VII
National Science Foundation	2, XXV; 5, XLIII; 45, VI
Federal Acquisition Regulation	48, 25
National Security Council	32, XXI
National Security Council and Office of Science and Technology Policy	47, II
National Telecommunications and Information Administration	15, XXIII; 47, III, IV
National Transportation Safety Board	49, VIII
Natural Resources Conservation Service	7, VI
Natural Resource Revenue, Office of	30, XII
Navajo and Hopi Indian Relocation, Office of	25, IV
Navy Department	32, VI
Federal Acquisition Regulation	48, 52
Neighborhood Reinvestment Corporation	24, XXV
Northeast Interstate Low-Level Radioactive Waste Commission	10, XVIII
Nuclear Regulatory Commission	2, XX; 5, XLVIII; 10, I
Federal Acquisition Regulation	48, 20
Occupational Safety and Health Administration	29, XVII
Occupational Safety and Health Review Commission	29, XX
Ocean Energy Management, Bureau of	30, V
Oklahoma City National Memorial Trust	36, XV
Operations Office	7, XXVIII
Overseas Private Investment Corporation	5, XXXIII; 22, VII
Patent and Trademark Office, United States	37, I
Payment From a Non-Federal Source for Travel Expenses	41, 304
Payment of Expenses Connected With the Death of Certain Employees	41, 303
Peace Corps	2, XXXVII; 22, III
Pennsylvania Avenue Development Corporation	36, IX
Pension Benefit Guaranty Corporation	29, XL
Personnel Management, Office of	5, I, XXXV; 5, IV; 45, VIII
Human Resources Management and Labor Relations Systems, Department of Homeland Security	5, XCVII
Federal Acquisition Regulation	48, 17
Federal Employees Group Life Insurance Federal Acquisition Regulation	48, 21
Federal Employees Health Benefits Acquisition Regulation	48, 16
Pipeline and Hazardous Materials Safety Administration	49, I
Postal Regulatory Commission	5, XLVI; 39, III
Postal Service, United States	5, LX; 39, I
Postsecondary Education, Office of	34, VI
President's Commission on White House Fellowships	1, IV
Presidential Documents	3
Presidio Trust	36, X
Prisons, Bureau of	28, V
Privacy and Civil Liberties Oversight Board	6, X
Procurement and Property Management, Office of	7, XXXII
Productivity, Technology and Innovation, Assistant Secretary	37, IV
Public Contracts, Department of Labor	41, 50
Public and Indian Housing, Office of Assistant Secretary for	24, IX
Public Health Service	42, I
Railroad Retirement Board	20, II
Reclamation, Bureau of	43, I
Refugee Resettlement, Office of	45, IV
Relocation Allowances	41, 302
Research and Innovative Technology Administration	49, XI
Rural Business-Cooperative Service	7, XVIII, XLII
Rural Development Administration	7, XLII
Rural Housing Service	7, XVIII, XXXV
Rural Telephone Bank	7, XVI
Rural Utilities Service	7, XVII, XVIII, XLII

Agency	CFR Title, Subtitle or Chapter
U.S. Copyright Office	37, II
Utah Reclamation Mitigation and Conservation Commission	43, III
Veterans Affairs Department	2, VIII; 38, I
Federal Acquisition Regulation	48, 8
Veterans' Employment and Training Service, Office of the Assistant Secretary for	41, 61; 20, IX
Vice President of the United States, Office of	32, XXVIII
Wage and Hour Division	29, V
Water Resources Council	18, VI
Workers' Compensation Programs, Office of	20, I, VII
World Agricultural Outlook Board	7, XXXVIII

Table of OMB Control Numbers

The OMB control numbers for chapter I of title 26 were consolidated into §§ 601.9000 and 602.101 at 50 FR 10221, Mar. 14, 1985. At 61 FR 58008, Nov. 12, 1996, § 601.9000 was removed. Section 602.101 is reprinted below for the convenience of the user.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

§ 602.101 OMB Control numbers.

(a) *Purpose*. This part collects and displays the control numbers assigned to collections of information in Internal Revenue Service regulations by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1980. The Internal Revenue Service intends that this part comply with the requirements of §§ 1320.7(f), 1320.12, 1320.13, and 1320.14 of 5 CFR part 1320 (OMB regulations implementing the Paperwork Reduction Act), for the display of control numbers assigned by OMB to collections of information in Internal Revenue Service regulations. This part does not display control numbers assigned by the Office of Management and Budget to collections of information of the Bureau of Alcohol, Tobacco, and Firearms.

(b) *Display*.

CFR part or section where identified and described	Current OMB control No.
1.1(h)–1(e)	1545–1654
1.23–5	1545–0074
1.25–1T	1545–0922
	1545–0930
1.25–2T	1545–0922
	1545–0930
1.25–3T	1545–0922
	1545–0930
1.25–4T	1545–0922
1.25–5T	1545–0922
1.25–6T	1545–0922
1.25–7T	1545–0922
1.25–8T	1545–0922
1.25A–1	1545–1630
1.28–1	1545–0619
1.31–2	1545–0074
1.32–2	1545–0074
1.32–3	1545–1575
1.36B–5	1545–2232
1.37–1	1545–0074
1.37–3	1545–0074
1.41–2	1545–0619
1.41–3	1545–0619
1.41–4A	1545–0074
1.41–4 (b) and (c)	1545–0074
1.41–8(b)	1545–1625
1.41–8(d)	1545–0732
1.41–9	1545–0619
1.42–1T	1545–0984
	1545–0988
1.42–2	1545–1005
1.42–5	1545–1357
1.42–6	1545–1102
1.42–8	1545–1102
1.42–10	1545–1102
1.42–13	1545–1357
1.42–14	1545–1423
1.42–17	1545–1357
1.42–18	1545–2088
1.43–3(a)(3)	1545–1292
1.43–3(b)(3)	1545–1292
1.44B–1	1545–0219
1.45D–1	1545–1765
1.45G–1	1545–2031
1.46–1	1545–0123
	1545–0155
1.46–3	1545–0155
1.46–4	1545–0155
1.46–5	1545–0155
1.46–6	1545–0155
1.46–8	1545–0155
1.46–9	1545–0155
1.46–10	1545–0118
1.46–11	1545–0155
1.47–1	1545–0155
	1545–0166
1.47–3	1545–0155
	1545–0166
1.47–4	1545–0123
1.47–5	1545–0092
1.47–6	1545–0099
1.48–3	1545–0155
1.48–4	1545–0155
	1545–0808
1.48–5	1545–0155
1.48–6	1545–0155
1.48–12	1545–0155
	1545–1783
1.50A–1	1545–0895
1.50A–2	1545–0895
1.50A–3	1545–0895
1.50A–4	1545–0895
1.50A–5	1545–0895
1.50A–6	1545–0895
1.50A–7	1545–0895
1.50B–1	1545–0895
1.50B–2	1545–0895
1.50B–3	1545–0895

CFR part or section where identified and described	Current OMB control No.
1.50B–4	1545–0895
1.50B–5	1545–0895
1.51–1	1545–0219
	1545–0241
	1545–0244
	1545–0797
1.52–2	1545–0219
1.52–3	1545–0219
1.56–1	1545–0123
1.56(g)–1	1545–1233
1.56A–1	1545–0227
1.56A–2	1545–0227
1.56A–3	1545–0227
1.56A–4	1545–0227
1.56A–5	1545–0227
1.57–5	1545–0227
1.58–1	1545–0175
1.58–9(c)(5)(iii)(B)	1545–1093
1.58–9(e)(3)	1545–1093
1.59–1	1545–1903
1.61–2	1545–0771
1.61–2T	1545–0771
1.61–4	1545–0187
1.61–15	1545–0074
1.62–2	1545–1148
1.63–1	1545–0074
1.66–4	1545–1770
1.67–2T	1545–0110
1.67–3	1545–1018
1.67–3T	1545–0118
1.71–1T	1545–0074
1.72–4	1545–0074
1.72–6	1545–0074
1.72–9	1545–0074
1.72–17	1545–0074
1.72–17A	1545–0074
1.72–18	1545–0074
1.74–1	1545–1100
1.79–2	1545–0074
1.79–3	1545–0074
1.83–2	1545–0074
1.83–5	1545–0074
1.83–6	1545–1448
1.103–10	1545–0123
	1545–0940
1.103–15AT	1545–0720
1.103–18	1545–1226
1.103(n)–2T	1545–0874
1.103(n)–4T	1545–0874
1.103A–2	1545–0720
1.105–4	1545–0074
1.105–5	1545–0074
1.105–6	1545–0074
1.108–4	1545–1539
1.108–5	1545–1421
1.108–7	1545–2155
1.108(i)–1	1545–2147
1.108(i)–2	1545–2147
1.110–1	1545–1661
1.117–5	1545–0869
1.118–2	1545–1639
1.119–1	1545–0067
1.120–3	1545–0057
1.121–1	1545–0072
1.121–2	1545–0072
1.121–3	1545–0072
1.121–4	1545–0072
	1545–0091
1.121–5	1545–0072
1.127–2	1545–0768
1.132–1T	1545–0771
1.132–2	1545–0771
1.132–2T	1545–0771
1.132–5	1545–0771
1.132–5T	1545–0771
	1545–1098
1.132–9(b)	1545–1676
1.141–1	1545–1451
1.141–12	1545–1451
1.142–2	1545–1451
1.142(f)(4)–1	1545–1730
1.148–0	1545–1098
1.148–1	1545–1098
1.148–2	1545–1098
	1545–1347
1.148–3	1545–1098
	1545–1347
1.148–4	1545–1098
	1545–1347
1.148–5	1545–1098
	1545–1490
1.148–6	1545–1098
	1545–1451
1.148–7	1545–1098
	1545–1347
1.148–8	1545–1098
1.148–11	1545–1098
	1545–1347
1.149(e)–1	1545–0720
1.150–1	1545–1347
1.151–1	1545–0074
1.152–3	1545–0071
	1545–1783
1.152–4	1545–0074
1.152–4T	1545–0074
1.162–1	1545–0139
1.162–2	1545–0139
1.162–3	1545–0139
1.162–4	1545–0139
1.162–5	1545–0139
1.162–6	1545–0139
1.162–7	1545–0139
1.162–8	1545–0139
1.162–9	1545–0139
1.162–10	1545–0139
1.162–11	1545–0139
1.162–12	1545–0139
1.162–13	1545–0139
1.162–14	1545–0139
1.162–15	1545–0139
1.162–16	1545–0139
1.162–17	1545–0139
1.162–18	1545–0139
1.162–19	1545–0139
1.162–20	1545–0139
1.162–24	1545–2115
1.162–27	1545–1466
1.163–5	1545–0786
	1545–1132
1.163–8T	1545–0995
1.163–10T	1545–0074
1.163–13	1545–1491
1.163(d)–1	1545–1421
1.165–1	1545–0177
1.165–2	1545–0177
1.165–3	1545–0177
1.165–4	1545–0177
1.165–5	1545–0177
1.165–6	1545–0177
1.165–7	1545–0177
1.165–8	1545–0177
1.165–9	1545–0177
1.165–10	1545–0177
1.165–11	1545–0074

CFR part or section where identified and described	Current OMB control No.
	1545–0177
	1545–0786
1.165–12	1545–0786
1.166–1	1545–0123
1.166–2	1545–1254
1.166–4	1545–0123
1.166–10	1545–0123
1.167(a)–5T	1545–1021
1.167(a)–7	1545–0172
1.167(a)–11	1545–0152
	1545–0172
1.167(a)–12	1545–0172
1.167(d)–1	1545–0172
1.167(e)–1	1545–0172
1.167(f)–11	1545–0172
1.167(l)–1	1545–0172
1.168(d)–1	1545–1146
1.168(f)(8)–1T	1545–0923
1.168(i)–1	1545–1331
1.168–5	1545–0172
1.169–4	1545–0172
1.170–1	1545–0074
1.170–2	1545–0074
1.170–3	1545–0123
1.170A–1	1545–0074
1.170A–2	1545–0074
1.170A–4(A)(b)	1545–0123
1.170A–8	1545–0074
1.170A–9	1545–0052
	1545–0074
1.170A–11	1545–0074
	1545–0123
	1545–1868
1.170A–12	1545–0020
	1545–0074
1.170A–13	1545–0074
	1545–0754
	1545–0908
	1545–1431
1.170A–13(f)	1545–1464
1.170A–14	1545–0763
1.171–4	1545–1491
1.171–5	1545–1491
1.172–1	1545–0172
1.172–13	1545–0863
1.173–1	1545–0172
1.174–3	1545–0152
1.174–4	1545–0152
1.175–3	1545–0187
1.175–6	1545–0152
1.177–1	1545–0172
1.179–2	1545–1201
1.179–3	1545–1201
1.179–5	1545–0172
	1545–1201
1.179B–1T	1545–2076
1.179C–1	1545–2103
1.179C–1T	1545–2103
1.180–2	1545–0074
1.181–1	1545–2059
1.181–2	1545–2059
1.181–3	1545–2059
1.182–6	1545–0074
1.183–1	1545–0195
1.183–2	1545–0195
1.183–3	1545–0195
1.183–4	1545–0195
1.190–3	1545–0074
1.194–2	1545–0735
1.194–4	1545–0735
1.195–1	1545–1582
1.197–1T	1545–1425
1.197–2	1545–1671
1.199–6	1545–1966
1.213–1	1545–0074
1.215–1T	1545–0074
1.217–2	1545–0182
1.243–3	1545–0123
1.243–4	1545–0123
1.243–5	1545–0123
1.248–1	1545–0172
1.261–1	1545–1041
1.263(a)–1	1545–2248
1.263(a)–3	1545–2248
1.263(a)–5	1545–1870
1.263(e)–1	1545–0123
1.263A–1	1545–0987
1.263A–1T	1545–0187
1.263A–2	1545–0987
1.263A–3	1545–0987
1.263A–8(b)(2)(iii)	1545–1265
1.263A–9(d)(1)	1545–1265
1.263A–9(f)(1)(ii)	1545–1265
1.263A–9(f)(2)(iv)	1545–1265
1.263A–9(g)(2)(iv)(C)	1545–1265
1.263A–9(g)(3)(iv)	1545–1265
1.265–1	1545–0074
1.265–2	1545–0123
1.266–1	1545–0123
1.267(f)–1	1545–0885
1.268–1	1545–0184
1.274–1	1545–0139
1.274–2	1545–0139
1.274–3	1545–0139
1.274–4	1545–0139
1.274–5	1545–0771
1.274–5A	1545–0139
	1545–0771
1.274–5T	1545–0074
	1545–0172
	1545–0771
1.274–6	1545–0139
	1545–0771
1.274–6T	1545–0074
	1545–0771
1.274–7	1545–0139
1.274–8	1545–0139
1.279–6	1545–0123
1.280C–4	1545–1155
1.280F–3T	1545–0074
1.280G–1	1545–1851
1.281–4	1545–0123
1.302–4	1545–0074
1.305–3	1545–0123
1.305–5	1545–1438
1.307–2	1545–0074
1.312–15	1545–0172
1.316–1	1545–0123
1.331–1	1545–0074
1.332–4	1545–0123
1.332–6	1545–2019
1.336–2	1545–2125
1.336–4	1545–2125
1.337(d)–1	1545–1160
1.337(d)–2	1545–1160
	1545–1774
1.337(d)–4	1545–1633
1.337(d)–5	1545–1672
1.337(d)–6	1545–1672
1.337(d)–7	1545–1672
1.338–2	1545–1658
1.338–5	1545–1658
1.338–10	1545–1658
1.338–11	1545–1990

CFR part or section where identified and described	Current OMB control No.
1.338(h)(10)–1	1545–1658
1.338(i)–1	1545–1990
1.341–7	1545–0123
1.351–3	1545–2019
1.355–5	1545–2019
1.362–2	1545–0123
1.362–4	1545–2247
1.367(a)–1T	1545–0026
1.367(a)–2T	1545–0026
1.367(a)–3	1545–0026
	1545–1478
1.367(a)–3T	1545–2183
1.367(a)–6T	1545–0026
1.367(a)–7	1545–2183
1.367(a)–7T	1545–2183
1.367(a)–8	1545–1271
	1545–2056
	1545–2183
1.367(b)–1	1545–1271
1.367(b)–3T	1545–1666
1.367(d)–1T	1545–0026
1.367(e)–1	1545–1487
1.367(e)–2	1545–1487
1.368–1	1545–1691
1.368–3	1545–2019
1.371–1	1545–0123
1.371–2	1545–0123
1.374–3	1545–0123
1.381(b)–1	1545–0123
1.381(c)(4)–1	1545–0123
	1545–0152
	1545–0879
1.381(c)(5)–1	1545–0123
	1545–0152
1.381(c)(6)–1	1545–0123
	1545–0152
1.381(c)(8)–1	1545–0123
1.381(c)(10)–1	1545–0123
1.381(c)(11)–1(k)	1545–0123
1.381(c)(13)–1	1545–0123
1.381(c)(17)–1	1545–0045
1.381(c)(22)–1	1545–1990
1.381(c)(25)–1	1545–0045
1.382–1T	1545–0123
1.382–2	1545–0123
1.382–2T	1545–0123
1.382–3	1545–1281
	1545–1345
1.382–4	1545–1120
1.382–6	1545–1381
1.382–8	1545–1434
1.382–9	1545–1120
	1545–1260
	1545–1275
	1545–1324
1.382–11	1545–2019
1.382–91	1545–1260
	1545–1324
1.383–1	1545–0074
	1545–1120
1.401–1	1545–0020
	1545–0197
	1545–0200
	1545–0534
	1545–0710
1.401(a)–11	1545–0710
1.401(a)–20	1545–0928
1.401(a)–31	1545–1341
1.401(a)–50	1545–0710
1.401(a)(9)–1	1545–1573
1.401(a)(9)–3	1545–1466
1.401(a)(9)–4	1545–1573
1.401(a)(9)–6	1545–2234
1.401(a)(31)–1	1545–1341
1.401(b)–1	1545–0197
1.401(f)–1	1545–0710
1.401(k)–1	1545–1039
	1545–1069
	1545–1669
	1545–1930
1.401(k)–2	1545–1669
1.401(k)–3	1545–1669
1.401(k)–4	1545–1669
1.401(m)–3	1545–1699
1.401–12(n)	1545–0806
1.401–14	1545–0710
1.402(c)–2	1545–1341
1.402(f)–1	1545–1341
	1545-1632
1.402A–1	1545–1992
1.403(b)–1	1545–0710
1.403(b)–3	1545–0996
1.403(b)–7	1545–1341
1.403(b)–10	1545–2068
1.404(a)–4	1545–0710
1.404(a)–12	1545–0710
1.404A–2	1545–0123
1.404A–6	1545–0123
1.408–2	1545–0390
1.408–5	1545–0747
1.408–6	1545–0203
	1545–0390
1.408–7	1545–0119
1.408(q)–1	1545–1841
1.408A–2	1545–1616
1.408A–4	1545–1616
1.408A–5	1545–1616
1.408A–7	1545–1616
1.410(a)–2	1545–0710
1.410(d)–1	1545–0710
1.411(a)–11	1545–1471
	1545–1632
1.411(d)–4	1545–1545
1.411(d)–6	1545–1477
1.412(b)–5	1545–0710
1.412(c)(1)–2	1545–0710
1.412(c)(2)–1	1545–0710
1.412(c)(3)–2	1545–0710
1.414(c)–5	1545–0797
1.414(r)–1	1545–1221
1.415–2	1545–0710
1.415–6	1545–0710
1.417(a)(3)–1	1545–0928
1.417(e)–1	1545–1471
	1545–1724
1.417(e)–1T	1545–1471
1.419A(f)(6)–1	1545–1795
1.422–1	1545–0820
1.430(f)–1	1545–2095
1.430(g)–1	1545–2095
1.430(h)(2)–1	1545–2095
1.432(e)(9)–1T	1545–2260
1.436–1	1545–2095
1.441–2	1545–1748
1.442–1	1545–0074
	1545–0123
	1545–0134
	1545–0152
	1545–0820
	1545–1748
1.443–1	1545–0123
1.444–3T	1545–1036
1.444–4	1545–1591
1.446–1	1545–0074

CFR part or section where identified and described	Current OMB control No.
	1545–0152
1.446–4(d)	1545–1412
1.448–1(g)	1545–0152
1.448–1(h)	1545–0152
1.448–1(i)	1545–0152
1.448–2	1545–1855
1.448–2T	1545–0152
	1545–1855
1.451–1	1545–0091
1.451–4	1545–0123
1.451–5	1545–0074
1.451–6	1545–0074
1.451–7	1545–0074
1.453–1	1545–0152
1.453–2	1545–0152
1.453–8	1545–0152
	1545–0228
1.453–10	1545–0152
1.453A–1	1545–0152
	1545–1134
1.453A–2	1545–0152
	1545–1134
1.453A–3	1545–0963
1.454–1	1545–0074
1.455–2	1545–0152
1.455–6	1545–0123
1.456–2	1545–0123
1.456–6	1545–0123
1.456–7	1545–0123
1.457–8	1545–1580
1.458–1	1545–0879
1.458–2	1545–0152
1.460–1	1545–1650
1.460–6	1545–1031
	1545–1572
	1545–1732
1.461–1	1545–0074
1.461–2	1545–0096
1.461–4	1545–0917
1.461–5	1545–0917
1.463–1T	1545–0916
1.465–1T	1545–0712
1.466–1T	1545–0152
1.466–4	1545–0152
1.468A–3	1545–1269
	1545–1378
	1545–1511
1.468A–3(h), 1.468A–7, and 1.468A–8(d)	1545–2091
1.468A–4	1545–0954
1.468A–7	1545–0954
	1545–1511
1.468A–8	1545–1269
1.468B–1	1545–1631
1.468B–1(j)	1545–1299
1.468B–2(k)	1545–1299
1.468B–2(l)	1545–1299
1.468B–3(b)	1545–1299
1.468B–3(e)	1545–1299
1.468B–5(b)	1545–1299
1.468B–9	1545–1631
1.469–1	1545–1008
1.469–2T	1545–0712
	1545–1091
1.469–4T	1545–0985
	1545–1037
1.469–7	1545–1244
1.471–2	1545–0123
1.471–5	1545–0123
1.471–6	1545–0123
1.471–8	1545–0123
1.471–11	1545–0123
	1545–0152

CFR part or section where identified and described	Current OMB control No.
1.472–1	1545–0042
	1545–0152
1.472–2	1545–0152
1.472–3	1545–0042
1.472–5	1545–0152
1.472–8	1545–0028
	1545–0042
	1545–1767
1.475(a)–4	1545–1945
1.475(b)–4	1545–1496
1.481–4	1545–0152
1.481–5	1545–0152
1.482–1	1545–1364
1.482–4	1545–1364
1.482–7	1545–1364
	1545–1794
1.482–9(b)	1545–2149
1.501(a)–1	1545–0056
	1545–0057
1.501(c)(3)–1	1545–0056
1.501(c)(9)–5	1545–0047
1.501(c)(17)–3	1545–0047
1.501(e)–1	1545–0814
1.501(r)–3	1545–0047
1.501(r)–4	1545–0047
1.501(r)–6	1545–0047
1.503(c)–1	1545–0047
	1545–0052
1.505(c)–1T	1545–0916
1.507–1	1545–0052
1.507–2	1545–0052
1.508–1	1545–0052
	1545–0056
1.509(a)–3	1545–0047
1.509(a)–4	1545–2157
1.509(a)–5	1545–0047
1.509(c)–1	1545–0052
1.512(a)–1	1545–0687
1.512(a)–4	1545–0047
	1545–0687
1.521–1	1545–0051
	1545–0058
1.527–2	1545–0129
1.527–5	1545–0129
1.527–6	1545–0129
1.527–9	1545–0129
1.528–8	1545–0127
1.533–2	1545–0123
1.534–2	1545–0123
1.542–3	1545–0123
1.545–2	1545–0123
1.545–3	1545–0123
1.547–2	1545–0045
	1545–0123
1.547–3	1545–0123
1.551–4	1545–0074
1.552–3	1545–0099
1.552–4	1545–0099
1.552–5	1545–0099
1.556–2	1545–0704
1.561–1	1545–0044
1.561–2	1545–0123
1.562–3	1545–0123
1.563–2	1545–0123
1.564–1	1545–0123
1.565–1	1545–0043
	1545–0123
1.565–2	1545–0043
1.565–3	1545–0043
1.565–5	1545–0043
1.565–6	1545–0043
1.585–1	1545–0123

CFR part or section where identified and described	Current OMB control No.
1.585–3	1545–0123
1.585–8	1545–1290
1.586–2	1545–0123
1.593–1	1545–0123
1.593–6	1545–0123
1.593–6A	1545–0123
1.593–7	1545–0123
1.595–1	1545–0123
1.597–2	1545–1300
1.597–4	1545–1300
1.597–6	1545–1300
1.597–7	1545–1300
1.611–2	1545–0099
1.611–3	1545–0007
	1545–0099
	1545–1784
1.612–4	1545–0074
1.612–5	1545–0099
1.613–3	1545–0099
1.613–4	1545–0099
1.613–6	1545–0099
1.613–7	1545–0099
1.613A–3	1545–0919
1.613A–3(e)	1545–1251
1.613A–3(l)	1545–0919
1.613A–5	1545–0099
1.613A–6	1545–0099
1.614–2	1545–0099
1.614–3	1545–0099
1.614–5	1545–0099
1.614–6	1545–0099
1.614–8	1545–0099
1.617–1	1545–0099
1.617–3	1545–0099
1.617–4	1545–0099
1.631–1	1545–0007
1.631–2	1545–0007
1.641(b)–2	1545–0092
1.642(c)–1	1545–0092
1.642(c)–2	1545–0092
1.642(c)–5	1545–0074
1.642(c)–6	1545–0020
	1545–0074
	1545–0092
1.642(g)–1	1545–0092
1.642(i)–1	1545–0092
1.645–1	1545–1578
1.663(b)–2	1545–0092
1.664–1	1545–0196
1.664–1(a)(7)	1545–1536
1.664–1(c)	1545–2101
1.664–2	1545–0196
1.664–3	1545–0196
1.664–4	1545–0020
	1545–0196
1.665(a)–0A through	
1.665(g)–2A	1545–0192
1.666(d)–1A	1545–0092
1.671–4	1545–1442
1.671–5	1545–1540
1.701–1	1545–0099
1.702–1	1545–0074
1.703–1	1545–0099
1.704–2	1545–1090
1.706–1	1545–0074
	1545–0099
	1545–0134
1.706–1T	1545–0099
1.706–4(f)	1545–0123
1.707–3(c)(2)	1545–1243
1.707–5(a)(7)(ii)	1545–1243
1.707–6(c)	1545–1243
1.707–8	1545–1243
1.708–1	1545–0099
1.732–1	1545–0099
	1545–1588
1.736–1	1545–0074
1.743–1	1545–0074
	1545–1588
1.751–1	1545–0074
	1545–0099
	1545–0941
1.752–2	1545–1905
1.752–5	1545–1090
1.752–7	1545–1843
1.754–1	1545–0099
1.755–1	1545–0099
1.761–2	1545–1338
1.801–1	1545–0123
	1545–0128
1.801–3	1545–0123
1.801–5	1545–0128
1.801–8	1545–0128
1.804–4	1545–0128
1.811–2	1545–0128
1.812–2	1545–0128
1.815–6	1545–0128
1.818–4	1545–0128
1.818–5	1545–0128
1.818–8	1545–0128
1.819–2	1545–0128
1.821–1	1545–1027
1.821–3	1545–1027
1.821–4	1545–1027
1.822–5	1545–1027
1.822–6	1545–1027
1.822–8	1545–1027
1.822–9	1545–1027
1.823–2	1545–1027
1.823–5	1545–1027
1.823–6	1545–1027
1.825–1	1545–1027
1.826–1	1545–1027
1.826–2	1545–1027
1.826–3	1545–1027
1.826–4	1545–1027
1.826–6	1545–1027
1.831–3	1545–0123
1.831–4	1545–0123
1.832–4	1545–1227
1.832–5	1545–0123
1.848–2(g)(8)	1545–1287
1.848–2(h)(3)	1545–1287
1.848–2(i)(4)	1545–1287
1.851–2	1545–1010
1.851–4	1545–0123
1.852–1	1545–0123
1.852–4	1545–0123
	1545–0145
1.852–6	1545–0123
	1545–0144
1.852–7	1545–0074
1.852–9	1545–0074
	1545–0123
	1545–0144
	1545–0145
	1545–1783
1.852–11	1545–1094
1.853–3	1545–2035
1.853–4	1545–2035
1.854–2	1545–0123
1.855–1	1545–0123
1.856–2	1545–0123
	1545–1004

CFR part or section where identified and described	Current OMB control No.
1.856–6	1545–0123
1.856–7	1545–0123
1.856–8	1545–0123
1.857–8	1545–0123
1.857–9	1545–0074
1.858–1	1545–0123
1.860–2	1545–0045
1.860–4	1545–0045
	1545–1054
	1545–1057
1.860E–1	1545–1675
1.860E–2(a)(5)	1545–1276
1.860E–2(a)(7)	1545–1276
1.860E–2(b)(2)	1545–1276
1.860G–2	1545–2110
1.861–2	1545–0089
1.861–3	1545–0089
1.861–4	1545–1900
1.861–8	1545–0126
1.861–8(e)(6) and (g)	1545–1224
1.861–9T	1545–0121
	1545–1072
1.861–18	1545–1594
1.863–1	1545–1476
1.863–3	1545–1476
	1545–1556
1.863–3A	1545–0126
1.863–4	1545–0126
1.863–7	1545–0132
1.863–8	1545–1718
1.863–9	1545–1718
1.864–4	1545–0126
1.871–1	1545–0096
1.871–6	1545–0795
1.871–7	1545–0089
1.871–10	1545–0089
	1545–0165
1.874–1	1545–0089
1.881–4	1545–1440
1.882–4	1545–0126
1.883–0	1545–1677
1.883–1	1545–1677
1.883–2	1545–1677
1.883–3	1545–1677
1.883–4	1545–1677
1.883–5	1545–1677
1.884–0	1545–1070
1.884–1	1545–1070
1.884–2	1545–1070
1.884–2T	1545–0126
	1545–1070
1.884–4	1545–1070
1.884–5	1545–1070
1.892–1T	1545–1053
1.892–2T	1545–1053
1.892–3T	1545–1053
1.892–4T	1545–1053
1.892–5T	1545–1053
1.892–6T	1545–1053
1.892–7T	1545–1053
1.897–2	1545–0123
	1545–0902
1.897–3	1545–0123
1.897–5T	1545–0902
1.897–6T	1545–0902
1.901–2	1545–0746
1.901–2A	1545–0746
1.901–3	1545–0122
1.902–1	1545–0122
	1545–1458
1.904–1	1545–0121
	1545–0122

CFR part or section where identified and described	Current OMB control No.
1.904–2	1545–0121
	1545–0122
1.904–3	1545–0121
1.904–4	1545–0121
1.904–5	1545–0121
1.904–7	1545–2104
1.904–7T	1545–2104
1.904(f)–1	1545–0121
	1545–0122
1.904(f)–2	1545–0121
1.904(f)–3	1545–0121
1.904(f)–4	1545–0121
1.904(f)–5	1545–0121
1.904(f)–6	1545–0121
1.904(f)–7	1545–1127
1.905–2	1545–0122
1.905–3T	1545–1056
1.905–4T	1545–1056
1.905–5T	1545–1056
1.911–1	1545–0067
	1545–0070
1.911–2	1545–0067
	1545–0070
1.911–3	1545–0067
	1545–0070
1.911–4	1545–0067
	1545–0070
1.911–5	1545–0067
	1545–0070
1.911–6	1545–0067
	1545–0070
1.911–7	1545–0067
	1545–0070
1.913–13	1545–0067
1.921–1T	1545–0190
	1545–0884
	1545–0935
	1545–0939
1.921–2	1545–0884
1.921–3T	1545–0935
1.923–1T	1545–0935
1.924(a)–1T	1545–0935
1.925(a)–1T	1545–0935
1.925(b)–1T	1545–0935
1.926(a)–1T	1545–0935
1.927(a)–1T	1545–0935
1.927(b)–1T	1545–0935
1.927(d)–1	1545–0884
1.927(d)–2T	1545–0935
1.927(e)–1T	1545–0935
1.927(e)–2T	1545–0935
1.927(f)–1	1545–0884
1.931–1	1545–0074
	1545–0123
1.934–1	1545–0782
1.935–1	1545–0074
	1545–0087
	1545–0803
1.936–1	1545–0215
	1545–0217
1.936–4	1545–0215
1.936–5	1545–0704
1.936–6	1545–0215
1.936–7	1545–0215
1.936–10(c)	1545–1138
1.937–1	1545–1930
1.952–2	1545–0126
1.953–2	1545–0126
1.954–1	1545–1068
1.954–2	1545–1068
1.955–2	1545–0123
1.955–3	1545–0123

CFR part or section where identified and described	Current OMB control No.
1.955A–2	1545–0755
1.955A–3	1545–0755
1.956–1	1545–0704
1.956–2	1545–0704
1.959–1	1545–0704
1.959–2	1545–0704
1.960–1	1545–0122
1.962–2	1545–0704
1.962–3	1545–0704
1.962–4	1545–0704
1.964–1	1545–0126
	1545–0704
	1545–1072
	1545–2104
1.964–3	1545–0126
1.970–2	1545–0126
1.985–2	1545–1051
	1545–1131
1.985–3	1545–1051
1.988–0	1545–1131
1.988–1	1545–1131
1.988–2	1545–1131
1.988–3	1545–1131
1.988–4	1545–1131
1.988–5	1545–1131
1.988–6	1545–1831
1.992–1	1545–0190
	1545–0938
1.992–2	1545–0190
	1545–0884
	1545–0938
1.992–3	1545–0190
	1545–0938
1.992–4	1545–0190
	1545–0938
1.993–3	1545–0938
1.993–4	1545–0938
1.994–1	1545–0938
1.995–5	1545–0938
1.1001–1	1545–1902
1.1012–1	1545–0074
	1545–1139
1.1014–4	1545–0184
1.1015–1	1545–0020
1.1017–1	1545–1539
1.1031(d)–1T	1545–1021
1.1033(a)–2	1545–0184
1.1033(g)–1	1545–0184
1.1034–1	1545–0072
1.1039–1	1545–0184
1.1041–1T	1545–0074
1.1041–2	1545–1751
1.1042–1T	1545–0916
1.1044(a)–1	1545–1421
1.1045–1	1545–1893
1.1060–1	1545–1658
	1545–1990
1.1071–1	1545–0184
1.1071–4	1545–0184
1.1081–4	1545–0028
	1545–0046
	1545–0123
1.1081–11	1545–2019
1.1082–1	1545–0046
1.1082–2	1545–0046
1.1082–3	1545–0046
	1545–0184
1.1082–4	1545–0046
1.1082–5	1545–0046
1.1082–6	1545–0046
1.1083–1	1545–0123
1.1092(b)–1T	1545–0644

CFR part or section where identified and described	Current OMB control No.
1.1092(b)–2T	1545–0644
1.1092(b)–3T	1545–0644
1.1092(b)–4T	1545–0644
1.1092(b)–5T	1545–0644
1.1211–1	1545–0074
1.1212–1	1545–0074
1.1221–2	1545–1480
1.1231–1	1545–0177
	1545–0184
1.1231–2	1545–0177
	1545–0184
1.1231–2	1545–0074
1.1232–3	1545–0074
1.1237–1	1545–0184
1.1239–1	1545–0091
1.1242–1	1545–0184
1.1243–1	1545–0123
1.1244(e)–1	1545–0123
	1545–1447
1.1245–1	1545–0184
1.1245–2	1545–0184
1.1245–3	1545–0184
1.1245–4	1545–0184
1.1245–5	1545–0184
1.1245–6	1545–0184
1.1247–1	1545–0122
1.1247–2	1545–0122
1.1247–4	1545–0122
1.1247–5	1545–0122
1.1248–7	1545–0074
1.1248(f)–2	1545–2183
1.1248(f)–3T	1545–2183
1.1250–1	1545–0184
1.1250–2	1545–0184
1.1250–3	1545–0184
1.1250–4	1545–0184
1.1250–5	1545–0184
1.1251–1	1545–0184
1.1251–2	1545–0074
	1545–0184
1.1251–3	1545–0184
1.1251–4	1545–0184
1.1252–1	1545–0184
1.1252–2	1545–0184
1.1254–1(c)(3)	1545–1352
1.1254–4	1545–1493
1.1254–5(d)(2)	1545–1352
1.1258–1	1545–1452
1.1272–3	1545–1353
1.1273–2(f)(9)	1545–1353
1.1273–2(h)(2)	1545–1353
1.1274–3(d)	1545–1353
1.1274–5(b)	1545–1353
1.1274A–1(c)	1545–1353
1.1275–2	1545–1450
1.1275–3	1545–0887
	1545–1353
	1545–1450
1.1275–4	1545–1450
1.1275–6	1545–1450
1.1287–1	1545–0786
1.1291–9	1545–1507
1.1291–10	1545–1304
	1545–1507
1.1294–1T	1545–1002
	1545–1028
1.1295–1	1545–1555
1.1295–3	1545–1555
1.1298–3	1545–1507
1.1301–1	1545–1662
1.1311(a)–1	1545–0074
1.1361–1	1545–0731

CFR part or section where identified and described	Current OMB control No.
	1545–1591
	1545–2114
1.1361–3	1545–1590
1.1361–5	1545–1590
1.1362–1	1545–1308
1.1362–2	1545–1308
1.1362–3	1545–1308
1.1362–4	1545–1308
1.1362–5	1545–1308
1.1362–6	1545–1308
1.1362–7	1545–1308
1.1362–8	1545–1590
1.1363–2	1545–1906
1.1366–1	1545–1613
1.1367–1(f)	1545–1139
1.1368–1(f)(2)	1545–1139
1.1368–1(f)(3)	1545–1139
1.1368–1(f)(4)	1545–1139
1.1368–1(g)(2)	1545–1139
1.1374–1A	1545–0130
1.1377–1	1545–1462
1.1378–1	1545–1748
1.1383–1	1545–0074
1.1385–1	1545–0074
	1545–0098
1.1388–1	1545–0118
	1545–0123
1.1397E–1	1545–1908
1.1398–1	1545–1375
1.1398–2	1545–1375
1.1402(a)–2	1545–0074
1.1402(a)–5	1545–0074
1.1402(a)–11	1545–0074
1.1402(a)–15	1545–0074
1.1402(a)–16	1545–0074
1.1402(b)–1	1545–0171
1.1402(c)–2	1545–0074
1.1402(e)(1)–1	1545–0074
1.1402(e)(2)–1	1545–0074
1.1402(e)–1A	1545–0168
1.1402(e)–2A	1545–0168
1.1402(e)–3A	1545–0168
1.1402(e)–4A	1545–0168
1.1402(e)–5A	1545–0168
1.1402(f)–1	1545–0074
1.1402(h)–1	1545–0064
1.1411–10(g)	1545–2227
1.1441–1	1545–1484
1.1441–2	1545–0795
1.1441–3	1545–0165
	1545–0795
1.1441–4	1545–1484
1.1441–5	1545–0096
	1545–0795
	1545–1484
1.1441–6	1545–0055
	1545–0795
	1545–1484
1.1441–7	1545–0795
1.1441–8	1545–1053
	1545–1484
1.1441–9	1545–1484
1.1443–1	1545–0096
1.1445–1	1545–0902
1.1445–2	1545–0902
	1545–1060
	1545–1797
1.1445–3	1545–0902
	1545–1060
	1545–1797
1.1445–4	1545–0902
1.1445–5	1545–0902
1.1445–6	1545–0902
	1545–1060
1.1445–7	1545–0902
1.1445–8	1545–0096
1.1445–9T	1545–0902
1.1445–10T	1545–0902
1.1446–1	1545–1934
1.1446–3	1545–1934
1.1446–4	1545–1934
1.1446–5	1545–1934
1.1446–6	1545–1934
1.1451–1	1545–0054
1.1451–2	1545–0054
1.1461–1	1545–0054
	1545–0055
	1545–0795
	1545–1484
1.1461–2	1545–0054
	1545–0055
	1545–0096
	1545–0795
1.1462–1	1545–0795
1.1492–1	1545–0026
1.1494–1	1545–0026
1.1502–5	1545–0257
1.1502–9	1545–1634
1.1502–9A	1545–0121
1.1502–13	1545–0123
	1545–0885
	1545–1161
	1545–1433
1.1502–16	1545–0123
1.1502–18	1545–0123
1.1502–19	1545–0123
	1545–1774
1.1502–20	1545–1774
1.1502–21	1545–1237
1.1502–21T	1545–2171
1.1502–31	1545–1344
1.1502–32	1545–1344
	1545–1774
1.1502–33	1545–1344
1.1502–35	1545–1828
1.1502–36	1545–2096
1.1502–47	1545–0123
1.1502–75	1545–0025
	1545–0123
	1545–0133
	1545–0152
1.1502–76	1545–1344
1.1502–76T	1545–2019
1.1502–77	1545–1699
1.1502–77A	1545–0123
	1545–1046
1.1502–77B	1545–1699
1.1502–78	1545–0582
1.1502–95	1545–1218
1.1502–95A	1545–1218
1.1502–96	1545–1218
1.1503–2	1545–1583
1.1503–2A	1545–1083
1.1503(d)–1	1545–1946
1.1503(d)–3	1545–1946
1.1503(d)–4	1545–1946
1.1503(d)–5	1545–1946
1.1503(d)–6	1545–1946
1.1552–1	1545–0123
1.1561–3	1545–0123
1.1563–1	1545–0123
	1545–0797
	1545–2019
1.1563–3	1545–0123

CFR part or section where identified and described	Current OMB control No.
1.5000A–3	1545–0074
1.5000A–4	1545–0074
1.6001–1	1545–0058
	1545–0074
	1545–0099
	1545–0123
	1545–0865
1.6011–1	1545–0055
	1545–0074
	1545–0085
	1545–0089
	1545–0090
	1545–0091
	1545–0096
	1545–0121
	1545–0458
	1545–0666
	1545–0675
	1545–0908
1.6011–2	1545–0055
	1545–0938
1.6011–3	1545–0238
	1545–0239
1.6011–4	1545–1685
1.6012–1	1545–0067
	1545–0074
	1545–0085
	1545–0089
	1545–0675
1.6012–2	1545–0047
	1545–0051
	1545–0067
	1545–0123
	1545–0126
	1545–0128
	1545–0130
	1545–0175
	1545–0687
	1545–0890
	1545–1023
	1545–1027
1.6012–3	1545–0047
	1545–0067
	1545–0092
	1545–0196
	1545–0687
1.6012–4	1545–0067
1.6012–5	1545–0067
	1545–0936
	1545–0967
	1545–0970
	1545–0991
	1545–1023
	1545–1033
	1545–1079
1.6012–6	1545–0067
	1545–0089
	1545–0129
1.6013–1	1545–0074
1.6013–2	1545–0091
1.6013–6	1545–0074
1.6013–7	1545–0074
1.6015–5	1545–1719
1.6015(a)–1	1545–0087
1.6015(b)–1	1545–0087
1.6015(d)–1	1545–0087
1.6015(e)–1	1545–0087
1.6015(f)–1	1545–0087
1.6015(g)–1	1545–0087
1.6015(h)–1	1545–0087
1.6015(i)–1	1545–0087
1.6017–1	1545–0074

CFR part or section where identified and described	Current OMB control No.
	1545–0087
	1545–0090
1.6031(a)–1	1545–1583
1.6031(b)–1T	1545–0099
1.6031(c)–1T	1545–0099
1.6032–1	1545–0099
1.6033–2	1545–0047
	1545–0049
	1545–0052
	1545–0092
	1545–0687
	1545–1150
	1545–2117
1.6033–3	1545–0052
1.6034–1	1545–0092
	1545–0094
1.6035–1	1545–0704
1.6035–2	1545–0704
1.6035–3	1545–0704
1.6037–1	1545–0130
	1545–1023
1.6038–2	1545–1617
	1545–2020
1.6038–3	1545–1617
1.6038A–2	1545–1191
1.6038A–3	1545–1191
	1545–1440
1.6038B–1	1545–1617
	1545–2183
1.6038B–1T	1545–0026
	1545–2183
1.6038B–2	1545–1617
1.6039–2	1545–0820
1.6041–1	1545–0008
	1545–0108
	1545–0112
	1545–0115
	1545–0120
	1545–0295
	1545–0350
	1545–0367
	1545–0387
	1545–0441
	1545–0957
	1545–1705
1.6041–2	1545–0008
	1545–0119
	1545–0350
	1545–0441
	1545–1729
1.6041–3	1545–1148
1.6041–4	1545–0115
	1545–0295
	1545–0367
	1545–0387
	1545–0957
1.6041–5	1545–0295
	1545–0367
	1545–0387
	1545–0957
1.6041–6	1545–0008
	1545–0115
1.6041–7	1545–0112
	1545–0295
	1545–0350
	1545–0367
	1545–0387
	1545–0441
	1545–0957
1.6042–1	1545–0110
1.6042–2	1545–0110
	1545–0295

CFR part or section where identified and described	Current OMB control No.
	1545–0367
	1545–0387
	1545–0957
1.6042–3	1545–0295
	1545–0367
	1545–0387
	1545–0957
1.6042–4	1545–0110
1.6043–1	1545–0041
1.6043–2	1545–0041
	1545–0110
	1545–0295
	1545–0387
1.6043–3	1545–0047
1.6044–1	1545–0118
1.6044–2	1545–0118
1.6044–3	1545–0118
1.6044–4	1545–0118
1.6044–5	1545–0118
1.6045–1	1545–0715
	1545–1705
1.6045–1(c)(3)(xi)(C)	1545–2186
1.6045–1(n)(5)	1545–2186
1.6045A–1	1545–2186
1.6045–2	1545–0115
1.6045–4	1545–1085
1.6046–1	1545–0704
	1545–0794
	1545–1317
1.6046–2	1545–0704
1.6046–3	1545–0704
1.6046A	1545–1646
1.6047–1	1545–0119
	1545–0295
	1545–0387
1.6047–2	1545–2234
1.6049–1	1545–0112
	1545–0117
	1545–0295
	1545–0367
	1545–0387
	1545–0597
	1545–0957
1.6049–2	1545–0117
1.6049–3	1545–0117
1.6049–4	1545–0096
	1545–0112
	1545–0117
	1545–1018
	1545–1050
1.6049–5	1545–0096
	1545–0112
	1545–0117
1.6049–6	1545–0096
1.6049–7	1545–1018
1.6049–7T	1545–0112
	1545–0117
	1545–0118
1.6050A–1	1545–0115
1.6050B–1	1545–0120
1.6050D–1	1545–0120
	1545–0232
1.6050E–1	1545–0120
1.6050H–1	1545–0901
	1545–1380
1.6050H–1T	1545–0901
1.6050H–2	1545–0901
	1545–1339
	1545–1380
1.6050I–2	1545–1449
1.6050J–1T	1545–0877
1.6050K–1	1545–0941
1.6050S–1	1545–1678
1.6050S–2	1545–1729
1.6050S–3	1545–1678
1.6050S–4	1545–1729
1.6052–1	1545–0008
1.6052–2	1545–0008
1.6055–1	1545–2252
1.6055–2	1545–2252
1.6060–1	1545–0074
1.6060–1(a)(1)	1545–1231
1.6061–1	1545–0123
1.6062–1	1545–0123
1.6063–1	1545–0123
1.6065–1	1545–0123
1.6071–1	1545–0123
	1545–0810
1.6072–1	1545–0074
1.6072–2	1545–0123
	1545–0807
1.6073–1	1545–0087
1.6073–2	1545–0087
1.6073–3	1545–0087
1.6073–4	1545–0087
1.6074–1	1545–0123
1.6074–2	1545–0123
1.6081–1	1545–0066
	1545–0148
	1545–0233
	1545–1057
	1545–1081
1.6081–2	1545–0148
	1545–1036
	1545–1054
1.6081–3	1545–0233
1.6081–4	1545–0188
	1545–1479
1.6081–6	1545–0148
	1545–1054
1.6081–7	1545–0148
	1545–1054
1.6091–3	1545–0089
1.6107–1	1545–0074
	1545–1231
1.6109–1	1545–0074
1.6109–2	1545–2176
1.6115–1	1545–1464
1.6151–1	1545–0074
1.6153–1	1545–0087
1.6153–4	1545–0087
1.6161–1	1545–0087
1.6162–1	1545–0087
1.6164–1	1545–0135
1.6164–2	1545–0135
1.6164–3	1545–0135
1.6164–5	1545–0135
1.6164–6	1545–0135
1.6164–7	1545–0135
1.6164–8	1545–0135
1.6164–9	1545–0135
1.6302–1	1545–0257
1.6302–2	1545–0098
	1545–0257
1.6411–1	1545–0098
	1545–0135
	1545–0582
1.6411–2	1545–0098
	1545–0582
1.6411–3	1545–0098
	1545–0582
1.6411–4	1545–0582
1.6414–1	1545–0096
1.6425–1	1545–0170

CFR part or section where identified and described	Current OMB control No.
1.6425–2	1545–0170
1.6425–3	1545–0170
1.6654–1	1545–0087
	1545–0140
1.6654–2	1545–0087
1.6654–3	1545–0087
1.6654–4	1545–0087
1.6655(e)–1	1545–1421
1.6662–3(c)	1545–0889
1.6662–4(e) and (f)	1545–0889
1.6662–6	1545–1426
1.6694–1	1545–0074
1.6694–2	1545–0074
1.6694–2(c)	1545–1231
1.6694–2(c)(3)	1545–1231
1.6694–3(e)	1545–1231
1.6695–1	1545–0074
	1545–1385
1.6695–2	1545–1570
1.6696–1	1545–0074
	1545–0240
1.6851–1	1545–0086
	1545–0138
1.6851–2	1545–0086
	1545–0138
1.7476–1	1545–0197
1.7476–2	1545–0197
1.7519–2T	1545–1036
1.7520–1	1545–1343
1.7520–2	1545–1343
1.7520–3	1545–1343
1.7520–4	1545–1343
1.7701(l)–3	1545–1642
1.7872–15	1545–1792
1.9100–1	1545–0074
1.9101–1	1545–0008
2.1–4	1545–0123
2.1–5	1545–0123
2.1–6	1545–0123
2.1–10	1545–0123
2.1–11	1545–0123
2.1–12	1545–0123
2.1–13	1545–0123
2.1–20	1545–0123
2.1–22	1545–0123
2.1–26	1545–0123
3.2	1545–0123
4.954–1	1545–1068
4.954–2	1545–1068
5.6411–1	1545–0042
	1545–0074
	1545–0098
	1545–0129
	1545–0172
	1545–0582
	1545–0619
5c.44F–1	1545–0619
5c.128–1	1545–0123
5c.168(f)(8)–1	1545–0123
5c.168(f)(8)–2	1545–0123
5c.168(f)(8)–6	1545–0123
5c.168(f)(8)–8	1545–0123
5c.305–1	1545–0110
5c.442–1	1545–0152
5f.103–1	1545–0720
5f.103–3	1545–0720
5f.6045–1	1545–0715
6a.103A–2	1545–0123
	1545–0720
6a.103A–3	1545–0720
7.465–1	1545–0712
7.465–2	1545–0712
7.465–3	1545–0712
7.465–4	1545–0712
7.465–5	1545–0712
7.936–1	1545–0217
7.999–1	1545–0216
7.6039A–1	1545–0015
7.6041–1	1545–0115
11.410–1	1545–0710
11.412(c)–7	1545–0710
11.412(c)–11	1545–0710
12.7	1545–0190
12.8	1545–0191
12.9	1545–0195
14a.422A–1	1545–0123
15A.453–1	1545–0228
16.3–1	1545–0159
16A.126–2	1545–0074
16A.1255–1	1545–0184
16A.1255–2	1545–0184
18.1371–1	1545–0130
18.1378–1	1545–0130
18.1379–1	1545–0130
18.1379–2	1545–0130
20.2010–2	1545–0015
20.2011–1	1545–0015
20.2014–5	1545–0015
	1545–0260
20.2014–6	1545–0015
20.2016–1	1545–0015
20.2031–2	1545–0015
20.2031–3	1545–0015
20.2031–4	1545–0015
20.2031–6	1545–0015
20.2031–7	1545–0020
20.2031–10	1545–0015
20.2032–1	1545–0015
20.2032A–3	1545–0015
20.2032A–4	1545–0015
20.2032A–8	1545–0015
20.2039–4	1545–0015
20.2051–1	1545–0015
20.2053–3	1545–0015
20.2053–9	1545–0015
20.2053–10	1545–0015
20.2055–1	1545–0015
20.2055–2	1545–0015
	1545–0092
20.2055–3	1545–0015
20.2056(b)–4	1545–0015
20.2056(b)–7	1545–0015
	1545–1612
20.2056A–2	1545–1443
20.2056A–3	1545–1360
20.2056A–4	1545–1360
20.2056A–10	1545–1360
20.2106–1	1545–0015
20.2106–2	1545–0015
20.2204–1	1545–0015
20.2204–2	1545–0015
20.6001–1	1545–0015
20.6011–1	1545–0015
20.6018–1	1545–0015
	1545–0531
20.6018–2	1545–0015
20.6018–3	1545–0015
20.6018–4	1545–0015
	1545–0022
20.6036–2	1545–0015
20.6060–1(a)(1)	1545–1231
20.6061–1	1545–0015
20.6065–1	1545–0015
20.6075–1	1545–0015

CFR part or section where identified and described	Current OMB control No.
20.6081–1	1545–0015
	1545–0181
	1545–1707
20.6091–1	1545–0015
20.6107–1	1545–1231
20.6161–1	1545–0015
	1545–0181
20.6161–2	1545–0015
	1545–0181
20.6163–1	1545–0015
20.6166–1	1545–0181
20.6166A–1	1545–0015
20.6166A–3	1545–0015
20.6324A–1	1545–0754
20.7520–1	1545–1343
20.7520–2	1545–1343
20.7520–3	1545–1343
20.7520–4	1545–1343
22.0	1545–0015
25.2511–2	1545–0020
25.2512–2	1545–0020
25.2512–3	1545–0020
25.2512–5	1545–0020
25.2512–9	1545–0020
25.2513–1	1545–0020
25.2513–2	1545–0020
	1545–0021
25.2513–3	1545–0020
25.2518–2	1545–0959
25.2522(a)–1	1545–0196
25.2522(c)–3	1545–0020
	1545–0196
25.2523(a)–1	1545–0020
	1545–0196
25.2523(f)–1	1545–0015
25.2701–2	1545–1241
25.2701–4	1545–1241
25.2701–5	1545–1273
25.2702–5	1545–1485
25.2702–6	1545–1273
25.6001–1	1545–0020
	1545–0022
25.6011–1	1545–0020
25.6019–1	1545–0020
25.6019–2	1545–0020
25.6019–3	1545–0020
25.6019–4	1545–0020
25.6060–1(a)(1)	1545–1231
25.6061–1	1545–0020
25.6065–1	1545–0020
25.6075–1	1545–0020
25.6081–1	1545–0020
25.6091–1	1545–0020
25.6091–2	1545–0020
25.6107–1	1545–1231
25.6151–1	1545–0020
25.6161–1	1545–0020
25.7520–1	1545–1343
25.7520–2	1545–1343
25.7520–3	1545–1343
25.7520–4	1545–1343
26.2601–1	1545–0985
26.2632–1	1545–0985
	1545–1892
26.2642–1	1545–0985
26.2642–2	1545–0985
26.2642–3	1545–0985
26.2642–4	1545–0985
26.2642–6	1545–1902
26.2652–2	1545–0985
26.2654–1	1545–1902
26.2662–1	1545–0015
	1545–0985
26.2662–2	1545–0985
26.6060–1(a)(1)	1545–1231
26.6107–1	1545–1231
31.3102–3	1545–0029
	1545–0059
	1545–0065
31.3121(b)(19)–1	1545–0029
31.3121(d)–1	1545–0004
31.3121(i)–1	1545–0034
31.3121(k)–4	1545–0137
31.3121(r)–1	1545–0029
31.3121(s)–1	1545–0029
31.3121(v)(2)–1	1545–1643
31.3302(a)–2	1545–0028
31.3302(a)–3	1545–0028
31.3302(b)–2	1545–0028
31.3302(e)–1	1545–0028
31.3306(c)(18)–1	1545–0029
31.3401(a)–1	1545–0029
31.3401(a)(6)	1545–1484
31.3401(a)(6)–1	1545–0029
	1545–0096
	1545–0795
31.3401(a)(7)–1	1545–0029
31.3401(a)(8)(A)–1	1545–0029
	1545–0666
31.3401(a)(8)(C)–1	1545–0029
31.3401(a)(15)–1	1545–0182
31.3401(c)–1	1545–0004
31.3402(b)–1	1545–0010
31.3402(c)–1	1545–0010
31.3402(f)(1)–1	1545–0010
31.3402(f)(2)–1	1545–0010
	1545–0410
31.3402(f)(3)–1	1545–0010
31.3402(f)(4)–1	1545–0010
31.3402(f)(4)–2	1545–0010
31.3402(f)(5)–1	1545–0010
	1545–1435
31.3402(h)(1)–1	1545–0029
31.3402(h)(3)–1	1545–0010
	1545–0029
31.3402(h)(4)–1	1545–0010
31.3402(i)–(1)	1545–0010
31.3402(i)–(2)	1545–0010
31.3402(k)–1	1545–0065
31.3402(l)–(1)	1545–0010
31.3402(m)–(1)	1545–0010
31.3402(n)–(1)	1545–0010
31.3402(o)–2	1545–0415
31.3402(o)–3	1545–0008
	1545–0010
	1545–0415
	1545–0717
31.3402(p)–1	1545–0415
	1545–0717
31.3402(q)–1	1545–0238
	1545–0239
31.3404–1	1545–0029
31.3405(c)–1	1545–1341
31.3406(a)–1	1545–0112
31.3406(a)–2	1545–0112
31.3406(a)–3	1545–0112
31.3406(a)–4	1545–0112
31.3406(b)(2)–1	1545–0112
31.3406(b)(2)–2	1545–0112
31.3406(b)(2)–3	1545–0112
31.3406(b)(2)–4	1545–0112
31.3406(b)(2)–5	1545–0112
31.3406(b)(3)–1	1545–0112
31.3406(b)(3)–2	1545–0112

CFR part or section where identified and described	Current OMB control No.
31.3406(b)(3)–3	1545–0112
31.3406(b)(3)–4	1545–0112
31.3406(b)(4)–1	1545–0112
31.3406(c)–1	1545–0112
31.3406(d)–1	1545–0112
31.3406(d)–2	1545–0112
31.3406(d)–3	1545–0112
31.3406(d)–4	1545–0112
31.3406(d)–5	1545–0112
31.3406(e)–1	1545–0112
31.3406(f)–1	1545–0112
31.3406(g)–1	1545–0096
	1545–0112
	1545–1819
31.3406(g)–2	1545–0112
31.3406(g)–3	1545–0112
31.3406(h)–1	1545–0112
31.3406(h)–2	1545–0112
31.3406(h)–3	1545–0112
31.3406(i)–1	1545–0112
31.3501(a)–1T	1545–0771
31.3503–1	1545–0024
31.3504–1	1545–0029
31.6001–1	1545–0798
31.6001–2	1545–0034
	1545–0798
31.6001–3	1545–0798
31.6001–4	1545–0028
31.6001–5	1545–0798
31.6001–6	1545–0029
	1459–0798
31.6011(a)–1	1545–0029
	1545–0034
	1545–0035
	1545–0059
	1545–0074
	1545–0256
	1545–0718
	1545–2097
31.6011(a)–2	1545–0001
	1545–0002
31.6011(a)–3	1545–0028
31.6011(a)–3A	1545–0955
31.6011(a)–4	1545–0034
	1545–0035
	1545–0718
	1545–1413
	1545–2097
31.6011(a)–5	1545–0028
	1545–0718
	1545–2097
31.6011(a)–6	1545–0028
31.6011(a)–7	1545–0074
31.6011(a)–8	1545–0028
31.6011(a)–9	1545–0028
31.6011(a)–10	1545–0112
31.6011(b)–1	1545–0003
31.6011(b)–2	1545–0029
31.6051–1	1545–0008
	1545–0182
	1545–0458
	1545–1729
31.6051–2	1545–0008
31.6051–3	1545–0008
31.6053–1	1545–0029
	1545–0062
	1545–0064
	1545–0065
	1545–1603
31.6053–2	1545–0008
31.6053–3	1545–0065
	1545–0714
31.6053–4	1545–0065
	1545–1603
31.6060–1(a)(1)	1545–1231
31.6065(a)–1	1545–0029
31.6071(a)–1	1545–0001
	1545–0028
	1545–0029
31.6071(a)–1A	1545–0955
31.6081(a)–1	1545–0008
	1545–0028
31.6091–1	1545–0028
	1545–0029
31.6107–1	1545–1231
31.6157–1	1545–0955
31.6205–1	1545–0029
	1545–2097
31.6301(c)–1AT	1545–0035
	1545–0112
	1545–0257
31.6302–1	1545–1413
31.6302–2	1545–1413
31.6302–3	1545–1413
31.6302–4	1545–1413
31.6302(c)–2	1545–0001
	1545–0257
31.6302(c)–2A	1545–0955
31.6302(c)–3	1545–0257
31.6402(a)–2	1545–0256
	1545–2097
31.6413(a)–1	1545–0029
	1545–2097
31.6413(a)–2	1545–0029
	1545–0256
	1545–2097
31.6413(c)–1	1545–0029
	1545–0171
31.6414–1	1545–0029
	1545–2097
32.1	1545–0029
	1545–0415
32.2	1545–0029
35a.3406–2	1545–0112
35a.9999–5	1545–0029
36.3121(l)(1)–1	1545–0137
36.3121(l)(1)–2	1545–0137
36.3121(l)(3)–1	1545–0123
36.3121(1)(7)–1	1545–0123
36.3121(1)(10)–1	1545–0029
36.3121(1)(10)–3	1545–0029
36.3121(1)(10)–4	1545–0257
40.6060–1(a)(1)	1545–1231
40.6107–1	1545–1231
40.6302(c)–3(b)(2)(ii)	1545–1296
40.6302(c)–3(b)(2)(iii)	1545–1296
40.6302(c)–3(e)	1545–1296
40.6302(c)–3(f)(2)(ii)	1545–1296
41.4481–1	1545–0143
41.4481–2	1545–0143
41.4483–3	1545–0143
41.6001–1	1545–0143
41.6001–2	1545–0143
41.6001–3	1545–0143
41.6060–1(a)(1)	1545–1231
41.6071(a)–1	1545–0143
41.6081(a)–1	1545–0143
41.6091–1	1545–0143
41.6107–1	1545–1231
41.6109–1	1545–0143
41.6151(a)–1	1545–0143
41.6156–1	1545–0143
41.6161(a)(1)–1	1545–0143
44.4401–1	1545–0235

CFR part or section where identified and described	Current OMB control No.
44.4403–1	1545–0235
44.4412–1	1545–0236
44.4901–1	1545–0236
44.4905–1	1545–0236
44.4905–2	1545–0236
44.6001–1	1545–0235
44.6011(a)–1	1545–0235
	1545–0236
44.6060–1(a)(1)	1545–1231
44.6071–1	1545–0235
44.6091–1	1545–0235
44.6107–1	1545–1231
44.6151–1	1545–0235
44.6419–1	1545–0235
44.6419–2	1545–0235
46.4371–4	1545–0023
46.4374–1	1545–0023
46.4375–1	1545–2238
46.4376–1	1545–2238
46.4701–1	1545–0023
	1545–0257
48.4041–4	1545–0023
48.4041–5	1545–0023
48.4041–6	1545–0023
48.4041–7	1545–0023
48.4041–9	1545–0023
48.4041–10	1545–0023
48.4041–11	1545–0023
48.4041–12	1545–0023
48.4041–13	1545–0023
48.4041–18	1545–0023
48.4041–19	1545–0023
48.4041–20	1545–0023
48.4041–21	1545–1270
48.4042–2	1545–0023
48.4052–1	1545–1418
48.4061(a)–1	1545–0023
48.4061(a)–2	1545–0023
48.4061(b)–3	1545–0023
48.4064–1	1545–0014
	1545–0242
48.4071–1	1545–0023
48.4073–1	1545–0023
48.4073–3	1545–0023
	1545–1074
	1545–1087
48.4081–2	1545–1270
	1545–1418
48.4081–3	1545–1270
	1545–1418
	1545–1897
48.4081–4(b)(2)(ii)	1545–1270
48.4081–4(b)(3)(i)	1545–1270
48.4081–4(c)	1545–1270
48.4081–6(c)(1)(ii)	1545–1270
48.4081–7	1545–1270
	1545–1418
48.4082–1T	1545–1418
48.4082–2	1545–1418
48.4082–6	1545–1418
48.4082–7	1545–1418
48.4091–3	1545–1418
48.4101–1	1545–1418
48.4101–1T	1545–1418
48.4101–2	1545–1418
48.4161(a)–1	1545–0723
48.4161(a)–2	1545–0723
48.4161(a)–3	1545–0723
48.4161(b)–1	1545–0723
48.4216(a)–2	1545–0023
48.4216(a)–3	1545–0023
48.4216(c)–1	1545–0023
48.4221–1	1545–0023
48.4221–2	1545–0023
48.4221–3	1545–0023
48.4221–4	1545–0023
48.4221–5	1545–0023
48.4221–6	1545–0023
48.4221–7	1545–0023
48.4222(a)–1	1545–0014
	1545–0023
48.4223–1	1545–0023
	1545–0257
	1545–0723
48.6302(c)–1	1545–0023
	1545–0257
48.6412–1	1545–0723
48.6416(a)–1	1545–0023
	1545–0723
48.6416(a)–2	1545–0723
48.6416(a)–3	1545–0723
48.6416(b)(1)–1	1545–0723
48.6416(b)(1)–2	1545–0723
48.6416(b)(1)–3	1545–0723
48.6416(b)(1)–4	1545–0723
48.6416(b)(2)–1	1545–0723
48.6416(b)(2)–2	1545–0723
48.6416(b)(2)–3	1545–0723
	1545–1087
48.6416(b)(2)–4	1545–0723
48.6416(b)(3)–1	1545–0723
48.6416(b)(3)–2	1545–0723
48.6416(b)(3)–3	1545–0723
48.6416(b)(4)–1	1545–0723
48.6416(b)(5)–1	1545–0723
48.6416(c)–1	1545–0723
48.6416(e)–1	1545–0023
	1545–0723
48.6416(f)–1	1545–0023
	1545–0723
48.6416(g)–1	1545–0723
48.6416(h)–1	1545–0723
48.6420(c)–2	1545–0023
48.6420(f)–1	1545–0023
48.6420–1	1545–0162
	1545–0723
48.6420–2	1545–0162
	1545–0723
48.6420–3	1545–0162
	1545–0723
48.6420–4	1545–0162
	1545–0723
48.6420–5	1545–0162
	1545–0723
48.6420–6	1545–0162
	1545–0723
48.6421–0	1545–0162
	1545–0723
48.6421–1	1545–0162
	1545–0723
48.6421–2	1545–0162
	1545–0723
48.6421–3	1545–0162
	1545–0723
48.6421–4	1545–0162
	1545–0723
48.6421–5	1545–0162
	1545–0723
48.6421–6	1545–0162
	1545–0723
48.6421–7	1545–0162
	1545–0723
48.6424–0	1545–0723
48.6424–1	1545–0723

CFR part or section where identified and described	Current OMB control No.
48.6424–2	1545–0723
48.6424–3	1545–0723
48.6424–4	1545–0723
48.6424–5	1545–0723
48.6424–6	1545–0723
48.6427–0	1545–0723
48.6427–1	1545–0023
	1545–0162
	1545–0723
48.6427–2	1545–0162
	1545–0723
48.6427–3	1545–0723
48.6427–4	1545–0723
48.6427–5	1545–0723
48.6427–8	1545–1418
48.6427–9	1545–1418
48.6427–10	1545–1418
48.6427–11	1545–1418
49.4251–1	1545–1075
49.4251–2	1545–1075
49.4251–4(d)(2)	1545–1628
49.4253–3	1545–0023
49.4253–4	1545–0023
49.4264(b)–1	1545–0023
	1545–0224
	1545–0225
	1545–0226
	1545–0230
	1545–0257
	1545–0912
49.4271–1(d)	1545–0685
49.5000B–1	1545–2177
51.2(f)(2)(ii)	1545–2209
51.7	1545–2209
52.4682–1(b)(2)(iii)	1545–1153
52.4682–2(b)	1545–1153
	1545–1361
52.4682–2(d)	1545–1153
	1545–1361
52.4682–3(c)(2)	1545–1153
52.4682–3(g)	1545–1153
52.4682–4(f)	1545–0257
	1545–1153
52.4682–5(d)	1545–1361
52.4682–5(f)	1545–1361
53.4940–1	1545–0052
	1545–0196
53.4942(a)–1	1545–0052
53.4942(a)–2	1545–0052
53.4942(a)–3	1545–0052
53.4942(b)–3	1545–0052
53.4945–1	1545–0052
53.4945–4	1545–0052
53.4945–5	1545–0052
53.4945–6	1545–0052
53.4947–1	1545–0196
53.4947–2	1545–0196
53.4948–1	1545–0052
53.4958–6	1545–1623
53.4961–2	1545–0024
53.4963–1	1545–0024
53.6001–1	1545–0052
53.6011–1	1545–0049
	1545–0052
	1545–0092
	1545–0196
53.6060–1(a)(1)	1545–1231
53.6065–1	1545–0052
53.6071–1	1545–0049
53.6081–1	1545–0066
	1545–0148
53.6107–1	1545–1231

CFR part or section where identified and described	Current OMB control No.
53.6161–1	1545–0575
54.4972–1	1545–0197
54.4975–7	1545–0575
54.4977–1T	1545–0771
54.4980B–6	1545–1581
54.4980B–7	1545–1581
54.4980B–8	1545–1581
54.4980F–1	1545–1780
54.4981A–1T	1545–0203
54.6011–1	1545–0575
54.6011–1T	1545–0575
54.6060–1(a)(1)	1545–1231
54.6107–1	1545–1231
54.9801–3	1545–1537
54.9801–4	1545–1537
54.9801–5	1545–1537
54.9801–6	1545–1537
54.9812–1T	1545–2165
54.9815–1251T	1545–2178
54.9815–2711T	1545–2179
54.9815–2712T	1545–2180
54.9815–2714T	1545–2172
54.9815–2715	1545–2229
54.9815–2719AT	1545–2181
54.9815–2719T	1545–2182
55.6001–1	1545–0123
55.6011–1	1545–0123
	1545–0999
	1545–1016
55.6060–1(a)(1)	1545–1231
55.6061–1	1545–0999
55.6071–1	1545–0999
55.6107–1	1545–1231
56.4911–6	1545–0052
56.4911–7	1545–0052
56.4911–9	1545–0052
56.4911–10	1545–0052
56.6001–1	1545–1049
56.6011–1	1545–1049
56.6060–1(a)(1)	1545–1231
56.6081–1	1545–1049
56.6107–1	1545–1231
56.6161–1	1545–0257
	1545–1049
57.2(e)(2)(i)	1545–2249
145.4051–1	1545–0745
145.4052–1	1545–0120
	1545–0745
	1545–1076
145.4061–1	1545–0224
	1545–0230
	1545–0257
	1545–0745
156.6001–1	1545–1049
156.6011–1	1545–1049
156.6060–1(a)(1)	1545–1231
156.6081–1	1545–1049
156.6107–1	1545–1231
156.6161–1	1545–1049
157.6001–1	1545–1824
157.6011–1	1545–1824
157.6060–1(a)(1)	1545–1231
157.6081–1	1545–1824
157.6107–1	1545–1231
157.6161–1	1545–1824
301.6011–2	1545–0225
	1545–0350
	1545–0387
	1545–0441
	1545–0957
301.6011(g)–1	1545–2079
301.6017–1	1545–0090

CFR part or section where identified and described	Current OMB control No.
301.6034–1	1545–0092
301.6035–1	1545–0123
301.6036–1	1545–0013
	1545–0773
301.6047–1	1545–0367
	1545–0957
301.6056–1	1545–2251
301.6056–2	1545–2251
301.6057–1	1545–0710
301.6057–2	1545–0710
301.6058–1	1545–0710
301.6059–1	1545–0710
301.6103(c)–1	1545–1816
301.6103(n)–1	1545–1841
301.6103(p)(2)(B)–1	1545–1757
301.6104(a)–1	1545–0495
301.6104(a)–5	1545–0056
301.6104(a)–6	1545–0056
301.6104(b)–1	1545–0094
	1545–0742
301.6104(d)–1	1545–1655
301.6104(d)–2	1545–1655
301.6104(d)–3	1545–1655
301.6109–1	1545–0003
	1545–0295
	1545–0367
	1545–0387
	1545–0957
	1545–1461
	1545–2242
301.6109–3	1545–1564
301.6110–3	1545–0074
301.6110–5	1545–0074
301.6111–1T	1545–0865
	1545–0881
301.6111–2	1545–0865
	1545–1687
301.6112–1	1545–0865
	1545–1686
301.6112–1T	1545–0865
	1545–1686
301.6114–1	1545–1126
	1545–1484
301.6222(a)–2	1545–0790
301.6222(b)–1	1545–0790
301.6222(b)–2	1545–0790
301.6222(b)–3	1545–0790
301.6223(b)–1	1545–0790
301.6223(c)–1	1545–0790
301.6223(e)–2	1545–0790
301.6223(g)–1	1545–0790
301.6223(h)–1	1545–0790
301.6224(b)–1	1545–0790
301.6224(c)–1	1545–0790
301.6224(c)–3	1545–0790
301.6227(c)–1	1545–0790
301.6227(d)–1	1545–0790
301.6229(b)–2	1545–0790
301.6230(b)–1	1545–0790
301.6230(e)–1	1545–0790
301.6231(a)(1)–1	1545–0790
301.6231(a)(7)–1	1545–0790
301.6231(c)–1	1545–0790
301.6231(c)–2	1545–0790
301.6241–1T	1545–0130
301.6316–4	1545–0074
301.6316–5	1545–0074
301.6316–6	1545–0074
301.6316–7	1545–0029
301.6324A–1	1545–0015
301.6361–1	1545–0024
	1545–0074
301.6361–2	1545–0024
301.6361–3	1545–0074
301.6402–2	1545–0024
	1545–0073
	1545–0091
301.6402–3	1545–0055
	1545–0073
	1545–0091
	1545–0132
	1545–1484
301.6402–5	1545–0928
301.6404–1	1545–0024
301.6404–2T	1545–0024
301.6404–3	1545–0024
301.6405–1	1545–0024
301.6501(c)–1	1545–1241
	1545–1637
301.6501(d)–1	1545–0074
	1545–0430
301.6501(o)–2	1545–0728
301.6511(d)–1	1545–0024
	1545–0582
301.6511(d)–2	1545–0024
	1545–0582
301.6511(d)–3	1545–0024
	1545–0582
301.6652–2	1545–0092
301.6685–1	1545–0092
301.6689–1T	1545–1056
301.6707–1T	1545–0865
	1545–0881
301.6708–1T	1545–0865
301.6712–1	1545–1126
301.6723–1A(d)	1545–0909
301.6903–1	1545–0013
	1545–1783
301.6905–1	1545–0074
301.7001–1	1545–0123
301.7101–1	1545–1029
301.7207–1	1545–0092
301.7216–2	1545–0074
301.7216–2(o)	1545–1209
301.7425–3	1545–0854
301.7430–2(c)	1545–1356
301.7502–1	1545–1899
301.7507–8	1545–0123
301.7507–9	1545–0123
301.7513–1	1545–0429
301.7517–1	1545–0015
301.7605–1	1545–0795
301.7623–1	1545–0409
	1545–1534
301.7654–1	1545–0803
301.7701–3	1545–1486
301.7701–4	1545–1465
301.7701–7	1545–1600
301.7701–16	1545–0795
301.7701(b)–1	1545–0089
301.7701(b)–2	1545–0089
301.7701(b)–3	1545–0089
301.7701(b)–4	1545–0089
301.7701(b)–5	1545–0089
301.7701(b)–6	1545–0089
301.7701(b)–7	1545–0089
	1545–1126
301.7701(b)–9	1545–0089
301.7805–1	1545–0805
301.9000–5	1545–1850
301.9001–1	1545–0220
301.9100–2	1545–1488
301.9100–3	1545–1488
301.9100–4T	1545–0016

CFR part or section where identified and described	Current OMB control No.
	1545–0042
	1545–0074
	1545–0129
	1545–0172
	1545–0619
301.9100–6T	1545–0872
301.9100–7T	1545–0982
301.9100–8	1545–1112
301.9100–11T	1545–0123
301.9100–12T	1545–0026
	1545–0074
	1545–0172
	1545–1027
301.9100–14T	1545–0046
301.9100–15T	1545–0046
301.9100–16T	1545–0152
302.1–7	1545–0024
305.7701–1	1545–0823
305.7871–1	1545–0823
404.6048–1	1545–0160
420.0–1	1545–0710
Part 509	1545–0846
Part 513	1545–0834
Part 514	1545–0845
Part 521	1545–0848
601.104	1545–0233
601.105	1545–0091
601.201	1545–0019
	1545–0819
601.204	1545–0152
601.401	1545–0257
601.504	1545–0150
601.601	1545–0800
601.602	1545–0295
	1545–0387
	1545–0957
601.702	1545–0429

(26 U.S.C. 7805)

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For changes to this volume of the CFR prior to this listing, consult the annual edition of the monthly List of CFR Sections Affected (LSA). The LSA is available at *www.fdsys.gov* For changes to this volume of the CFR prior to 2001, see the ''List of CFR Sections Affected, 1949–1963, 1964–1972, 1973–1985, and 1986–2000'' published in 11 separate volumes. The ''List of CFR Sections Affected 1986–2000'' is available at *www.fdsys.gov*.

2011

26 CFR

76 FR Page

Chapter I

1.446–1 (e)(3)(i) and (4)(i) amended; (e)(4)(iii) added 45688
1.468A–6 (e)(3) *Example 2* correctly amended 3837
1.475(a)–4 (d)(4) *Examples 1*, *2* and *3* revised 39281
1.475(a)–4T Added 39281
1.482–0 Amended 80087
1.482–0T Removed 80089
1.482–1 (b)(2)(i) revised; (b)(2)(iii) added; (c)(1) and (j)(6)(i) amended...................................80089
1.482–1T Removed 80090
1.482–2 (e) and (f) revised................80090
1.482–2T Removed 80090
1.482–4 (f)(3)(i)(B), (g) and (h) revised; (f)(7) removed..................80090
1.482–4T Removed 80090
1.482–5 (c)(2)(iv) amended 80090
1.482–7 Added 80090
(g)(2)(v)(B)(*2*) and (4)(vi)(F)(*2*) revised; (g)(4)(viii) *Example 8* added 80250
1.482–7T Removed 80134
Added 80250
1.482–8 (b) *Examples 13* through *18* and (c)(1) revised 80134
1.482–8T Removed 80136
1.482–9 (m)(3) revised.....................80136
1.482–9T Removed 80136

2012

26 CFR

77 FR Page

Chapter I

1.482–1 (b)(2)(i) correctly amended..3606
1.482–7 (c)(3), (g)(2)(v)(C) *Examples* (i) and (ii) correctly amended; (k)(2)(ii)(*3*) correctly revised 3606
(g)(4)(viii) *Examples 2* and *3* corrected...8144
(g)(2)(v)(C) *Example* (i) and (4)(viii) corrected; (g)(3) and (k)(2)(ii)(3) corrected to (g)(4) and (k)(2)(ii)(A)(*3*) 8144

2013

26 CFR

78 FR Page

Chapter I

1.469-0 Amended 72421
1.469-11 (b)(3)(iv) Added.................72421
1.475(a)-4 (d)(4) *Example 1*, *Example 2* and *Example 3* revised 54760
1.475(a)-4T Removed 54760
1.482-1 (c)(1) correctly amended; CFR correction.........................18234
1.482-7 (g)(2)(v)(B)(*2*), (4)(vi)(F)(*2*), (viii) *Example 8* and (l) revised; (g)(4)(v) and (g)(4)(viii) *Example 9* added.....................................52855
(g)(4)(vi)(F)(*2*) correctly amended...62426
1.482-7T Removed 52856

2014

26 CFR

79 FR Page

Chapter I

1.469-11 (b)(3)(iv)(C)(*1*) and (*3*) *Example 4* correctly revised 18159
1.471-3 (e) and (g) added; undesignated text designated as (f) 2098
1.471-8 Revised 48036

2015

26 CFR

80 FR Page

Chapter I

1.446-3 (j) redesignated as (j)(1); (g)(4), (6) *Examples 2, 3, 4* and new (j)(1) heading revised; (j)(2) and (k) added 26440

26 CFR—Continued

80 FR Page

Chapter I—Continued

(k) correctly removed 34051
1.446-3T Added 26440
(j)(2) correctly revised 61308
1.482-0 Amended 55540
1.482-1 (f)(2)(i) and (ii)(B) revised; (j)(7) added 55541
1.482-1T Added 55541

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(No regulations published from January 1, 2016, through April 1, 2016)